Cabo Verde’s Integrated Financing Framework

Analytical Priorities for the Development Finance Assessment

White Paper

Strategy and Policy Unit

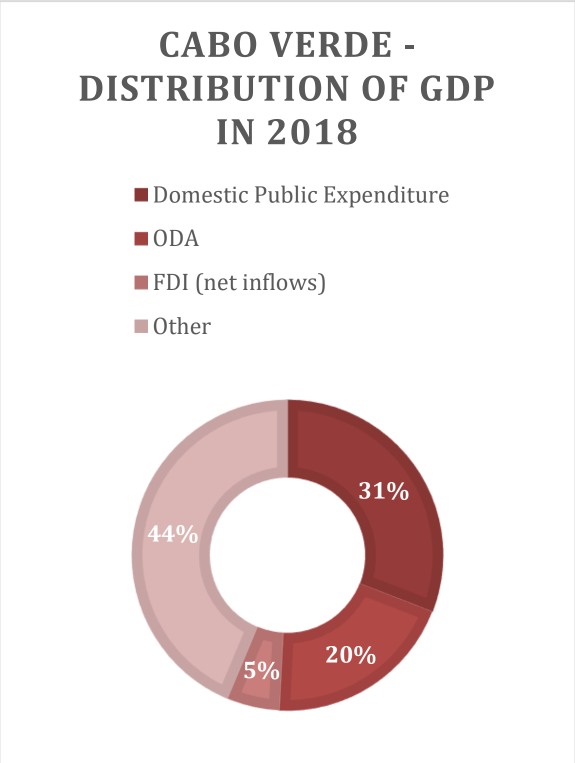
UNDP Cabo Verde

In the aftermath of the Addis Financing for Development Conference in 2015, the World Bank and IMF estimated that achieving the SDGs would require some US$ 135 billion in ODA at the outset. Though necessary, ODA would not prove sufficient to achieve the global goals. International development cooperation funds would have to be complemented by philanthropy, remittances, South-South flows, the private sector and foreign direct investment. Indeed, while the most substantial development spending was concentrated at the national level in the form of public resources, the largest potential resides with private sector business, finance and investment. Precisely for this reason, the outcome of the Addis conference outlined action agendas in the areas of:

1) Domestic Public Resources
2) Domestic and International Private Business and Finance
3) International Development Cooperation
4) International Trade as an Engine for Development
5) Debt and Debt Sustainability
6) Systemic Issues, including institutions, regulatory gaps and incentive structures
7) Science, Technology and Innovation

Collectively, these various forms of financing would have to be augmented more than US$ 1 trillion. This was referred to as the *trajectory from billions to trillions*.[1]

With 2020 marking a third of the way to 2030, the world has arrived at a critical juncture in the post-2015 agenda. What started out as a promising decade of action has been jeopardized by the global COVID-19 pandemic. COVID-19 has exposed the fragility of a small-island developing state that derives about a third of its GDP from tourism and complementary sectors like transport and services, including the informal sector. The global pandemic and the pursuant socioeconomic crisis have evidently rendered prior financing assumptions and calculations obsolete. It has also served as a stark reminder of the country's dependence on its links to the outer world.



Cabo Verde must now find its place in a global economy underpinned by an increasingly multipolar geopolitical system fraught by economic uncertainty. With the economies of the US and EU shrinking by double digit figures in the last quarter, we can expect significant reductions not only in terms of global ODA (since it is often directly linked to GNI) but also in terms of FDI and domestic production and revenues. The INFF exercise must account for the vast changes in terms of global, regional and domestic financing flows imposed by COVID-19.

Already prior to the impact of COVID-19, Cabo Verde faced a dire financial situation marked by unsustainable debt levels and excessive reliance on public expenditure. In 2017-18, the share of GDP (estimated at 1 967 million USD) comprised by ODA was 19.92% or 392.7 million USD (OECD) and state expenditures in 2018

[1] http://pubdocs.worldbank.org/en/69291436554303071/dfi-idea-action-booklet.pdf

accounted for a further 30.9 % of GDP, whereas FDI (net inflows) only accounted for 5.49 % of GDP in 2018. As such, public resources account for over half of the economy[2] (see Figure 1) and COVID-19 will further exacerbate this situation. Key strategic investments will be necessary to enhance Cabo Verde's resilience to exogenous shocks and allow it to build forward.

The INFF therefore is an instrument aimed at fulfilling Cabo Verde's Ambition 2030 – as the encapsulation of country's commitment to the SDGs – by adapting the principles and norms collectively determined in Addis within the Cabo Verde context. As such, it is a tool that will be owned and led by the government in a collective and concerted effort together with its partners to unlock financing. In order to accomplish this, it will have to be closely integrated and oriented towards the goals and missions of PEDS II and III as the operational manifestation of Ambition 2030. To this end, the INFF seeks to:

1) Harmonization and alignment with Ambition 2030

The INFF process is an inclusive mechanism that brings aboard all actors – whether public or private, domestic or foreign – that can make a substantive contribution to development financing in Cabo Verde, especially with a view towards PEDS II & III. It particularly seeks to integrate development financing along three policy axes; namely,

1. Between planning and financing
2. Between public and private finance
3. And across government & its international partners

Under the government's leadership, with support from the UN and other international partners, including the World Bank and the European Union, the INFF will seek to mobilize and strengthen a wide range of public and private financing for development, including

- Public resources and debt management
- State-owned Enterprises
- Public-private partnerships
- Development cooperation
- Philanthropy and NGOs
- Diaspora engagement
- Investment promotion
- Micro, small, and medium-sized enterprises
- Impact investment and social enterprises
- Financial inclusion
- Finance sector development

The INFF process will seek to be inclusive by bringing on board all actors, whether public or private, that can make a substantive contribution to development financing in Cabo Verde

This process begins with the Development Finance Assessment and the pursuant Finance Strategy. The INFF DFA will therefore scope opportunities for diversification through its investment streams, especially within the areas highlighted within Ambition 2030 and SDG Accelerators identified via last year's UN MAPS mission. The deep dives foreseen within the initial assessment will focus on how to most effectively allocate scarce resources in the areas of:

[2] Estimate derived from compilation of OECD (for ODA), World Bank (FDI), and IMF (public expenditure) sources.

- Tourism and Culture,
- Blue Economy,
- Innovation and Digitalization,
- Green and Circular Economy, and
- Human Capital as a crosscutting asset.

2. Division of labor and economic diversification: Promoting innovation and entrepreneurship

Finance is not a zero-sum game. Rather, it is about growing the size of the pie and allocating the slices towards productive purposes, thus generating greater value to meet people's demands. It is about creating new value through cooperation, trade, and exchange of goods, services, and ideas. This can only be achieved by creating the right institutional framework with appropriate incentive structures for all actors involved.

This will require a vibrant economic framework that is open, dynamic and innovative. It is essential that ordinary people can participate in this system through enabling and inclusive structures promoting initiative and offering corresponding rewards. It is important to recall that innovation and creative destruction are inherently decentralized processes. Good ideas can come from anywhere and they usually arise from real-world, practical problems that people face within their daily and local situations.

One of the predominant challenges here in Cabo Verde is that resource scarcity and finite internal production capacities limit financing opportunities for prospective entrepreneurs with new and creative ideas. This occurs in two important ways:

First, low levels of real savings derived from production and surplus value prevent entrepreneurs from accessing the types of financial resources necessary to launch their businesses and turn their ideas into monetary value. These problems are compounded in turn by three persistent gaps in capital markets that neither the domestic financial system nor external private investors are prepared to fill, namely:

1. Early-stage finance for firms and infrastructure
2. High-risk projects
3. Local currency products and services

By looking at how these financing challenges overlap within particular sectors, and how blended finance or other strategies might help to address them, could help in devising a coherent investment roadmap and identify key sectoral entry points.

Second, Cabo Verde's market size limits absorption capacity for innovative designs and ideas. This poses a challenge for producing and supplying innovative goods and services at scale, not necessarily because people do not want these goods or services but because consumer demand is stifled by low purchasing power and corresponding choice constraints that force trade-offs. Those struggling to meet basic needs, moreover, have no choice at all.

In other words, real savings derived from surplus revenues are necessary to enhance capital investment, which in a domestic economy with a perennially limited resource base and low factors of production stifles the types of entrepreneurship, innovation and technological changes that could help Cabo Verde overcome (some) of these traditional constraints.

The integrated financing framework seeks to alleviate this catch-22. As the Addis Conference outcome document stated in 2015, "We recognize the important contribution that direct investment, including foreign direct investment, can make to sustainable development….

Government policies can strengthen positive spillovers from foreign direct investment, such as know-how and technology, including through establishing linkages with domestic suppliers, as well as encouraging the integration of local enterprises, in particular micro, small and medium-sized enterprises…, into regional and global value chains."

3) Institutions: Establishing the rules of the game

Despite this consensus regarding the importance of direct investment – whether domestic or foreign – for sustainable development, in 2018 just over half of Cabo Verde's GDP resulted from public resources of domestic or foreign origin. FDI comprised just over 5% of market share.

Among other priorities, therefore, the Cabo Verde INFF will focus on increasing the proportion of private enterprise and investment in the Cabo Verdean economic system. In contrast to public investment, this will be a more challenging task because private finance cannot be driven or channeled – it can only be attracted. The challenge, therefore, will be creating an incentive environment conducive to the movement of people, goods, finance, and ideas within and across Cabo Verde's borders.

Setting up an integrated financing framework with appropriate incentive structures in many ways resembles the creation of a sports competition. Herein, *rules* are the fundamental basis for constructing a game that produces clear results and that can be repeated over time. These rules need to be clearly delineated for all involved and applied homogenously to ensure that actors compete on a level playing field.

The rules of the game are important because they determine the costs involved in a transaction, which allows players to determine whether a particular action is worthwhile or not. Indeed, it is the rules of the game, for the most part, that determine the incentive environment and the costs that the players incur, whether transaction, opportunity or marginal costs. High transaction costs, including administrative burdens, complex contracting procedures, dealing with multiple actors simultaneously, uncertainty of outcomes, etc. all increase the likelihood that businesses will look for other options. Special economic zones, for instance, offer a special set of rules that exempt some players from certain costs – the effects of such policies should be understood in order to ensure that they achieve the desired impact.

In other words, it is not just the transformation or production costs or prices determined by the laws of supply and demand that matter. Transaction and opportunity costs are essential determinants of decision-making among financial actors. In a world with many different options for regional and global players, transaction, opportunity and marginal costs can therefore be the difference-maker. Understanding these various sources of costs involves 'seeing the unseen', or imagining the opportunities foregone by allocating finance or resources in one area as opposed to another.

Players will also adapt to these rules over time. Whether in finance or sports, tactics will be adapted to even minor rule changes in order to achieve a competitive advantage. For this reason, we need to be cognizant of the varied effects or externalities that rules generate, including transaction costs, opportunity costs, and the law of marginal returns. This necessitates incremental changes to the rules, particularly when rules have become obsolete or are being circumvented. Though we are still learning about the effects and impacts of COVID-19, we can reasonably assume that it has already fundamentally transformed the rules of the game. We must also recognize the role of cultural norms and informal or tacit rules that make transactions possible by building trust and confidence.

As part of CV's IFF, therefore, we will take a thorough look at the rules of the game in order to make sure that we have the right incentive environments in place so that players make the most of their choices within the context of the opportunities and constraints they face. For this reason, the development finance assessment will analyze the institutional framework and conduct a mapping of the relevant players relative to this framework in order to ensure that we have the right incentive environment in place to meet our common objectives.

4) The referee: Enforcing a level playing field

In order for the game to function properly, however, it is not enough to have good rules on paper. These also need to be respected, observed and enforced in practice. This is the role of the referee.

When it comes to development finance, the state needs to be the referee in the form of a responsive and effective legal system and judiciary. This involves:

- Enforcement of property rights, including intellectual rights
- Reducing the complexity and administrative burden of contracting without reducing the effectiveness of agreements
- Ensuring dispute resolution mechanisms are in place that do not involve lengthy and drawn-out legal processes
- Ensure confidence in the marketplace by signaling that fraud will be detected, rule violators punished, and victims compensated for their losses
- Cooperation with third states on enforcement, including via regional and global arbitration mechanisms embedded within trade agreements and common markets

The role of the referee must also include enforcement the principles of sustainability in accordance with economic, social and environmental criteria, as manifested by the Sustainable Development Goals.

5) Constructing an open and flexible arena

The best players tend to play in the largest arenas against the best competition. This is the world stage where the greatest value is created and where the course of history is changed. Fortunately for a small-island state like Cabo Verde, in an increasingly global and digital world, playing on the world stage is no longer necessarily defined by geography, place or location. What matters most is creating *strong links and connections to the world.* The arena should be open to new players and sufficiently flexible to allow for new forms of partnerships and collaborations that reflect Cabo Verde's ambitions.

As part of the INFF process, the UN system will seek to support the government in reaching out to public and private partners that can help catalyze developmental processes, including through investment platforms and forums like those in Sal and Boston in 2019 as well as through targeted, sector-specific missions. This must be carried out in close cooperation with Cabo Verde's network of diplomatic missions and its new paradigm for diplomacy.

Furthermore, strategically positioning Cabo Verde as a pivot point between regions will be essential for establishing and maintaining competitiveness. Consistent with the Addis outcome, "We underline that regional markets are an effective way to achieve scale and depth not attainable when individual markets are small." The integrated financing framework will therefore seek to take full advantage of Cabo Verde's strategic position in relation to various regions and markets, especially ECOWAS but also Mercosul via the CPLP, the EU common market via GSP+, the United States via AGOA, as well as SIDS.

To achieve this, Cabo Verde must take full advantage of the Ocean. For small island developing states, the equation is quite simple: No shipping, no shopping. Over the course of history, coastal locations have offered states a crucial comparative advantage in terms of transportation and trade. While Cabo Verde enjoys unrestricted access to this natural comparative advantage, turning this into a competitive advantage, particularly in the West African context, will require significant investment. Expanding ports and the shipping industry is a capital-intensive process. It is precisely here where impact investment and other forms of sustainable financing oriented towards the blue economy can provide the financial resources necessary to make strategic investments and infrastructure upgrades that enhance Cabo Verde's gateways to the world.

Conclusion

In other words, the integrated financing framework seeks to create a diverse and polycentric arena for development finance where multiple actors interact across sectors and at various levels, including regional and global dimensions. When the rules of the game and the referee together create a level playing field, this boosts market confidence and reduces risk perceptions, which in turn attracts international investors to what becomes an open, dynamic and innovative finance arena. As such, an efficient institutional framework for finance, marked by stable rules combined with commensurate and proportional enforcement mechanisms for contracting and other market transactions, becomes a bankable asset in and of itself.

When implementing Ambition 2030 via the INFF, therefore, it is necessary to avoid thinking in terms of costs and expenses as one-off rounds. Rather, we should reorient our thinking in terms of catalytic investments, as part of a continuous process, supported through a variety of public and private instruments, including blended finance, capital guarantees, and impact investments. Such investments can generate new value and opportunities for innovation in a recursive and self-reinforcing fashion as productivity gains and real savings continuously catalyze complementary opportunities as the sustainable development process unfolds.

Within this system, removing market access barriers and making relevant information open, accessible, and transparent will help ensure that the market is an open and participatory arena for all who seek to 'truck, barter, and exchange' within it. Such an approach will ensure both greater autonomy and resilience, which are not only mutually reinforcing but will also help ensure that no one is left behind.

Indeed, it is important to recall that money is a means of exchange, not an end in itself. In a world where currency is not backed by a physical commodity and where value is inherently subjective, we need to ensure that capital is oriented towards a framework that reflects economic, social, and environmental purposes. This is what the INFF and Ambition 2030 – together – seek to achieve.