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GUINEA-BISSAU

SELECTED ISSUES

November 21, 2017

Approved By
African Department

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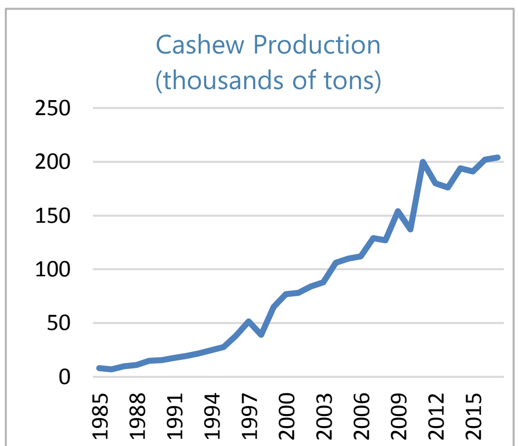
THE CASHEW ECONOMY AND THE UNFOLDING OF THE 2017 CAMPAIGN[1]

1. Cashew production is a mainstay of Guinea Bissau's economy and its dominant source of export revenue. At least half of all households are thought to be engaged in production, commercialization, or exportation of cashew nuts.[2] The activity has at least four macroeconomic impacts: one, it injects liquidity to producers; two, owing to producers' high propensity to consume, it impacts the price level; third, it is the main provider of foreign exchange via exports; and fourth, it is an important source of fiscal revenues. The bulk of the nuts are exported in raw form, mainly to India where they are processed before final sale on the global market. Cashew farming has lately accounted for about 10 percent of GDP and cashew sales for close to 90 percent of total exports. In addition, cashew-specific taxes and fees generate directly about 10 percent of government revenue, not counting cashew-related proceeds from taxes on corporate income and other general taxes in amounts that are not readily quantifiable but are likely to be substantial.

2. Despite streamlining of marketing arrangements over the years, cashew production is still subject to significant government intervention. Vested interests have traditionally permeated public policies, with non-transparent issuance of licenses and permits used in some instances to block competition. The sector also remains subject to considerable taxation. Cashew-specific taxes and fees include: export tax of 6 percent; industrial contribution of 3 percent; rural contribution of CFAF 15 per kg; sales taxes of 5 percent on services associated with the activity; contribution to the Cashew National Agency of CFAF 5 per kg; export license from the Ministry of Commerce; phytosanitary license; using of port charges; and seal taxes on the licenses.

A. The Consolidation of the Cashew Economy

3. Cashew production started to expand during the 1980s and yearly output has over the years increased to currently about 200,000 tons. Native of north Brazil, cashew trees were introduced by the Portuguese during the colonial period but output remained negligible through to the country's independence in 1973. In the early post-independence years, agricultural policies focused on reaching self-sufficiency in food production. The economy was centrally planned and government supported food production with managed extension services, construction of storage facilities, and introduction of



Source: Ministry of Finance.

[1] This chapter was prepared by Oscar Melhado.

[2] See for instance 2010 Household Survey (ILAP II).

new seed varieties. The expansion of cashew production that started in the 1980s was facilitated by changes in marketing arrangements, which allowed increases in producer prices and broadened the role of the private sector in intermediation and exports.

4. **During the mid-1980s, the government repealed many economic control measures, broadening the space for the private sector.** It liberalized producer's prices, adjusted the exchange rate, and transformed the national logistics and storage enterprises. These steps were aimed at addressing the slow pace of economic growth and rising smuggling and parallel activities. In response, producer prices of cashew, palm kernel, rice and groundnuts increased by about 65 percent, and agricultural exports doubled in less than a year.

5. **From the outset, cashew plantations were spread among small landowners.**[3] The rapid expansion of cashew trees was facilitated by conducive natural conditions, including adequate rainfall and rich soils. Moreover, the cashew tree does not need major investment, maintenance, and technology, and was thus a good match for the country's landowners, who have traditionally been low skilled, capital scarce, and risk averse. Given increasing prices and the relatively non-demanding cashew agriculture, landowners have expanded areas cultivated with cashew. Output growth has been relatively stable and, even in years of unfavorable weather conditions, drops in production have not been dramatic.

B. The Structure of the Cashew Economy

6. **Cashew production is organized in three distinct layers.** The base consists of the large number of mostly small family farmers that grow and harvest the cashew nuts. Most of these farmers own and inherit land through ethnic traditions, where the leader of the community has customary authority to assign land.[4] The next layer comprises a range of intermediaries, who buy from producers and sell to exporters. Only in a few cases do the intermediaries also export, and only a small part of the product is processed domestically. The final layer consists of a small number of exporters, with three enterprises from India dominating more than 80 percent of the market.

7. **Intermediaries include different groups operating along nationality lines.** Guinea-Bissau nationals are the most diversified group and range from small freelance intermediaries to larger traders with ties to exporters. In recent years, intermediaries from Mauritania have become prevalent. It is estimated that about 4,000 Mauritanians have settled in Guinea-Bissau for business purposes and another 3,000 to 4,000 come and go during the cashew season. The Mauritanians operate with CFA francs brought in cash from abroad, with only the largest intermediaries or exporters using the banking system for transactions. Mauritanians have a strong field knowledge and go to remote places to trade with producers. Other traders operating along nationality lines are the Senegalese, Conakry-Guineans, Lebanese and, more recently, the Chinese. Competition among intermediaries is intense.

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[3] The average dimension of plantations by owner is between 1½ and 2 hectares.

[4] Per the "Land law", the land belongs to the country and only can be given in concession to privates for 50 years.

8. Cashew production and marketing follows a yearly cycle. Plantations are cleaned and prepared during October to January; tree blooming takes place from January to late April, depending on the region; traders start approaching producers in January offering them credits in cash or barter for future production; the campaign starts in March with the announcement of the official farmgate reference price, which is the minimum price that producers should receive;[5] the harvest period goes from January to July; and exporting starts in May and can continue up to September. During harvest, farmers wait for the cashew apple to fall from the tree and the cashew nut is then separated by hand.[6]

9. Selling arrangements vary. Traders may buy directly at the plantation or producers may organize at the communal level to sell. Producers with storage capacity may decide to hold on to the product with a view to getting higher prices later. In general, however, producers are not well organized and a lack of storage capacity limits their negotiating position. The transaction between producers and traders needs to respect the minimum reference price announced by the government and must be done after the cashew campaign has been officially inaugurated. It has, however, been common for traders to offer pre-campaign credit to producers in cash or barter.[7] Lately, owing to high farmgate prices, the market is becoming more liquid and barter has become less common.

10. Many transactions are informal and the role of the banking system is limited. Producers do not need much cash to prepare the cashew trees. Moreover, the harvest will typically be done by the extended family, with several non-cash arrangements for remuneration. For instance, labor may receive the cashew apple, which is used to prepare a traditional wine, or an amount of cashew nuts. Farmers do not have access to credit except through advance barter or other trades with intermediaries. Even among intermediaries only the larger operators use the banking system and then mainly for cash transfers and not for credit. Some of the larger national traders do have credit lines with commercial banks but the volume of such financing fell after a series of defaults in 2012-13.[8]

11. Three domestic prices are relevant. First, is the price received by producers at the farmgate, which is subject to the official farm reference price. Second, is the price received by intermediaries from exporters. And third, is the price that exporters receive, after paying the export tax that is based on a government-set export reference price. Prices and the distribution of rents depend on the degree of competition and negotiating capacity of each group.

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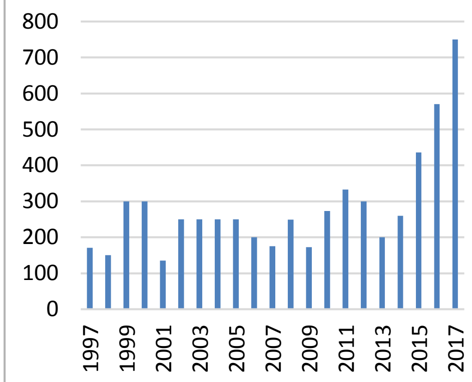
[5] This is an indicative price since the government has no capacity to guarantee it. During recent years; however, producers have received at least that price.

[6] Separating the cashew nut while is still in the tree lowers its quality.

[7] The traditional barter product has been rice, reflecting the subsistence nature of the agricultural economy. A sack of cashew had the equivalent in barter in sacks of rice. Other barter products could be house wares and appliances.

[8] Among the largest non-performing loans in the banking system come from the national group engaged in trading and exporting activities.

12. Prices have been increasing sharply for the past several years. Demand for cashew has been increasing strongly, with China entering the consumer market and further demand from United States and the European Union. Guinea-Bissau is a price taker in international markets. Though it is becoming an increasingly important cashew exporter in terms of quantity and quality, with a global market share of about 2 percent, the country does not have the scale to affect international prices. Moreover, while most of the international market is for the kernel one gets after removing the cashew almond from its shell, Ivory Coast and Guinea-Bissau mainly export the unprocessed cashew nut.



Source: Ministry of Finance.

C. The 2017 Cashew Campaign

13. This year's campaign started hesitantly with expectations of low production and high prices. At the beginning of the season, the expectation was that production would remain flat or slightly lower given that neither rain nor blossoming was as abundant as in the previous year. Producers were expecting high prices based on the recent trend. They negotiated better any pre-financing from intermediaries and were generally reluctant to sell in advance a high proportion of their future harvest. News of high international prices spread at the beginning of the year, led by competition between India and Vietnam for the West African market, which drove prices higher. The guaranteed farmgate price at Ivory Coast, which is used as reference for marketing developments in Guinea-Bissau because it opens a month before, was set at CFAF 440 per kilogram, up 26 percent from 2016. Moreover, Ivory Coast producers soon reported prices reaching levels of more than CFAF 800 per kilogram.

14. The opening of the campaign was surrounded by high uncertainty owing to policies blocking some intermediaries and exporters from entering the market. A draft bill prepared by the Ministry of Commerce would have forbidden foreign intermediaries from buying directly from producers. This would have significantly reduced competition and likely depressed farmgate prices. In addition, the issuing of licenses, phytosanitary titles, and other permits was non-transparent and used in some instances to avoid competition.[9]

15. The government announced a reference price of CFAF 500 per kg at the opening of the campaign on March 31st, 2017, double the previous year's price. The execution of transactions was slow initially. Alarms were set off by reports of cashew smuggled to Senegal and Gambia receiving prices of CFAF 1,000 per kg or higher. The President of the Republic intervened by temporarily stopping the campaign and making clear that that the proposed initiative to ban foreign intermediaries was not official policy. Market reactions were favorable and farmgate prices rose in

[9] Some exporters interviewed for this note reported the buying of licenses for prices much higher than the official amount set.

the following days to levels higher than CFAF 1,000 per kg in some cases. Exports took off and exports had by mid-August reached levels of about 155,000 tons.

16. In the end, both production and prices were better than expected. Farmgate prices are estimated to have averaged in a range of CFAF 750-850 per kg, up from CFAF 450 per kg in 2016. Moreover, total exports for the year are likely to be about 175,000 tons, which after adjusting for smuggling would probably be close to the level of 2016. This was helped by producers, perhaps explained by high farmgate prices, taking good care of their plantations, partially offsetting the less favorable weather conditions. The logistic infrastructure supporting the market also improved substantially, with the construction of a new road to the port and the building of additional storage capacity by exporters.[10]

17. The main beneficiaries of this year's cashew campaign have been the farmers and the many poor households that depend on cashew production.[11] Producers appeared more informed of market developments and better able to negotiate than in previous years. Moreover, the high demand and increased commercialization of the market meant that they were predominantly paid in cash, rather than in barter for rice at inferior terms of trade as was often the case in the past. Intermediaries, in contrast, maintained roughly similar margins as last year, about CFAF 200 per kg. The price received by exporters at the point of delivering and loading the cargo at the port with all duties paid averaged about CFAF 1,350 per kg.

18. Exporters' performance was mixed, with the three main Indian exporters consolidating their market share. Exporters benefitted from the improved transport and storage infrastructure. At the same time, some exporters saw reduced profit margins, partly explained by their having signed contracts based on the assumption of farm prices near the official reference price of CFAF 500 per kg and not foreseeing the later sharp increase. Those exporters did not at that time have all the product in storage and had to buy at higher prices to observe the contracts. The few processing units also did not do well because of the sharp increase in input costs from higher farmgate prices.

D. Cashew Policy Issues for the Short Term

19. The hesitant start to the cashew 2017 campaign highlights the importance of stable policies for the cashew sector. Cashew is the backbone of the economy and a clear and transparent policy framework is needed to maximize social welfare from the activity. To be effective, the framework would need to cover: (i) enabling market forces to operate, under clear rules and with government avoiding interventions in favor of vested interests; and (ii) removing obstacles to production and value-addition by simplifying administrative procedures, streamlining the myriad of duties and fees, and improving infrastructure and public services delivery, notably the provision of electricity.

[10] At least 30 new warehouses were constructed, mainly in the Antula region.

[11] Results from a World Food Program survey show that food insecurity declined from 29.1 percent in December 2016 to 15.5 percent in May 2017.

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TAX REVENUE MOBILIZATION IN GUINEA-BISSAU[1]

This chapter assesses the tax revenue performance of Guinea-Bissau and discusses the challenges the country faces in mobilizing revenue. It also examines the composition and magnitude of tax revenue in Guinea-Bissau compared to its peers, and highlights examples of countries that successfully improved tax revenue. The analysis shows that although Guinea-Bissau's tax revenue has improved over the last decade, it still falls below that of comparator countries and the requirements for sustainable growth and development. Notably, there is considerable scope for increasing tax revenue through administrative improvements and tax policy reforms.

A. Background and Recent Trends

1. **Enhancing revenue mobilization is a key developmental challenge for Guinea-Bissau.** As for other fragile states (FS)[2], improving tax revenue performance in Guinea-Bissau is critical to create fiscal space for priority infrastructure and social spending. Building tax capacity is also important because of the substantial reduction in donor support the country has experienced in recent years. Besides the direct fiscal benefits, a sustained and consistent increase in revenue can also contribute to social stability in post-conflict countries, such as Guinea-Bissau, and assist the country in exiting fragility (IMF, 2017a). More generally, the literature suggests a "tipping point" at about 12¾ percent of GDP beyond which tax revenue enables a significant acceleration in economic growth (Gaspar et. al., 2016).

2. **Guinea-Bissau's tax revenue performance has improved over the past decade, but it still falls far below potential.** The tax-to-GDP ratio increased from 4.2 percent in 2002 to a peak of 10.1 percent in 2015 (Figure 1). The tax-to-GDP ratio then fell to 9.2 percent in 2016, with much of the decline explained by one-off revenues in 2015. Between 2002 and 2016, sales tax, which accounts for the largest share of tax revenue, increased substantially by 1.8 percentage points of GDP. There were also notable increases in corporate income tax (CIT) (1.1 percent of GDP) and trade tax (1.2 percent of GDP) during the period. Personal income tax (PIT) increased modestly by 0.5 percent of GDP. By contrast, there was a decline in excise tax revenue by 0.2 percent of GDP. Even with the overall increase, however, Guinea-Bissau's tax performance is estimated to be far below its tax capacity. Results from an econometric analysis indicate that Guinea-Bissau's tax potential is about 21 percent of GDP, implying significant scope to enhance tax revenue (see IMF 2015, Box 3).

3. **The increase in the tax-to-GDP ratio over the past decade was mainly due to strengthened revenue administration, as there were no significant tax policy changes.** The authorities did, however, implement a series of administrative reforms at the tax and customs offices during 2011-17 with technical assistance (TA) by the IMF and other development partners. Table 1 summarizes the key measures that helped enhance administrative capacity in domestic revenue collection.

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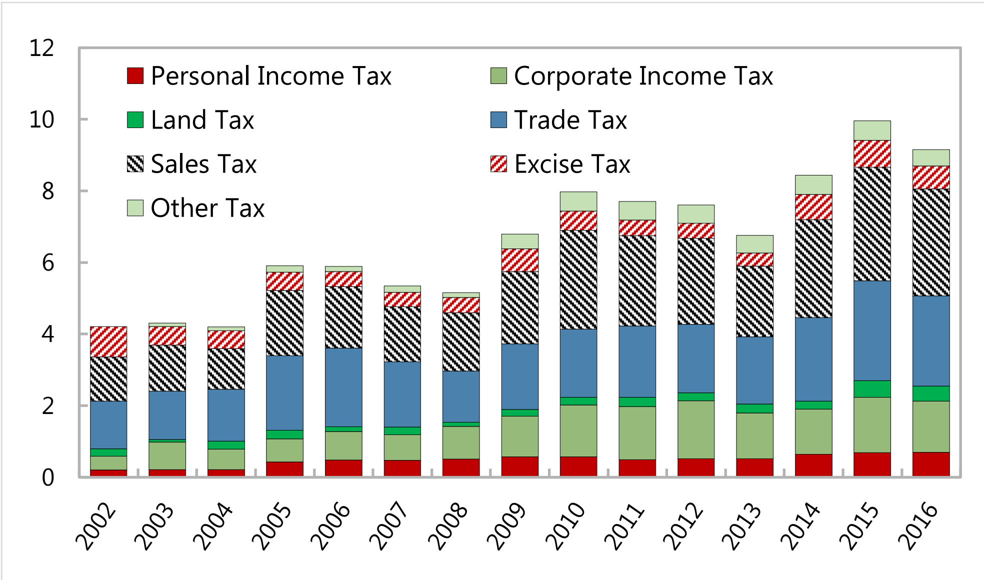
[1] Prepared by Keyra Primus. Helpful comments were provided by Jiro Honda and Zayda Manatta; and Philippe Wingender facilitated access to the Gaspar et al. (2016) database.

[2] Thirty-nine countries are classified in fragile situations according to IMF (2017a).

Figure 1. Tax Revenue in Guinea-Bissau

(in percent of GDP)



Sources: Guinea-Bissau's authorities; and IMF staff estimates.

4. **This chapter examines Guinea-Bissau's experience in mobilizing tax revenue and provides a comparison with the country's peers.** The remainder of this chapter is organized as follows. Section B outlines Guinea-Bissau's challenges in improving tax collection. Section C provides an analysis of the composition and magnitude of tax revenue in comparison to other countries, and discusses successful cross-country experiences in mobilizing tax revenue. Section D provides suggestions to improve the country's tax performance, and the final section concludes.

B. Challenges in Mobilizing Revenue

5. **There have been no substantial tax policy changes for many years.** Guinea-Bissau's tax system is still largely based on the colonial system created in the early 1960s (Government of Guinea-Bissau, 2015). There were two main phases of tax reform. The first phase occurred in the 1980s, when income tax was revised; and the second phase occurred in the 1990s, when the general sales and services tax and excise duty were introduced. Subsequently, some changes were made to various taxes through state budget laws and individual laws. Nonetheless, since the 1990s, there have been few changes to the structure of the tax system.

Table 1. IMF Technical Assistance in Revenue Administration

Measures	Implementation Description
Reorganize the tax department	• The tax department was organized along functional lines. • Taxpayers were segmented by their relevance and the risks they pose to the tax administration's goals.
Enhance the tax capacity of the Directorate General of Contributions and Taxation (DGCI)	• A new operating framework for DGCI was introduced and services were streamlined. • DGCI strengthened its procedures and core processes. • The tax office hired 94 technical employees, following a competitive process. • An automatic taxpayer registration module was implemented, which resulted in the number of registered taxpayers increasing from 4,887 in 2014 to 12,413 in 2016. • A model for collection enforcement was developed, which greatly reduced the possibility of staff irregularly dismissing penalties and interests on late payments.
Improve taxpayer registration	• An IT system was developed for taxpayer registration; however, its use is still limited to some offices due to lack of IT infrastructure in most offices. • The structure of the Taxpayer Identification Numbers (TINs) was revised per best practices. • The assignment of TINs to most known taxpayers was completed; and the Customs Department and the Business Registration Bureau use the TINs.
Develop a strategic plan for revenue reform	• A revised revenue reform strategic plan for 2017–20 was developed and approved by the government. • Operational plans were developed in-line with the strategic plan. Project managers were appointed for each of the actions, and a monitoring model was defined.
Improve collection of duties and taxes	• An intra-trade post was implemented in Safim to reconcile invoice merchandise data with actual contents of the cargo. • The tax management software (SYDONIA++) was extended to a major border post.
Source: IMF.	

6. There are several challenges in improving the effectiveness and efficiency of tax collection in Guinea-Bissau. The main impediments include: (i) political instability and weak institutional capacity (ii) generous tax exemptions——tax and customs exemptions were estimated to account for approximately 2.7 percent of GDP (IMF, 2011); (iii) poor tax compliance——tax liabilities amounted to about 1.4 percent of GDP in 2016 (IMF, 2017c); and (iv) inefficiencies in tax and customs administration——resulting from poor filing, registration and staffing in the tax and customs offices.

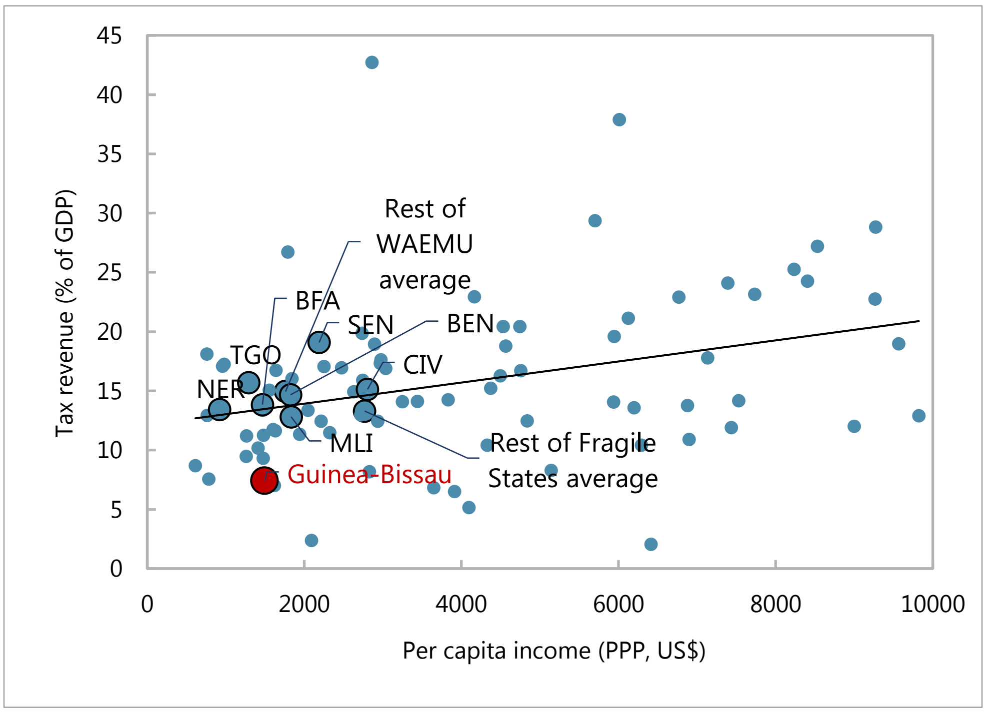
C. Analysis

Cross-Country Comparison

7. Tax collection in Guinea-Bissau falls behind that of comparator countries and below the "tipping point". The tax-to-GDP ratio in Guinea-Bissau is below the level in countries with similar per capita GDP (Figure 2). Moreover, although having risen over the years, in 2016 the tax-to-GDP ratio remained below the averages of other WAEMU countries and FS by 6.7 and 4.2 percentage points, respectively (Figure 3). Notably, Guinea-Bissau has remained below the 12¾ percent of GDP "tipping point" identified by Gaspar et al. (2016), whereas the WAEMU average has consistently been above that threshold. While Guinea-Bissau's growth performance has lately been strong, the cross-country relationship between growth and the level of tax revenue found by Gaspar et al. (Figure 4) suggests that raising tax revenue by the 3-4 percentage points of GDP needed to reach the tipping point could facilitate an acceleration in economic growth.

Figure 2. Tax Revenue and Per Capita Income

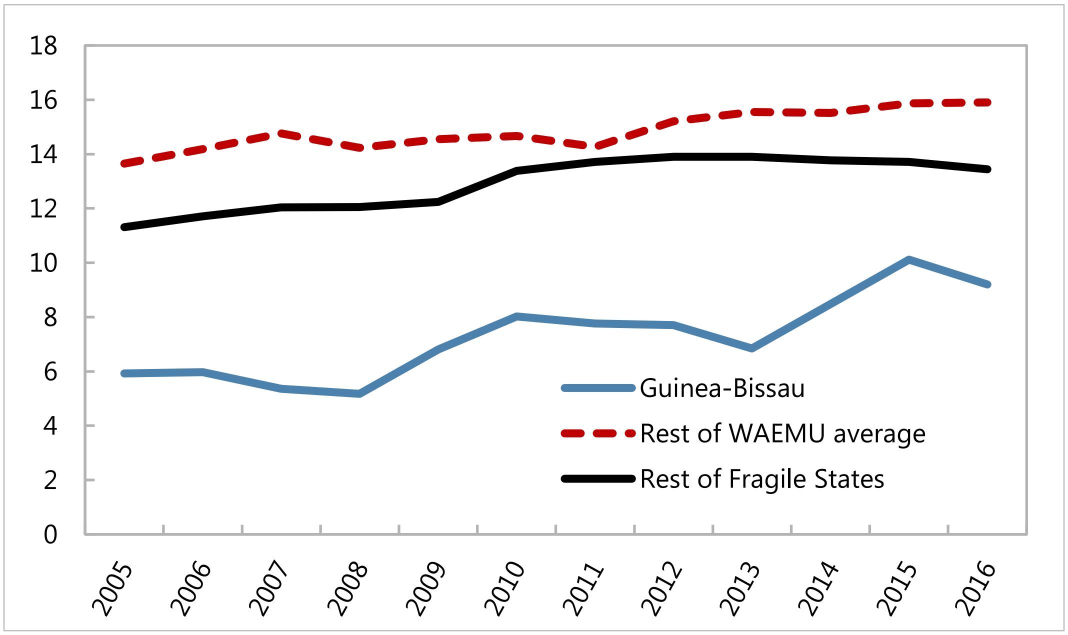
(Average 2006–16)



Sources: IMF, World Economic Outlook database; and IMF staff estimates.

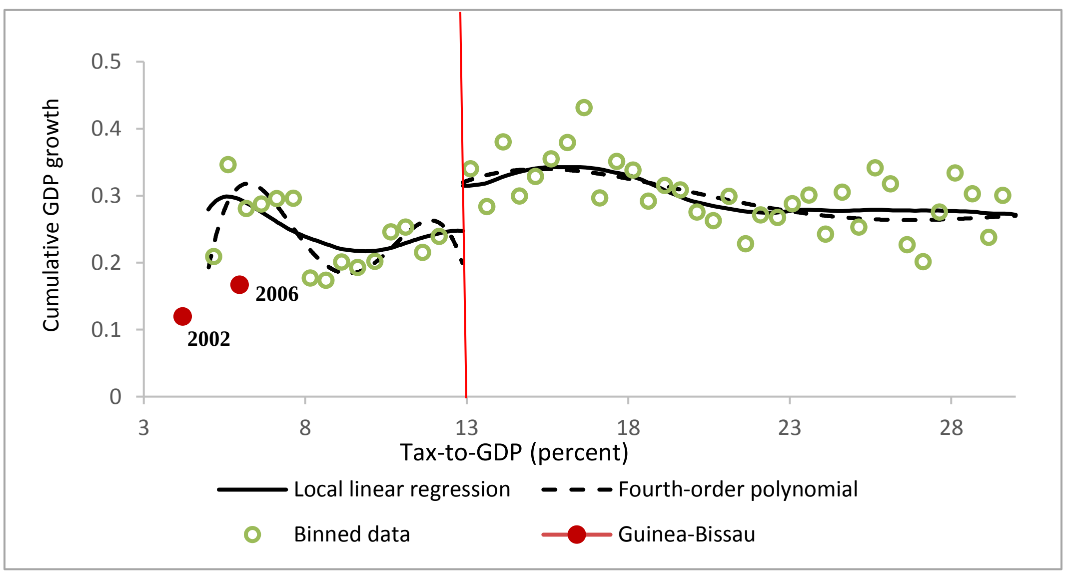
Figure 3. Tax Revenue

(in percent of GDP)



Sources: IMF, World Economic Outlook database; and IMF staff estimates.

Figure 4. Tax Revenue and Cumulative GDP Growth

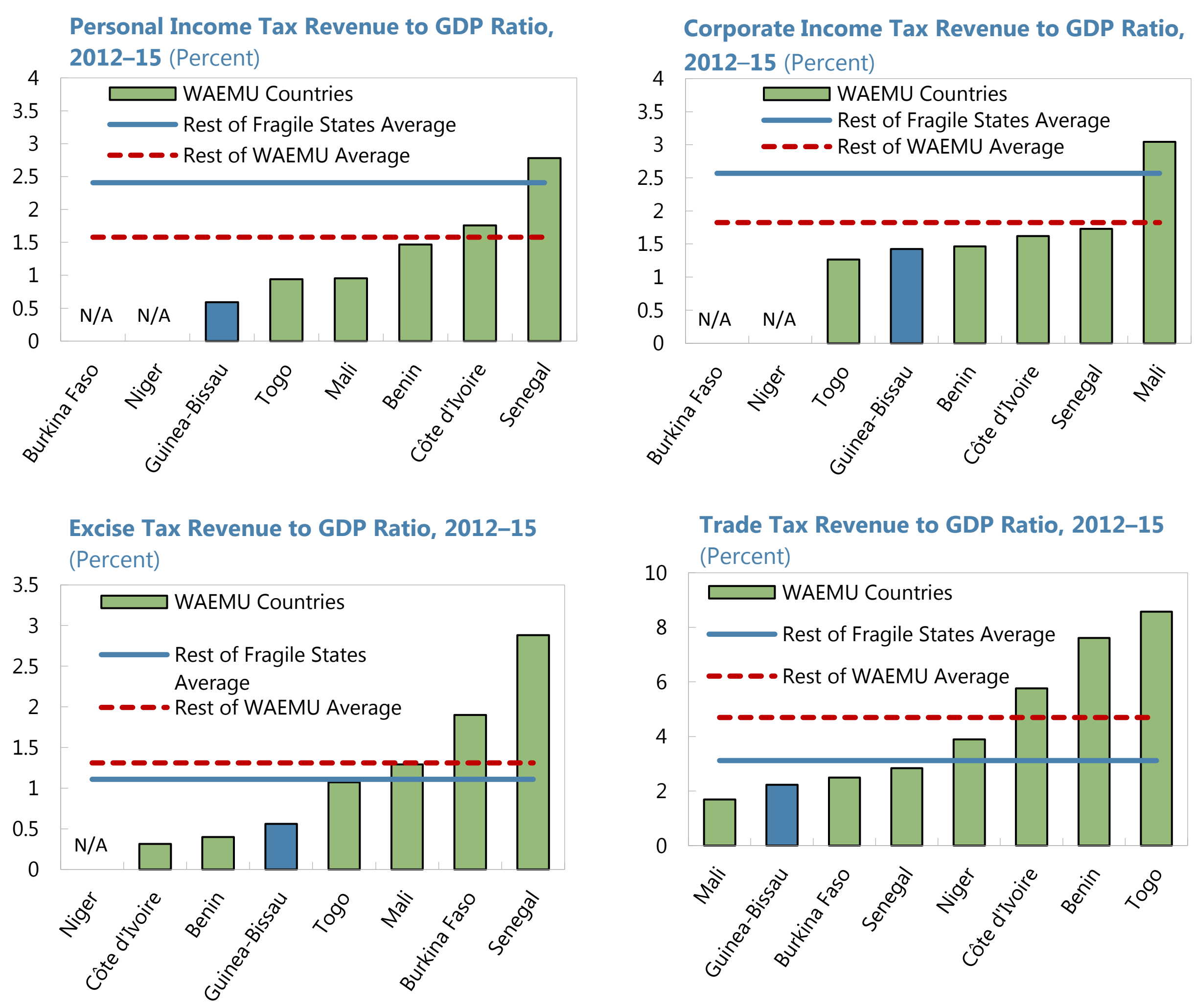


Note: The chart shows the combination of 10-year cumulative GDP growth and average tax-to-GDP ratios for 139 countries during 1965–2011, binned in 0.5 percentage point growth increments. For Guinea-Bissau, the tax-to-GDP ratio and cumulative GDP growth are shown for 10-year periods in 2002 and 2006, respectively.

Sources: Gaspar et al. (2016) and IMF staff estimates.

8. The tax ratios for Guinea-Bissau fall below the average ratios of its peers in all major subcategories (Figure 5). During 2012–15, PIT as a share of GDP measured 0.6 percent in Guinea-Bissau, compared to 1.6 percent and 2.4 percent in other WAEMU countries and FS, respectively. For the same period, CIT in Guinea-Bissau amounted to 1.4 percent of GDP, compared to 1.8 percent and 2.6 percent in other WAEMU countries and FS, respectively. Similarly, excise tax revenue in Guinea-Bissau was below the average of other WAEMU countries and FS by about 0.8 percent of GDP and 0.5 percent of GDP, respectively. Finally, taxes on international trade—despite including sizable revenue from export taxes on cashew—amounted to 2.2 percent of GDP in Guinea-Bissau compared to 3.8 percent in other WAEMU countries and 3.5 percent in other FS.

Figure 5. Cross-Country Comparison of Guinea-Bissau's Tax Revenue Performance, 2012–15



Sources: IMF, World Revenue Longitudinal Database; World Economic Outlook; and IMF staff estimates.

9. Tax rates in Guinea-Bissau are generally on the low side within the region (Table 2). The PIT rate in Guinea-Bissau is the lowest in the WAEMU region, and, uniquely, below the CIT rate. Guinea-Bissau's CIT rate is more comparable to rates prevailing in other WAEMU countries but lower than the average. Excise tax rates on non-alcoholic beverages and beer are in line with other WAEMU countries but excise duty on cigarettes is the lowest in the WAEMU region.

Table 2. Tax Rates in WAEMU Countries (2015–16)

	Personal Income Tax	Corporate Income Tax	Excise Taxes		
			Non-alcoholic Beverages	Beer	Cigarettes
Benin	30%	30%	5%,7%,10%	20%	40% + 5%
Burkina Faso	27%	28%	10%	25%	30%-40%
Côte d'Ivoire	60%	25%	12%	15%	35% + 7%
Guinea-Bissau	**12%**	**25%**	**10%**	**25%**	**25%**
Mali	37%	30%	12%	50%	32%
Niger	35%	30%	10%,15%	45%	45%
Senegal	40%	30%	3%,5%	40%+1500,5000 CFAF	45%
Togo	35%	29%	2%,5%,10%	15%	45%

Note: PIT rates are for the top income bracket.
Source: Fiscal Affairs Department (Tax Policy Division), IMF.

Country Experiences in Mobilizing Tax Revenue

10. Several FS and low income countries (LICs) have significantly increased tax revenue collection. A paper by Akitoby et al. (forthcoming) highlighted successful mobilization efforts in LICs and emerging markets (EMs). One of the criteria used in Akitoby et al. to identify large tax revenue increases is where a country raised its tax-to-GDP ratio by at least 1.5 percent within three years. Based on this criterion, Guinea-Bissau was identified as a successful case over the period 2008–10.[1] However, this increase was not sustained as revenue as a share of GDP declined in 2011–13. Akitoby et al. showed that several FS and LICs sustained increases in their tax-to-GDP ratios, even under volatile economic and political circumstances. The pivotal question that arises is *how* these countries managed to sustain their revenue gains.

11. Guinea-Bissau relied mainly on revenue administration to improve tax revenue, whereas other countries used a combination of revenue administration and tax policy measures. Akitoby et al. showed that revenue administration measures played a pivotal role in increasing tax revenue in FS when they were accompanied by tax policy reform. Notably, FS with high tax-to-GDP ratios, such as Comoros, Guinea, Liberia, and Tuvalu boosted tax collection with a combination of various revenue administration and tax policy reform measures. The measures undertaken included increasing VAT rates, raising excises, curbing exemptions, enforcing tax

[1] The increase in tax revenue in Guinea-Bissau during 2008–10 was mainly due to enhanced tax administration, tighter controls at customs, and robust economic activity.

compliance, recovering tax arrears, and computerizing tax and customs administration. Box 1 discusses the measures implemented in two countries similar to Guinea-Bissau: Liberia (a FS and LIC) and Burkina Faso (a LIC in the WAEMU region).

Box 1. Successful Cases in Mobilizing Tax Revenue

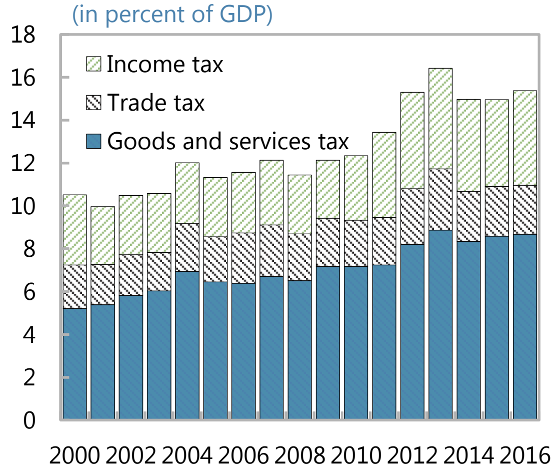
Burkina Faso, 2008–13

The tax-to-GDP ratio increased by 4.6 percentage points between 2008–13 on the back of improved tax administration and tax reform measures. Tax administration was enhanced by efforts to modernize tax administration, raise awareness of tax compliance, and combat tax evasion and corruption, as well as measures to increase filing from large taxpayers. Tax policy reforms included broadening the coverage of VAT and changing the royalty rate from a single 3 percent rate to a sliding scale of 3–5 percent depending on global prices.

Liberia, 2005–07; 2008–12

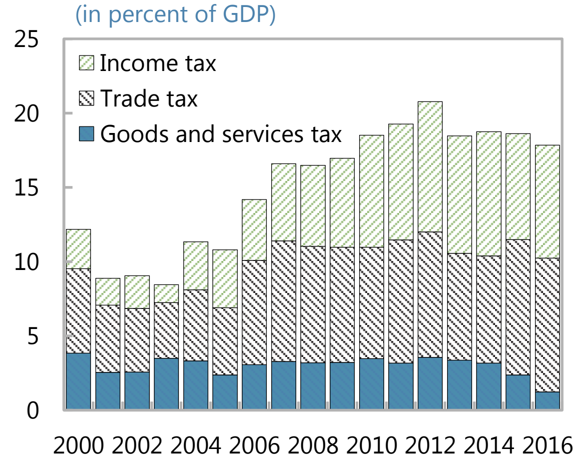
In Liberia, tax revenue increased by 5.9 percent of GDP during 2005–07 and 4.4 percent during 2008–12. The increase in tax revenue was mainly driven by improved tax and customs administration, as well as tax policy measures. Revenue administration measures included establishing a taxpayer service center to improve compliance, computerizing tax and customs administration, conducting audits of large taxpayers, and strengthening the large taxpayers' office. In addition, international experts were hired to work in the main revenue agencies to help enhance capacity. Tax policy reforms included increasing excises on alcoholic beverages, cigarettes, cell phone usage, airlines and hotels; and application of goods and services taxes (GST) on duty-paid value and the full GST to restaurant services.

Burkina Faso: Main Tax Revenue Categories
(in percent of GDP)



Sources: Burkinabè authorities; IMF staff estimates.

Liberia: Main Tax Revenue Categories
(in percent of GDP)



Source: IMF, World Economic Outlook database.

D. How Can Guinea-Bissau Mobilize Tax Revenue?

12. Improving tax performance will require overcoming a series of impediments. Key factors that adversely impact tax revenue are weak administrative capacity of the tax and customs offices, generous tax exemptions, large tax liabilities, and poor compliance—especially among large taxpayers. There is also a lack of basic equipment to conduct core work functions and limited skilled staff. Revenue mobilization has also been adversely affected by political instability, which contributed to limited tax policy reform.

13. Experiences of other countries suggest that it will be important for Guinea-Bissau to interlink tax policy and revenue administration reforms. This could be assisted by outlining a reform strategy that properly sequences reforms, taking into account administrative capacity. Specific revenue mobilizing measures could include:

Short-term measures:

- *Enhance compliance*, by strengthening compliance, administering audits, and enforcing sanctions for failure to file.
- *Rationalize tax exemptions*, by curbing tax exemptions.
- *Strengthen core operations in tax and customs administration*, by improving taxpayer registration, ensuring timely filing and payment of taxes, strengthening customs control, and controlling importers' and exporters' reporting and payment obligations.
- *Broaden the tax base*, by combating tax evasion, increasing the number of registered taxpayers, and locating and reactivating inactive taxpayers.
- *Manage large taxpayers*, by ensuring filing and appropriate reporting.
- *Review excise taxes*, by examining if there can be merit in applying excise taxes on additional items and adjusting rates to be closer to those in other WAEMU countries.
- *Recover tax arrears*, by stepping up enforcement of existing claims and developing a policy to limit, manage, monitor, and routinely report tax arrears.
- *Build administrative and institutional capacity*, by strengthening technical skills of staff at the tax and customs offices, computerizing tax and customs administration to support tax payments and filing, and addressing shortcomings in supporting infrastructure.

Long-term measures:

- *Undertake tax policy reform*, following a comprehensive assessment of the tax system. Objectives could include simplification of the tax structure, reviewing taxation of small and medium-sized enterprises, and establishing fiscal frameworks for natural resource extraction. Particular attention would need to be given to compatibility with tax rates and frameworks prevailing in other WAEMU countries.

E. Conclusion

14. The analysis shows that Guinea-Bissau trails behind its peers in revenue mobilization and that there is considerable scope to raise tax revenue. Tax revenue in Guinea-Bissau is below comparator countries because of inefficiencies and weaknesses in its tax and customs offices, and limited or no tax policy reform for almost two decades. On the back of dwindling donor support, the government of Guinea-Bissau faces the challenge of markedly improving tax performance to support investment and priority spending, and to bring tax collection more in line with comparator countries. Although Guinea-Bissau is a FS with volatile economic and political circumstances, experiences of FS elsewhere show that it is still possible to enhance tax revenue. Guinea-Bissau should aim to achieve a tax-to-GDP ratio of at least 15 percent. This is the level that IMF's Fiscal Affairs Department generally considers the minimum level appropriate. The experiences of other countries that have successfully raised revenue suggest that it could take Guinea-Bissau 5–10 years to achieve this target. Even so, it would require steadfast improvements in revenue administration along with tax policy reform.

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GOVERNMENT EXPENDITURE MANAGEMENT IN GUINEA-BISSAU[1]

A. Background

1. Guinea-Bissau is a fragile country with large development needs, low government revenue, and limited administrative capacity. Chronic political instability has led to frequent changes in leadership, high staff turnover, and delays in the establishment of an adequate legal and regulatory framework for the management of public finances. Technical capacity of government staff and the resources and technology available to them are scarce. Per the 2016 World Bank's Country Policy and Institutional Assessment (CPIA), both the quality of the public administration and the transparency and accountability of the public sector are below the regional average.[2] Government revenue, although increasing, is low and limits scope for significant increases in spending.

2. This chapter assesses features of Guinea-Bissau's government expenditure and aims to identify ways to improve the efficiency of spending. Given constraints on the level of spending, higher spending efficiency will be necessary for meeting the country's development goals. The chapter documents the levels and apparent efficiency of general government spending in Guinea-Bissau, focusing on education and health. Government spending is low compared with the rest of the West Africa Economic and Monetary Union (WAEMU), the average for low-income countries (LICs), and the average for fragile states (FS).[3] Further, the chapter highlights the main Public Financial Management (PFM) weaknesses and attempts to identify areas where PFM improvements could lead to better prioritization of resources and more effective service delivery.

B. Trends in Government Spending and Cross-Country Comparisons

3. Government spending is lower in Guinea-Bissau than in comparator countries. Compared to the size of its economy, Guinea-Bissau had in 2010-2016 the lowest public spending level within WAEMU, with average government spending standing at 19.3 percent of GDP, about 4 percentage points below the WAEMU average. The gap to other fragile states was even larger.

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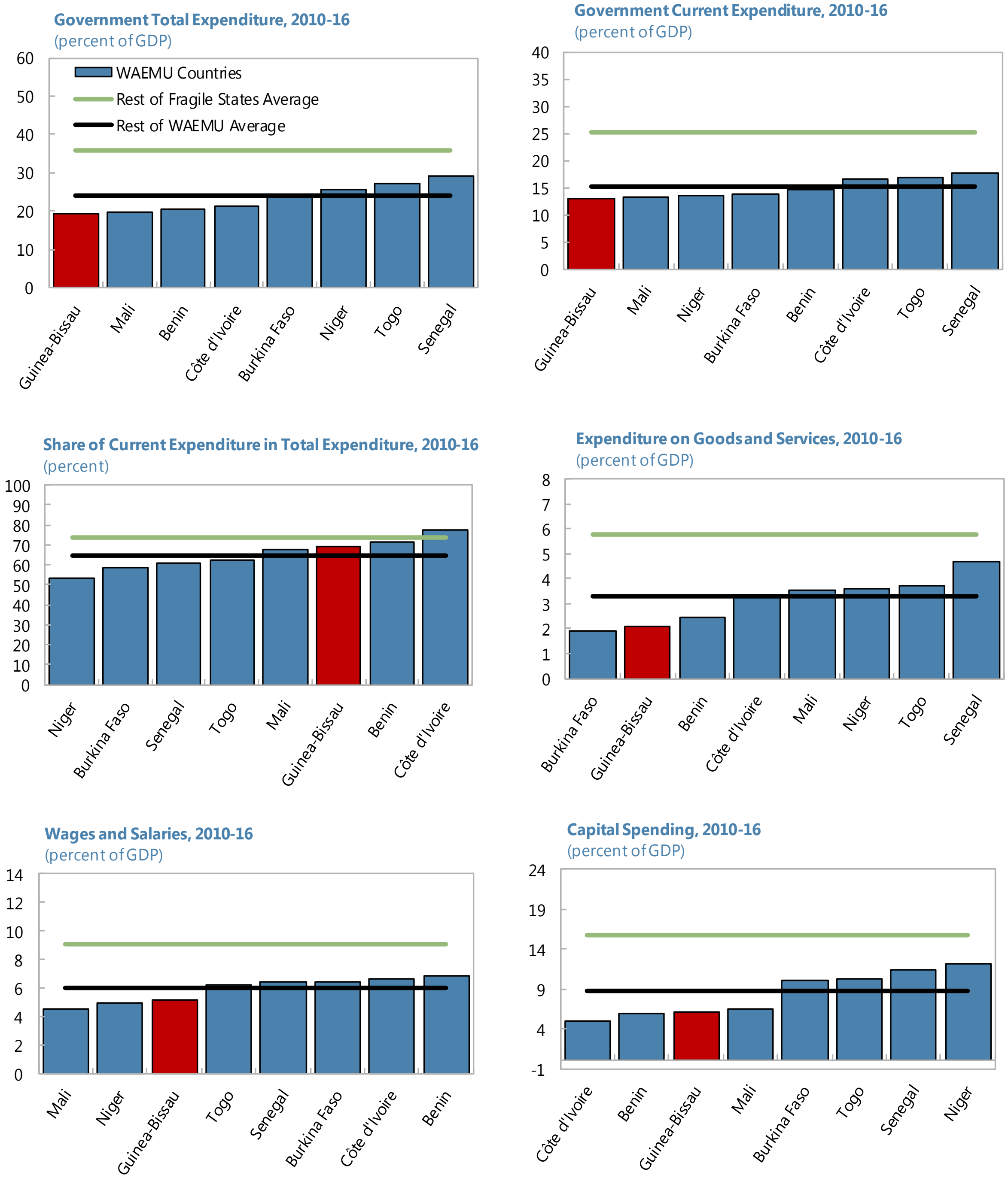
[1] Prepared by Elena Arjona Pérez. Helpful comments were provided by Fiseha Haile Gebregziabher (World Bank) and Ramon Hurtado Arcos.

[2] The Guinea-Bissau 2016 CPIA indicator for Quality of the Public Administration was 2.5 out of 6. The indicator for Transparency, Accountability and Corruption in the Public Sector was 2 out of 6. The average values for the rest of the WAEMU region were 3.1 for both indicators.

[3] The IMF defines fragile states (FS) as having either weak institutional capacity measured by a CPIA score (average of 3.2 or lower) and/or experience of conflict (signaled by presence of a peace-keeping or peace-building operation in the most recent three-year period). The current list of countries is: Angola, Burundi, Central African Republic, Chad, Comoros, Congo (Republic of), Congo DRC, Côte d'Ivoire, Eritrea, Guinea, Guinea-Bissau, Liberia, Madagascar, Malawi, Mali, São Tome & Principe, Sierra Leone, South Sudan, Togo, Zimbabwe, Kiribati, Marshall Islands, Micronesia, Myanmar, Nepal, Solomon Islands, Timor-Leste, Tuvalu, Bosnia & Herzegovina, Kosovo, Afghanistan, Iraq, Libya, Somalia, Sudan, Syria, West Bank & Gaza, Yemen, and Haiti.

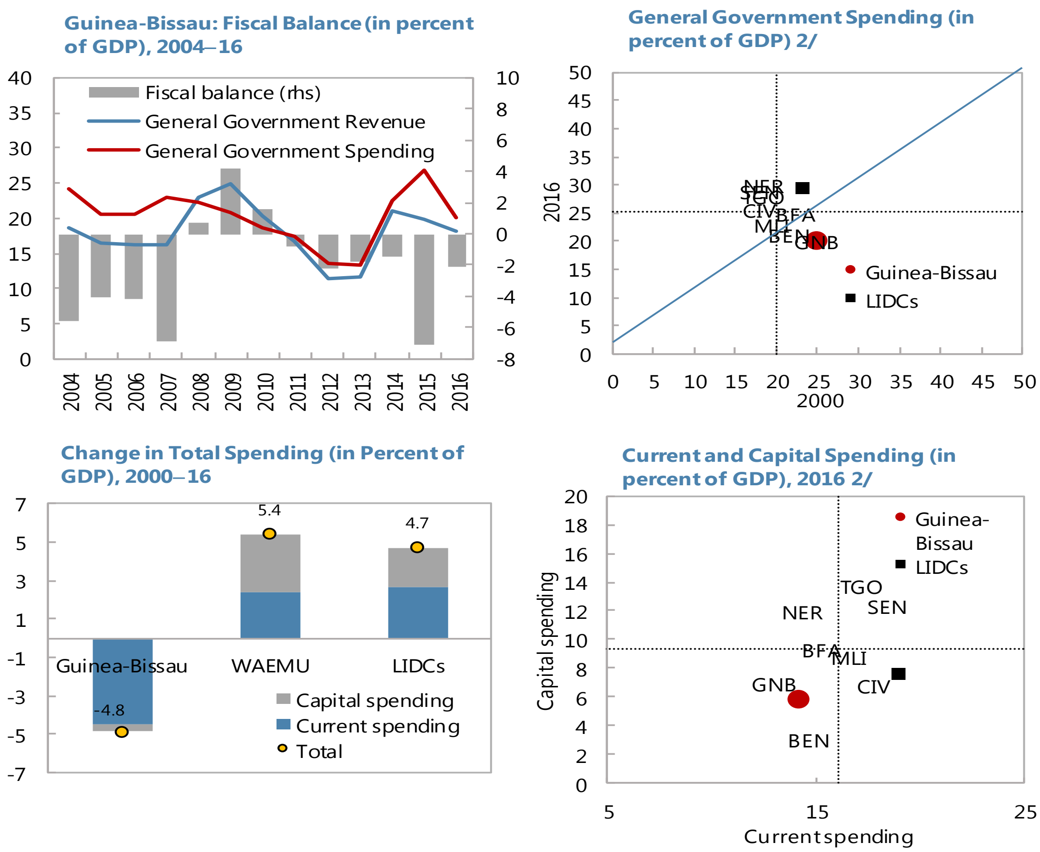
Figure 1. Guinea-Bissau's Government Expenditure in a Cross-Country Perspective



Sources: IMF, World Economic Outlook; and IMF staff estimates.

4. Government spending has been volatile but on the whole declining since 2000. Government spending fell to a low of just 13 percent of GDP in 2012, when a coup and falling cashew prices disrupted economic activity, but spending had also been falling before that. Economic recovery, higher revenue collection, and increased donor assistance supported a subsequent recovery. Nevertheless, with other WAEMU countries having raised government spending since 2000, the ratio of spending to GDP in Guinea-Bissau has remained below the WAEMU average.

Figure 2. Guinea-Bissau's Government Spending and Economic Classification[1/]

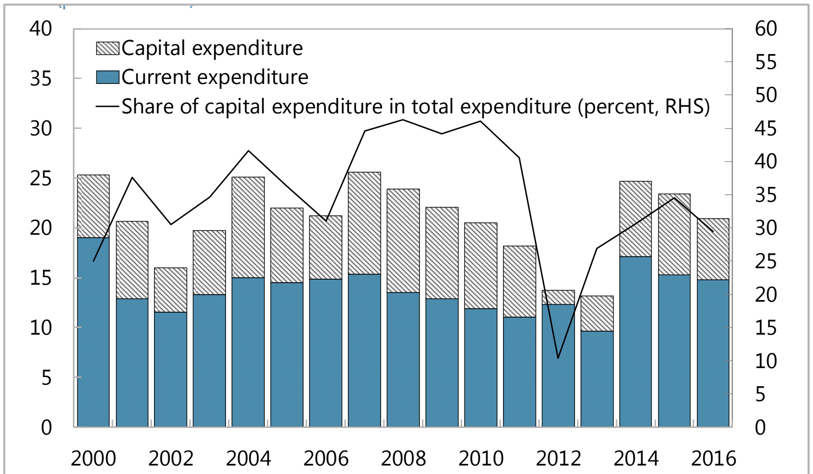


Sources: IMF FAD Expenditure Assessment Tool (EAT); and World Economic Outlook.
1/ Coverage refers to general government as per World Economic Outlook metadata.
2/ Dash lines are the average of WAEMU.

5. Capital spending has tended to absorb most of the budget cuts in periods of intensifying fiscal pressure. After the military coup and the suspension of budget support, investment expenses plunged from a record high of 46 percent in 2010 to 10 percent of total expenditure in 2012. Greater fiscal space since then enabled the investment share to rise to 29 percent in 2016, but the level has remained 7 percentage points of GDP below the WAEMU average.

6. Public investment relies heavily on foreign-funded projects, which use donors' systems for appraisal, management, and reporting. Whereas the government is making efforts to set priorities to guide donors' initiatives and consolidate data on disbursements, it has struggled to monitor execution and plan for associated future maintenance costs, often to be borne by the state. Domestically-funded investment accounts for only 5 percent of total capital expenditure and is mainly dedicated to counterpart funding of externally-financed projects. The execution of these projects is further constrained by inadequate annual and monthly programing of both resources and expenses, and there has historically been a tendency to redirect funding towards current spending.

Figure 3. Guinea-Bissau's Government Expenditure Trends and Composition (percent of GDP)



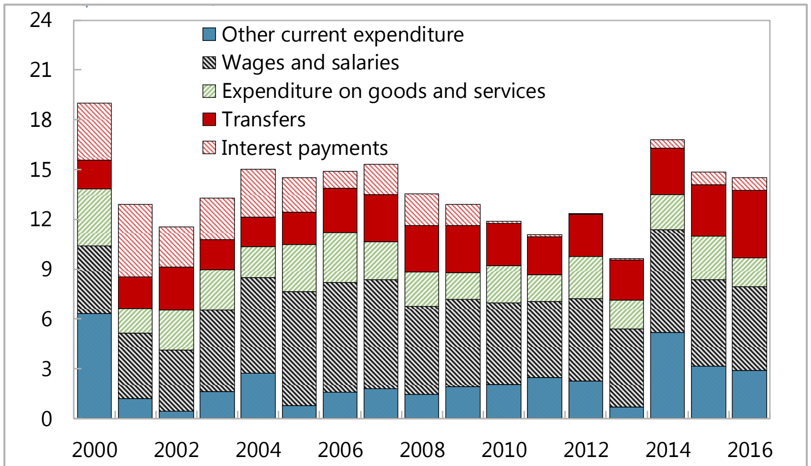
Sources: Guinea-Bissau's authorities; and IMF staff estimates.

7. Within current expenditures, efforts have been made to rationalize the government wage bill but transfers have risen. The share of wages and salaries in current spending is relatively high (34 percent in 2016). The wage bill has been decreasing since 2005, although that may partly reflect that some staff costs have increasingly been recorded as other expenses. Transfers are currently the second largest contributor to current spending, with the figures for 2016 inflated by debt repayments for public enterprises included in this category.

8. Interest payments have reemerged. After achieving HIPC completion in 2010, interest payments reemerged in 2014 as the country has accumulated debt to finance its budget deficits. In 2017, however, the interest burden of the overall debt stock was reduced by eliminating expensive domestic debts and obtaining more favorable terms on borrowings.

9. The category of "other expenses" is relatively high (20 percent of current expenditure in 2016), highlighting weaknesses in accounting and reporting. This category comprises some expenditures, such as bonuses and other staff benefits as well as some purchases of goods and services, which should have been recorded in other categories. It would be necessary to increase the disaggregation of the data currently provided by the financial management system (SIGFIP) to better assess the composition of this category. Efforts to improve the accounting and reporting functions to comply with the WAEMU directives should help to improve the classification of expenses. Reinforcing internal control measures can avoid excessive recourse to "other expenses", often associated with non-priority spending.

Figure 4. Guinea-Bissau: Current Expenditure Trends and Composition (percent of GDP)



Sources: Guinea-Bissau's authorities; and IMF staff estimates.

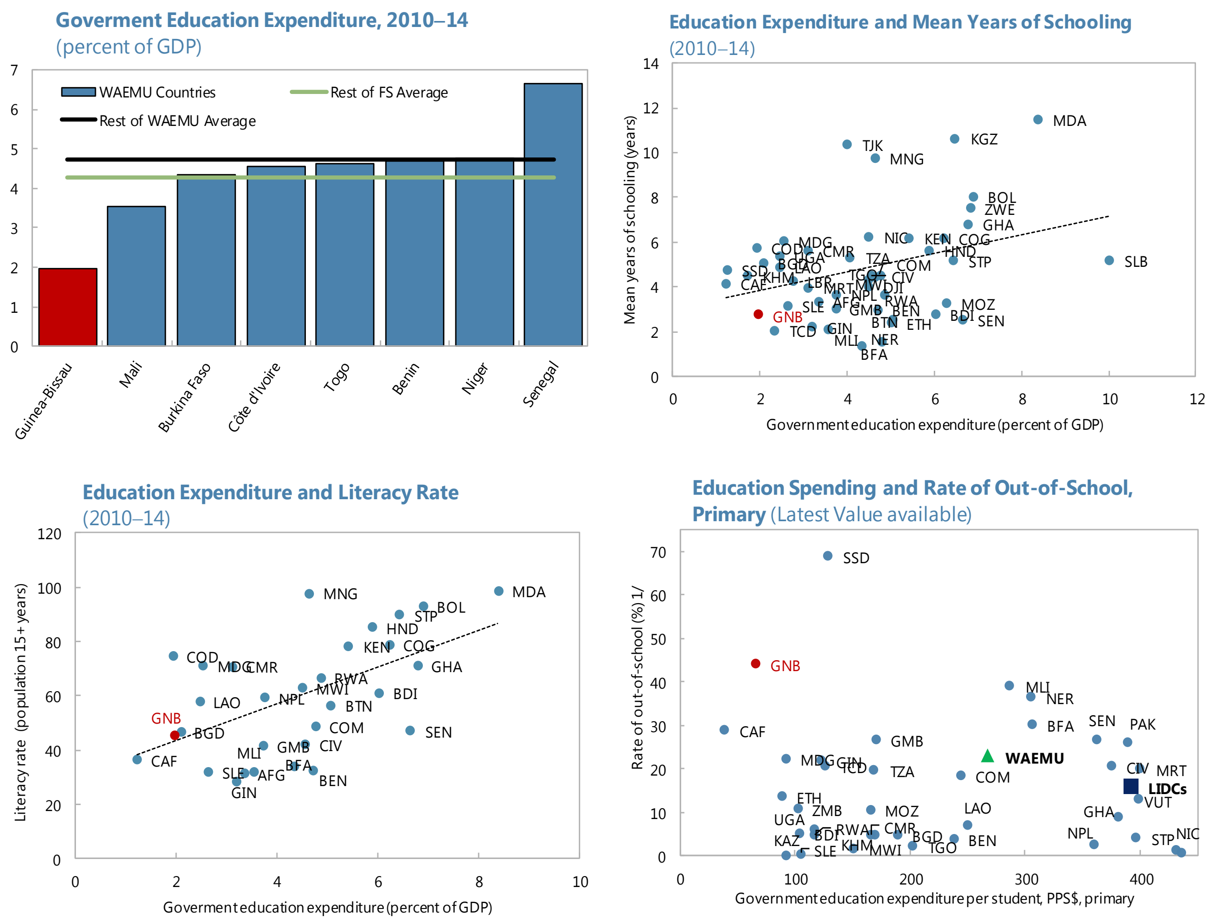
C. Government Spending Efficiency in Education and Health

10. Social spending is low and outcomes are often disappointing.

11. In education, Guinea-Bissau has the lowest level of government spending in the WAEMU region. Expenditure in education accounted for on average 2 percent of GDP during 2010–14, far below both the regional average (about 5 percent of GDP) and the fragile countries average (4.3 percent of GDP). In absolute terms, government spending per primary school student in Guinea-Bissau was PPP$ 66 in 2016, only about a quarter of the WAEMU average based on data from the World Bank. The low level of spending has hampered the country's ability to provide basic school infrastructure and retain qualified teachers.

12. Education outcomes are poor. Data from national surveys and UNESCO indicate that 44 percent of primary school age children are out of school, almost double the WAEMU average. Other countries with the same limited level of expenditure manage to enroll more children and retain pupils in school for longer. At the same time, Guinea-Bissau performs better than some countries with higher spending, and its overall literacy rate is slightly higher than expected given the level of public spending on education.

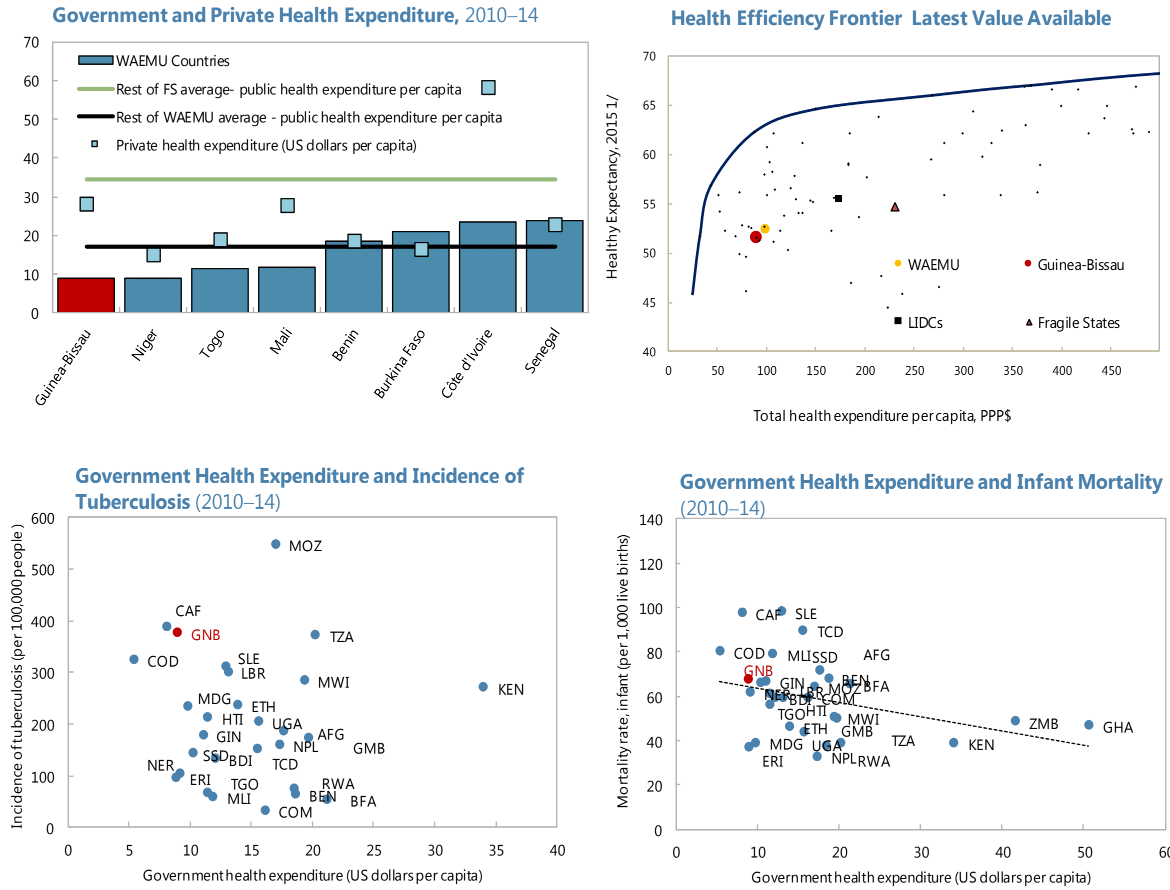
Figure 5. Government Public Education Spending and Outcomes in Guinea Bissau and Comparator Countries, 2010–14



Sources: IMF FAD Expenditure Assessment Tool (EAT); World Economic Outlook; World Bank, World Development Indicators; UNESCO Institute for Statistics; Guinea-Bissau's Education Management Information System 2015; and staff estimates.
1/ Rate of out-of-school children of primary school age, both sexes (percentage).

13. **Government spending on health is also lower than the WAEMU average and results have been particularly disappointing.** At about US$9 per person per year during 2010–14, government health spending in Guinea-Bissau was less than half the WAEMU average. Private health spending compensates for lack of public resources and total health expenditure per capita in Guinea-Bissau is comparable to the regional average. Nevertheless, Guinea-Bissau appears to be achieving relatively low results for each dollar spent. Even compared to the low level of government spending, the country has among others, relatively high incidence of tuberculosis and infant mortality. The health-adjusted life expectancy is in Guinea-Bissau about 52 years, below most fragile states and LICS.

Figure 6. Health Spending and Outcomes in Guinea Bissau and Comparator Countries, 2010–14



Sources: World Bank, World Development Indicators, and World Health Organization.

1/ Healthy life expectancy (HALE) is a measure of health expectancy that applies disability weights to health states to compute the equivalent number of years of life expected to be lived in full health.

14. Lack of data constrains the analysis of public expenditure efficiency and makes international comparisons difficult. The availability of reliable socio-economic data for Guinea-Bissau is much lower than for other developing countries.[4] The Bureau of National Statistics (INE) and line ministries have little capacity to implement surveys and consistently collect administrative data that meet international standards. This concerns data on both quantity and quality of public services delivered to the population. Lack of solid information is a stumbling block for analyzing

[4] This chapter does not include an assessment of public investment efficiency due to the lack of reliable data on infrastructure and fragmentation of financial data for (mostly foreign-funded) investments.

spending effectiveness and ultimately making adequate policy decisions. The World Bank, UN and other donors are providing TA to improve the information systems relating to health and education.

D. Strengthening Public Financial Management

15. Narrowing of infrastructure and social gaps requires careful prioritization and execution. The PFM system in Guinea-Bissau is weak, as shown by several assessments.[5] There have been attempts to address the lingering weaknesses in the budget preparation, execution, and reporting functions during 2007–10 and 2015, but incipient reforms were reversed during periods of political instability and deteriorating governance.

16. There is a need to sustainably reinforce the basic functionalities of the whole PFM system, including line ministries, to ensure effective control of revenues and expenditures and a budget execution process that reflects policy priorities. In 2017 there has been notable progress, albeit mostly confined to the Ministry of Finance. Technical assistance from development partners is geared towards building institutional capacity and supporting the implementation of the current PFM reforms inspired by the WAEMU directives.

17. Scope for using the budget to guide spending decisions is severely undermined by weak budget preparation and execution processes. The government is legally still operating on the basis of the 2015 appropriations, since Parliament has not been sitting since late 2015 and therefore never approved the 2016 and 2017 budgets. The budget preparation process is being improved with the preparation of a budget calendar and measures to integrate the medium-term perspective. For example, the authorities are instituting a wage policy to guide public sector wage increases.

18. An urgent challenge has been to improve planning for in-year budget execution. The Ministry of Finance and the Treasury have limited capacity to forecast cash commitments and requirements and to provide information on the availability of funds to units in charge of service delivery. In 2017 the Treasury has prepared monthly cash-flow projections consistent with the annual budget, helping guide budget execution. In addition, bank reconciliations now take place on a weekly basis.

19. Budget execution has improved with the introduction of twice weekly Treasury Committee meetings. This system of cash management has also improved budget control, with the elimination of expenditures outside the required procedures (DNTs). However, in a context of limited resource availability, pressure to finance immediate needs often steer the prioritization of expenses.

20. The quality of financial data constraints the analysis of the composition of public spending. The production since early 2017 of quarterly reports on budget execution by ministries,

[5] The 2013 Public Expenditure and Financial Accountability (PEFA) funded by the EU and the World Bank, the 2009 World Bank Public Expenditure Management and Financial Accountability Review (PEMFAR) and reports from IMF Technical Assistance.

with details along economic classification of expenses, is a major achievement. The government had not produced annual execution reports in 2015 and 2016. However, the reliability of the financial data is undermined by significant weaknesses in the way expenditures are processed and recorded in the financial management system (SIGFIP). Consistency checks with data from Treasury (on cash payments) is often necessary. In addition, the partial application of the functional classification limits the scope for categorizing expenditure according to the purposes and objectives for which they were intended. The IMF and the World Bank are currently working with the authorities on the reinforcement of SIGFIP. A Public Expenditure Review (PER) on Education and Health and a Public Expenditure Management and Accountability Review (PEMFAR) are planned for 2018.

21. Prospects for increased fiscal space for domestically-funded public investment underscore the importance of adequate planning, allocation, and execution of projects. Given the large infrastructure gap, there is scope for raising both the level and the efficiency of investment. The budgeting for capital and recurrent expenditure are separate processes and there are currently no guidelines for public investment project preparation or established criteria for project screening and selection. Improved processes for execution and reporting of capital spending are also needed.

E. Conclusion

22. Guinea-Bissau is a fragile country with large economic development and social needs. However, the level of government spending in social areas is low. Against a backdrop of weak institutions and lack of capacity, the authorities have recently achieved some progress, notably on treasury and debt management. Revenue mobilization permitting, domestically-funded public investment is expected to increase, which will place additional challenges on spending efficiency.

23. There is scope for improving the prioritization and management of government expenditure. It would be necessary to develop a planning and execution framework that effectively steers in-year spending decisions toward meeting the medium-term social and investment policy objectives. TA from development partners can assist in building the needed institutional capacity, and experiences from other fragile state can help inform the sequencing of reforms.

24. Improving the availability, coverage, and timeliness of sectoral performance information as well as the quality of financial reports would assist the analysis of public spending effectiveness and help enable improved quality of spending.

IMPACT OF ECONOMIC STRUCTURE AND POLICY ON POVERTY INCIDENCE AND DISTRIBUTION[1]

Political instability and conflict have held back inclusive economic growth in Guinea-Bissau. This chapter analyzes the incidence of poverty under alternative growth paths—the status quo versus a more diversified growth path with less dependence on cashew—based on the latest available light household survey. Diversification resulting merely from a redistribution of growth between occupational sectors is found to result in a slightly higher overall poverty rate, reflecting the current concentration of poverty in cashew-dependent rural areas. With a growth dividend, a diversified growth path reduces poverty unambiguously, with lower incidence and a more equal distribution. The results highlight the importance of reforms to improve aggregate productivity, as well as sectoral policies to protect the poor in the areas where they are concentrated.

A. Background

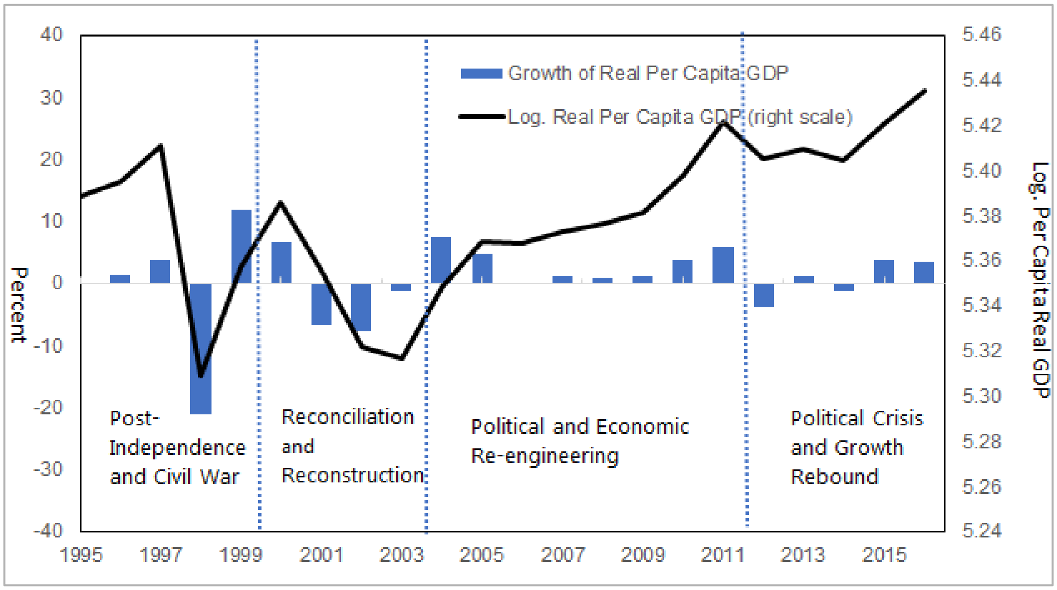
1. **Political instability and conflict since independence have adversely impacted economic growth and poverty alleviation in Guinea-Bissau.** Following independence in 1974, bouts of political tension and instability, culminating in the 1998–99 civil war, eroded gains made during brief periods of stability. National reconciliation and restructuring efforts in the immediate post-civil war period (including the Government of National Union, the National Reconciliation and Reconstruction Program, and the elections of 1999) helped restore peace, but stability was short-lived and gave way to a series of coups. During 1996–2003, per capita GDP declined by an average of 1.3 percent per year, extreme poverty averaged 53.9 percent, and inflation 14.7 percent per year. This was a period of institutional deterioration, falling economic activity, and plummeting social indicators.

2. **The period of 2004–11 witnessed greater stability and improved economic outcomes, albeit punctuated by military interventions.** The Emergency Economic Management Plan adopted by the government following elections in early 2004 imposed budgetary discipline and led to the drafting of a Poverty Reduction Strategy Paper that highlighted the need to address the declining living conditions and high poverty. During this period of political and economic re-engineering, real per capita GDP growth turned positive to average just under 2 percent per year, and inflation moderated to 3.2 percent a year. This period of relative political stability and economic advancement was abruptly ended by a coup in 2012.

3. **The period since 2012 has witnessed swings in the country's terms of trade and related improvements in growth and external balances.** Falling cashew prices coupled with economic disruptions from the coup resulted in real per capita GDP declines of on average 1.3 percent per year during 2012–14. Elections and restoration of constitutional order in 2014 along with surging cashew prices and lower oil prices supported a subsequent sharp improvement of the current account and higher growth.

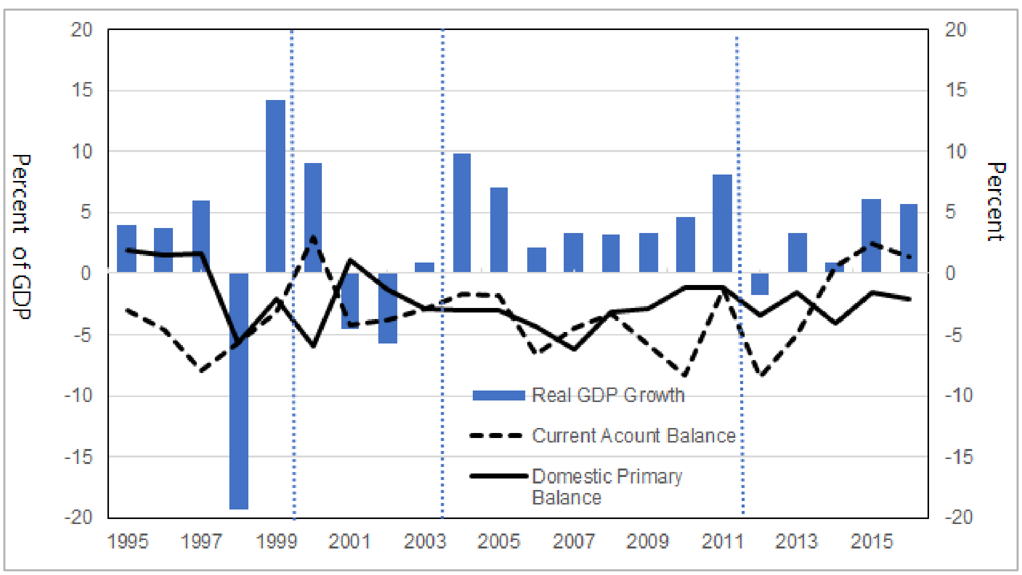
[1] Prepared by Brais Álvarez Pereira (Macroeconomic Advisor, Economic Studies, MOEF), Totas João Correia (Director, Economic Studies, MOEF), Francis Y. Kumah (IMF), and Bedanhoba Na Salú (Economist, Economic Studies, MOEF).

Guinea-Bissau: Cyclical Per Capital Real GDP, 1995–2016



Sources: World Economic Outlook; and authors' estimates.

Guinea-Bissau: Economic Performance over the Cycles, 1995–2016



Sources: World Economic Outlook; and authors' estimates.

4. The history of conflict and political instability has scared social development. Extreme poverty increased from around 43 percent in 1992 to 64 percent just after the civil war in 1999. Economic improvements during the period of political and economic reconstruction helped moderate extreme poverty to 54 percent in 2002, but poverty nevertheless rose to 67 percent in 2010. With the notable exception of literacy, where Guinea-Bissau scores relatively well, the country has fallen behind its regional peers on most indicators of human development and poverty alleviation.

5. **Structure of the analysis.** The next section summarizes results from the 2010 cross-sectional light household survey (ILAP). The following section summarizes results from an analysis of the impact of economic diversification on poverty and its incidence across occupations. The analysis assumes two alternative paths to economic diversification; one that assumes redistribution of sectoral growth rates away from cashew (a pessimistic growth path) and the other based on an assumption of expansion across all sectors of the economy (a more optimistic growth path). The final section concludes.

Guinea-Bissau: Selected Social Indicators, 2006–15

(in indicated measures)[1]

	Per capita Income	Poverty Headcount	Income Distribution	Adult Literacy Rate (%, 15 and older)	Human Development Index
Benin	753	53.1	43.4	34	0.460
Burkina Faso	585	49.5	37.5	31	0.375
Cote d'Ivoire	1,278	29.0	43.2	42	0.444
Guinea Bissau	**518**	**67.1**	**50.7**	59	**0.410**
Mali	689	49.9	36.0	31	0.405
Niger	357	56.0	34.2	17	0.325
Senegal	994	38.0	40.3	48	0.461
Togo	510	54.9	44.1	60	0.461
Regional Average [2]	711	49.7	41.2	40	0.418
Sub-Saharan Africa	1,556	44.1	…	61	…

Source: World Development Indicators, 2015; and authors' estimates.

[1] Poverty headcount measures percent of population that earn less than $1.90 a day (in PPP terms). Income distribution is measured by the GINI coefficient--the lower the more equal income/wealth distribution. Human development measures the composite index (average achievement in the three basic dimensions of human development- a long and healthy life, knowledge and a decent standard of living as prescribed by the United Nations. Per Capita Income measures GDP per Capita (at Constant 2010, US$).

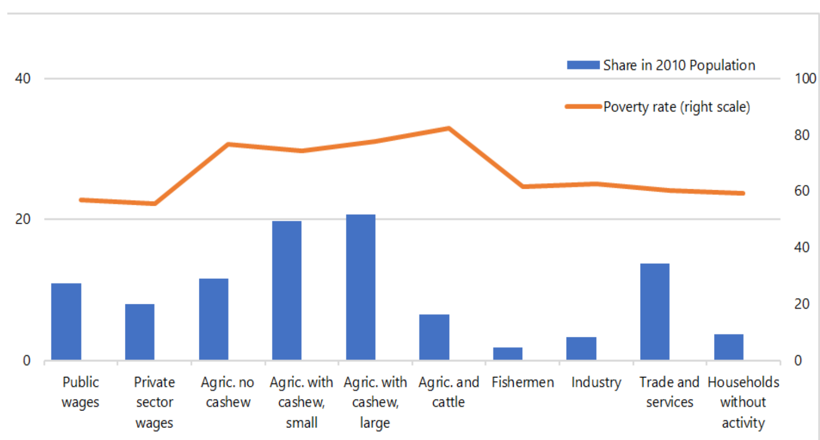
[2] A simple average of indicators for Benin, Burkina Faso, Cote d'Ivoire, Guinea Bissau, Mali, Niger, Senegal and Togo.

B. Results from Cross-Sectional Household Survey (ILAP 2010)

6. **Guinea-Bissau's population is small with a large rural proportion and high concentration in cashew farming.** Out of a population of about 1.8 million, about 60 percent live in households that have the primary sector as the main source of employment and income. Some 40 percent are engaged in cashew production, split roughly equally between small and large plantations. Another 20 percent or so are engaged in other areas of agriculture and fisheries. The remaining roughly 40 percent work mainly in the tertiary sector.

Guinea-Bissau: Occupational Distribution of Poverty, 2010

Poverty remains high in dominant occupations



Sources: Guinea-Bissau ILAP 2010, and authors' estimates.

7. Per the 2002 and 2010 ILAP surveys, poverty has been consistently highest in rural areas and occupations while overall poverty has increased over time. Poverty incidence at the national level, measured as the proportion of the population living on less than US$2 (in 2010 PPP terms) per day, increased by 4.6 percentage points between 2002 and 2010. Extreme poverty (i.e. living on US$1 per day) increased during the same period by some 11 percentage points to 33 percent. In 2010, urban poverty was 58.6 percent and rural poverty 76.4 percent; these figures indicate 5.3 and 6 percentage point increases, respectively, relative to 2002. Extreme poverty increased more in the rural than in the urban areas, increasing the poverty differential across the urban-rural divide.

C. Poverty Under Alternative Policies and Structure

8. The analysis utilizes the 2010 ILAP along with the semi-accounting input-output model of the national economy (TCHINTCHOR). It estimates the evolution of national poverty during 2010–22 under alternative growth paths—the status quo and two more diversified growth paths.[2] The semi-accounting model of the national economy is based on a Social Accountancy Matrix (SAM) that links the different sectors of the economy to the income of the different family categories. In the absence of information on the evolution of population since 2010 and of monetary inputs and outputs across different sectors, agents, and economic activities since 2013, the analysis necessitated three assumptions. First, population across all the households in each category is assumed to grow at an estimated national population growth rate of 2.2 percent a year.[3] Second, the monetary flows across different variables in the SAM remain proportional to those in 2013. Finally, income is assumed to grow at the same rate for every family with a household head working in each occupational category.

9. Three alternative growth paths are considered. Under the status quo—i.e. with cashew production as the dominant income-generating activity—we assume continued expansion of cashew production under favorable terms of trade. An alternative growth path (the economic diversification path) has two branches. The first assumes similar overall

Key Assumptions Under the Scenarios[1]

	2016	2017	2018	2019	2020	2021	2022
Status quo							
Real GDP Growth	5.8	5.5	5.0	5.0	5.0	5.0	5.0
Cashew Exports	161.7	211.9	204.5	201.9	205.6	207.3	211.2
Pessimistic Diversiifcation							
Real GDP Growth	5.8	5.5	5.0	5.0	5.0	5.0	5.0
Cashew Exports	161.7	206.5	185.5	160.5	137.2	109.4	87.7
Optimistic Diversification							
Real GDP Growth	5.8	5.5	5.6	5.8	5.8	5.9	6.5
Cashew Exports	161.7	211.9	204.5	201.9	205.6	207.3	211.2

[1] Real GDP growth is denoted in percent and cashew exports in billions of CFAFs.

[2] While earlier researchers (e.g. Creppy and Wodon (2006)) analyzed the effect of growth variations on poverty incidence in Guinea-Bissau, this chapter examines the impact of redistributing growth among occupations.

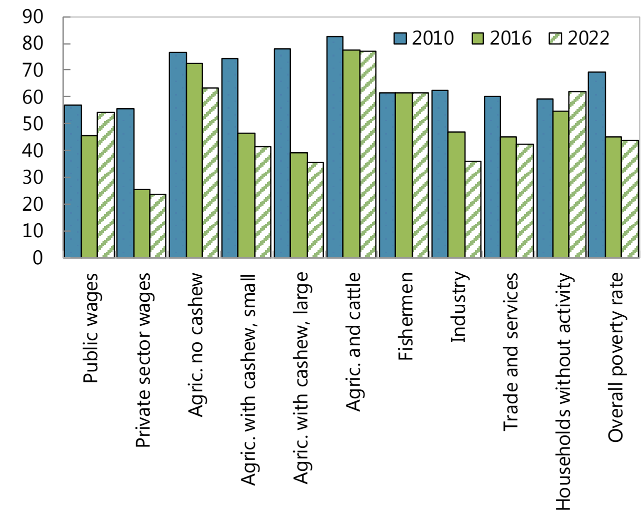
[3] This could pose problems, particularly if the elasticity of head of household occupation to the economic evolution of different economic activities is high. While unfortunately available information does not allow for the estimation of these elasticities, factors such as limited access to credit make it reasonable to think that in the context of Guinea-Bissau these might not be too high in the short run.

growth as under the status quo but with a shrinking cashew sector offset by expansion in other sectors (such as public employment, trade and services). The second branch allows some improvement in overall growth rate under the additional assumption of full delivery of gains from the structural reform agenda, particularly enhancing efficiency in the public service delivery in a more transparent governance environment that supports economic diversification.

10. Maintaining the current growth path reduces poverty, albeit unevenly across occupational groups. Under this scenario, cashew production and related activities are assumed to continue to be the main drivers of economic expansion. Hence, in a period of relatively robust economic growth, driven mainly by cashew production and export, the model predicts an important but far from sufficient reduction in poverty during 2010–16. Overall poverty in 2016 is estimated at 45.2 percent. Even with continued robust growth rates under this *status quo* scenario, however, the projected reduction in poverty rates slows down sharply by the end of the estimation period in 2022. Households that depend on private sector wages along with those engaged in cashew production and industry and trade services witness the largest estimated declines in poverty. Overall poverty declines by some 25 percentage points to 43.7 percent by 2022; urban and rural poverty rates see similar declines to 35.4 and 52.4 percent, respectively.

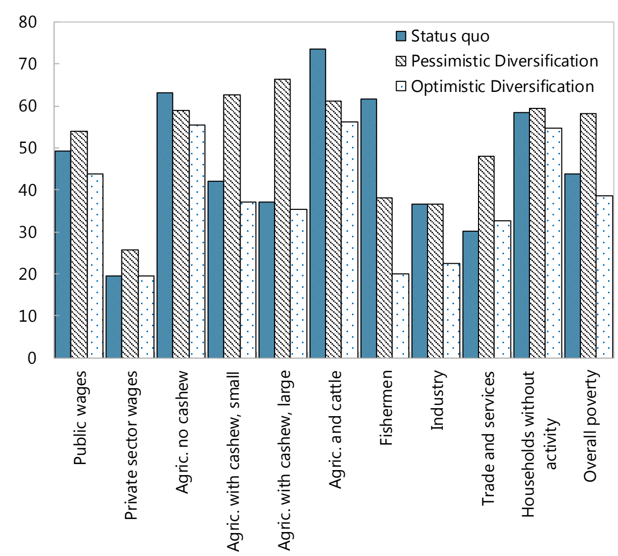
11. Poverty incidence increases under a pessimistic diversification scenario relative to the status quo. Overall poverty incidence under this diversification scenario is slightly higher in the long term, mainly because of the assumption of declining cashew output

Guinea-Bissau: Poverty Incidence under the Status Quo, 2010–22 (in percent)



Sources: Guinea-Bissau ILAP 2010, and authors' estimates.

Guinea-Bissau: Estimated Poverty under Alternative Growth Path, 2022 (in percent)



Sources: Guinea-Bissau ILAP 2010, and authors' estimates.

and income.[4] The rural-urban poverty divide worsens as well. However, differences in poverty rates across occupations are somewhat smaller under this alternative growth path, making it more egalitarian by that measure.

12. Under a more optimistic diversification scenario, growth-enhancing policies unambiguously reduce poverty and income inequality. Under the second alternative growth path—the optimistic diversification scenario—poverty incidence shrinks with enhanced growth rates, reflecting reforms to bolster public service delivery and governance. Income distribution becomes more equal as well, as diversification enhances job opportunities across all non-cashew sectors. Although sensitive to the assumed growth elasticity of diversification, this alternative growth path almost halves overall poverty by 2022 compared to 2010 and it is clearly superior to the other two growth paths. It also outperforms the other two growth paths in declines in both rural and urban poverty rates.

Alternative Poverty Measures and Distributional Analysis

13. Additional poverty measures offer richer perspectives on poverty in Guinea-Bissau. The main advantage of a simple headcount index of poverty (HCI) used in the foregoing analysis is its simplicity and ease of interpretation. However, it does not tell us anything about changes below the poverty line. Alternative indicators, such as a HCI at a lower ($1 a day) poverty line, the poverty gap index (PG), the intensity of poverty index (IP), or the average growth in expenditure per capita for each quantile of the income distribution quantify alternative dimensions of poverty.[5] These additional measures enable a richer understanding of the evolution of poverty in the different scenarios. The additional indicators confirm the superiority of the optimistic diversification scenario over the other two scenarios. Importantly, the reduction in average expenditure

Guinea-Bissau: Poverty Gap and Intensity Across Scenarios[1]
(in percent, unless otherwise indicated)

	2010	2016	2022		
			Status Quo	Diversification	
				Pessimistic	Optimistic
Poverty HCI (< US$ 2/day)	69.3	46.6	43.7	48.3	38.7
Poverty HCI (< US$ 1/day)	33.0	15.7	13.6	23.2	10.2
Poverty Gap [1]	0.32	0.19	0.17	0.25	0.03
Poverty Intensity [1]	0.19	0.1	0.09	0.14	0.02
Change in PC Expenditure (percent per year)					
Total population		9.7	3.0	-0.9	5.7
Poorest half (across deciles)		11.2	3.3	-1.9	6.8
Richest half (across deciles)		9.5	2.9	-0.9	5.7

[1] The poverty gap and intensity indicators relate to the US$2 per day poverty line
Sources: Guinea-Bissau ILAP 2010, and authors' estimates.

[4] In this scenario, the value of cashew exports is assumed to decline by 10 percent in 2018 and continue to fall over the medium term, whereas the status quo scenario has cashew exports falling by 3.5 percent in 2018 and then recovering slightly over the medium term.

[5] The formula used are as follows: Poverty Gap = $\frac{1}{n}\sum_{i=1}^{n}\frac{z-y_i}{z}$; Poverty Intensity = $\frac{1}{n}\sum_{n=i}^{n}\left(\frac{z-y_i}{z}\right)^2$, where z indicates the threshold income determining the poverty line, y_i refers to individual income, for agents *i = 1,2,…,n*. Average Change in Expenditure per capita for each decile *p* of the distribution, (directly related to the *growth incidence curve* defined by Ravallion and Chen (2003) is given by ACEpc(*p*)=$\frac{Y_{t(p)}}{Y_{t-1(p)}} - 1$, where $Y_{t(p)}$ is income in period *t* for those families in decile *p*.

per capita in the pessimistic scenario illustrates the strong relationship between poverty and cashew production In Guinea-Bissau. The low values of the Poverty Gap and the Intensity of Poverty in the optimistic scenario indicate the potential for a combination of good performance of the cashew sector and increasing economic diversification to significantly reduce the incidence of the most severe forms of poverty in the country.

D. Conclusion

14. Conflict and political instability have resulted in high poverty. Sustained strong growth is needed to simply revert poverty back to the levels prior to the 1998 civil war. The analysis finds that growth in cashew production and other agriculture—the areas where poverty is highest—is especially important to alleviate poverty. However, a more diversified growth path that brings higher overall growth reduces poverty more effectively along all dimensions.

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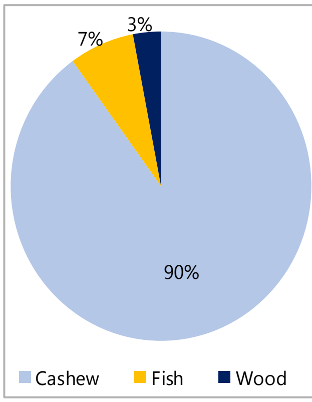
DIVERSIFICATION IN GUINEA-BISSAU[1]

This chapter discusses the challenges Guinea-Bissau faces in diversifying its economy. Drawing on a combination of cross-country econometrics and case studies, the chapter evaluates which structural reforms and policies would contribute to a successful diversification take-off in Guinea-Bissau. The findings underscore the need for investing in human capital, improving the business environment, strengthening governance, increasing government effectiveness, promoting financial deepening, and improving the quality of infrastructure.

A. Stylized Facts

1. Guinea-Bissau is a small open economy that is highly dependent on the production and export of one product: cashew nuts (Figure 1). Cashew represents about 90 percent of total exports and more than half of households are thought to be engaged in its production, processing, or sale. Most cashew is exported in raw form and mainly to India where it is processed for sale around the world. The highly undiversified pattern of exports leaves the country exposed to fluctuations in international commodity prices and to local weather events.

Figure 1. Guinea-Bissau: Composition of Exports and Trading Partners, 2010–17



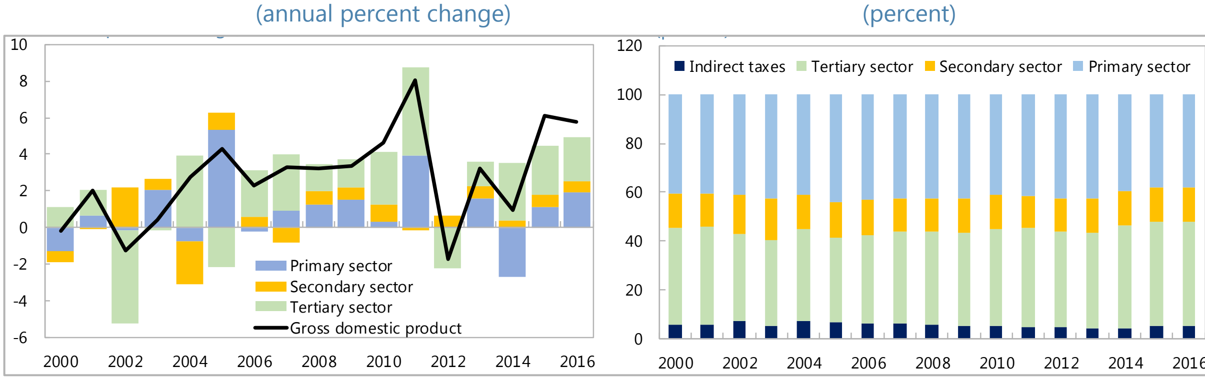
Share of total exports	
India	68.2
SSA	15.3
Vietnam	5.3
China	5.2
Europe	1.7
Brazil	0.9
Middle East	0.8
Others	2.5

Sources: National authorities' numbers; and Direction of Trade Statistics.

2. The structure of the economy has changed little in recent decades. The primary sector and services each represent about 40 percent of real GDP and those shares have been broadly unchanged since at least 2000, despite volatile growth rates from year to year (Figure 2). The secondary sector, which includes manufacturing, has remained small.

Figure 2. Real GDP Contributions by Sector and by Real Sectoral Share

(annual percent change) (percent)

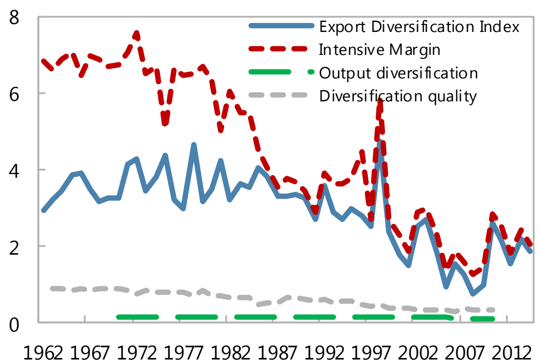


Sources: INE, MEF, IMF staff calculations.

[1] Prepared by Cristina Cheptea.

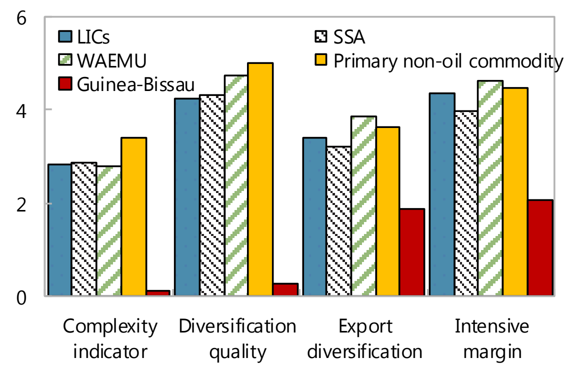
3. The broadly unchanged sectoral composition of the economy reflects little or no movement towards diversification. Guinea-Bissau has always been dependent on just a few products for export—before cashews it was peanuts—but, by most measures, the country has become less diversified since 1980s. (Figure 3). This contrast with the pattern elsewhere in Sub-Saharan Africa (SSA), where many economies have become more diversified. As a result, Guinea-Bissau falls far below regional averages on different measures of diversification (Box 1 and Figure 4). By one measure (Figure 5), which captures export diversification, it is the second least diversified economy in SSA. By another measure (Figure 6), which considers the complexity of products produced, Guinea-Bissau is the least diversified country in the world, falling below many countries with lower levels of per capita GDP.

Figure 3. Guinea-Bissau: Diversification Index
(Index, Higher Values = Higher Diversification)



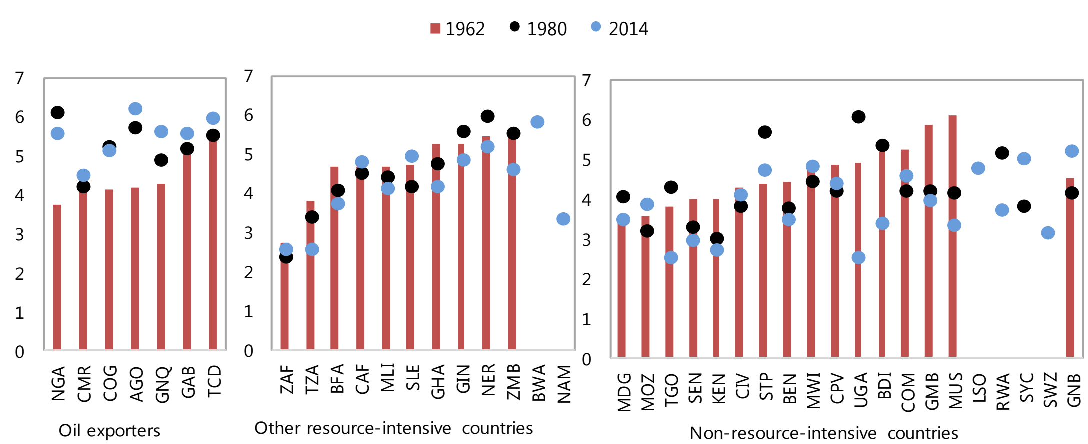
Sources: IMF Diversification Toolkit; Comtrade.

Figure 4. Diversification Indices Across Country Groups (Index, Higher Value = Better)



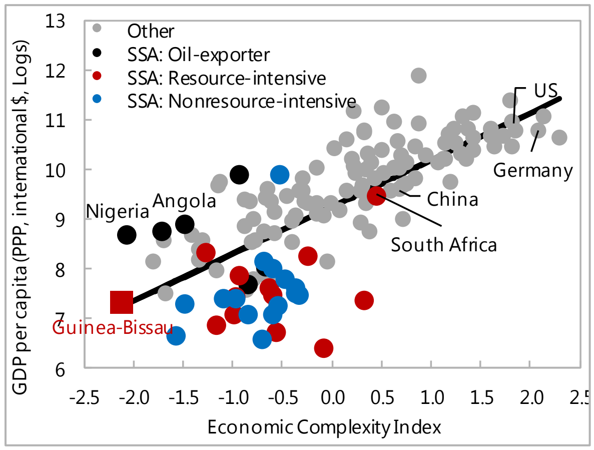
Sources: IMF Diversification Toolkit; Comtrade.

Figure 5. Export Diversification by Country
(Theil Index, Lower Value = Higher Diversification)



Source IMF Diversification Toolkit; Comtrade.
Note: Note: For Malawi, Tanzania, and Zambia the red bars represent the value for the diversification index in 1965; for Cabo Verde, Comoros, Equatorial Guinea, São Tomé and Príncipe, and Seychelles; the blue dots represent the value for the diversification index in 2013.

Figure 6. Export Complexity and Per Capita GDP, 2015



Sources: Observatory of Economic Complexity and World Bank's World Development Index.

Box 1. Measures of Diversification

The ***export product diversification index*** reflects the number of products a country exports and the extent to which the export structure is concentrated on a few products. By construction, lower index values indicate higher levels of export diversification. Mathematically, this is the Theil index of export diversification (IMF 2014a), which consists of a "between" and a "within" sub-index.

$$Theil\ Index = \frac{1}{N}\sum_{i}^{N}\frac{Export\ Value_i}{Average\ Exp.\ Value}\cdot\ln\frac{Export\ Value_i}{Average\ Exp.\ Value}$$

$$= Theil_{between} + Theil_{within},$$

In this equation, i is the product index and N the total number of products. The "between" Theil index captures the extensive margin of diversification, that is how many goods a country exports. Lower values represent a higher number of products in the economy. The "within" Theil dimension captures the intensive margin, that is how concentrated a county's export base is. Higher values represent a more concentrated distribution.

The ***output diversification index*** is derived similarly to the export Theil index described above, using real subsectors from the United Nation's sectoral database (IMF 2014).

The ***export product quality*** index proxies the quality of a country's export products by the mark-up they command. Mathematically, the index is measured by the export's unit value adjusted for differences in production costs and the relative distance to the trading partner. The higher the cost a country can charge for its exports, adjusted for these factors, the higher the export quality according to this index. The index is normalized for each year to show export quality relative to the rest of the world, thus giving a relative ranking of each country for each year.

The ***economic complexity index*** assigns higher weights to goods requiring more complex skills, knowledge and infrastructure to be produced. Goods with lower complexity such as commodities, tend to require fewer underlying capabilities, while machinery and equipment, tend to be more complex to produce and are also better connected, implying that they are more likely to be associated with the underlying capabilities to produce a wider range of goods (Hausmann and others, 2011).

B. Why Diversify

4. **Diversification has clear benefits.** International evidence shows that diversification is associated with higher growth and lower output volatility (Papageorgiou and Spatafora, 2012; and IMF 2014a). There is growing evidence that diversification is especially important in the early stages of the development process (Cadot et al., 2011), and also evidence that export diversification and the reallocation of resources from less to more productive sectors are linked (McMillan and Rodrik, 2011). In general, the picture that emerges is that overall trade flows are lower where the exporting country has a relatively small manufacturing sector and where exports are less diversified.

5. **While the benefits of diversification are well documented, it is less clear how best to achieve diversification.** The conventional view, based on the experiences of industrialized countries, is to move from agriculture to industry/manufacturing and then to services (McMillan and Rodrik, 2011). An alternative view, suggests scope to move directly from agriculture to services (Carmignani and Mandeville, 2010). Others (IMF 2014a) suggest focusing on quality upgrading.

C. The Policy Mix

6. **Cross-country analysis provides insights into which structural reforms are associated with greater diversification.** We estimated the following model using univariate panel fixed effects estimators:

$$\text{Diversification}_{it} = \beta_1 \text{ Structaral Factors}_{it} + \gamma \text{ Policies}_{it} + \mu_i + \nu_t + \varepsilon_{it}$$

Here *Diversification*$_{it}$ is one of six measures of diversification: export diversification index (total Theil, between Theil and within Theil), output diversification index, export quality index, and economic complexity index. *Structural Factors*$_{it}$ are country characteristics and initial conditions that may significantly impact a country's ability to diversify, including ones previously highlighted in the literature, such as real GDP per capita (and its square), population size, an index of human capital, and the share of fuel exports.[2] *Policies*$_{it}$ is one of 316 indicators from six broad categories. μ_i, ν_t *and* ε_{it} stand for country fixed effects, time fixed effects and the error term, respectively. The model was estimated using a sample of 182 countries for the period 1962-2016. We use fixed effects regressions to account for structural country characteristics and initial conditions.[3] The results are only suggestive, as they do not establish causation and do not consider interactions between policy indicators.

7. **The results show that the same variables widely regarded as improving economic growth and stability also have positive links to diversification.** The fact that these variables have an additional positive impact on growth and stability via diversification only adds to an already strong argument for implementing them. In general, broader measures (such as overall risk rating,

[2] The structural factors identified as having a potential effect on diversification were drawn from a variety of sources: Fraser Institute; IMF, Export Diversification and Quality database, World Economic Outlook database; Transparency International; The PBS group; World Bank Doing Business database, World Developmental Indicators, Worldwide Governance indicators; and World Economic Forum. The list of variables and data is available upon request.

[3] Bayesian Model Averaging would have been preferable to test these variables jointly. However, to test all variables, would have necessitated the same country and time sample for each indicator, which is impossible to achieve with this large number of granular indicators.

primary education, estimates of government effectiveness) were found to be more closely associated with diversification than more detailed measures or measures less likely to have a wide impact (such as number of firms offering training, agricultural policy costs, efficacy of corporate boards, or flexibility of wage determination). An overview of the results (see Table 1) is as follows:

At all stages of development, *macroeconomic stability and efficient government operations* create the foundations for diversification efforts to develop.

- All measures of diversification are closely associated with a country's economic risk rating. Lower economic risk allows for long-term planning by the private sector and hence higher investment. Similar results hold for more detailed indicators of macroeconomic management, such as lower debt service and higher budget balances, highlighting that prudent fiscal management is good not only for growth but also for diversification.
- The efficiency and quality of government procedures and service delivery also matter. Diversification measures are closely linked to government effectiveness. The quality of roads, railroad, and port infrastructure were found to be more closely associated with diversification than the quantity of roads. For SSA, improving electric power transmission and distribution were found to be closely linked with greater output diversification and higher quality of diversification.
- Measures of political instability are negatively associated with various diversification measures. Political instability would be expected to have a poisonous impact on innovation and investment. It increases the risks associated with investments, particularly investments in newer industries that may not receive favorable treatment because of their lack of systemic importance or because their participants are less well connected.

Human capital formation has, as could be expected, a positive impact on the amount and quality of diversification. A healthy and well-educated workforce has greater capacity to produce and innovate. It will also most likely be wealthier, and thus generate local demand for a greater variety of goods. Indeed, most measures of education were highly significant in the analysis, with primary school enrollment the third most commonly significant variable, and education spending also positively associated with most diversification measures across countries.

Strong institutions are also associated with multiple measures of diversification. General business regulation, regulatory quality, property rights, and general law and order are associated with greater diversification for all groups of countries. While local supplier quantity and quality and the extent of marketing generally matter, they appear to be less important in SSA than elsewhere, while the number of procedures to start a business and the time required to get electricity matters relatively more in SSA. Compliance costs of importing and exporting and regulatory trade barriers are closely associated with export diversification, with SSA countries on average scoring poorly on the number of documents required to import and export.

Finally, measures of *financial development* are closely associated with diversification. The presence of foreign banks was the second most significant variable for all countries. Consistently, the ratio of bank credit to deposits and indicators of access to credit and the degree of competition in the banking system were found to be relevant factors in low-income countries and sub-Saharan Africa.

Moreover, financial stability matters, as evidenced by the negative association between nonperforming loans and diversification.

Table 1. Hit Map: Top 50 Indicators and Their Level of Significance

(by Country, Category, and Diversification Index)

		All countries						LIC						SSA					
	Expected sign	Export Diversification	Extensive Margin	Intensive Margin	Output diversification	Diversification quality	Economic Complexity	Export Diversification	Extensive Margin	Intensive Margin	Output diversification	Diversification quality	Economic Complexity	Export Diversification	Extensive Margin	Intensive Margin	Output diversification	Diversification quality	Economic Complexity
Macro / Cyclical factors																			
Economic risk rating	-	-	+	-	-	-	-	-		-	-	-	-	-		-	-	-	-
Log(Real Effective Exchange Rate)	-	-	-	-	-	+	-	-	-	-	-			-	-	-	+		
Terms of trade	-	-	-	-	-	+		-	-	-		+		-	-	-		+	
Personal remittances, paid	+	-				+	+	+		+		+	+	+		+	+	+	+
Domestic market size index	+	-	+	-	-	-	+	-	+	-	+			-		-			
Socioeconomic conditions	+	-	-	-	-	+	-	+				+		+	+		+	+	
Risk for debt service	-	-		-	-	-	-	-		-		-	+	-		-			
Risk for budget balance	-	-	-	-	-		-	-		-			-			-			-
Quality of port infrastructure	+	+		+	+		-		-	+			-	+		+			-
Political																			
Religious tensions	-	-	-		-	+	-	-		-	-	+	-	-		-	+	+	-
Military interference in rule of law and politics	+	+		+	-	+	-				-	+	-	+	+	+	+	+	-
Political risk rating	+	+	-		-		-			-		+	-	+	+	+	+	+	-
Economic freedom summary index	+	+		+	-		-	+		+	-			+	+	+	-		
Composite risk rating	-	+			-		-	-		-	-		-				+	+	-
Voice and accountability	+	+		+	-	+		+		+		+	+	+				+	
Ethnic tensions	-		-		-	+	-	-	-		-		-		-				-
Cross-border conflict	-	-		-		-	-	-		-			-	-		-			-
Regulatory environment and institutions																			
Legal System & Property Rights	+	+		+	-	+	-	+		+		+		+		+	-	+	-
Regulatory restrictions on the sale of real property	+	+		+		+		+		+			-	+	-	+		+	-
Regulation of business, credit and labor markets	+	+	+	+	-	-		+		+	-			+	+	+	-		+
Regulatory Quality	+	+		+		+				+	+	+	-		-	+	+	+	
Extent of marketing	+	+	-	+	-	+	+				-	+	+					+	+
Business regulations	+	+		+			+	+		+			-	+	+	+	+		
Time required to start a business (days)	-	+	-	-	-			-		-		-	+	-					
Compliance costs of importing and exporting	+	+		+		-	-	+		+	+			+		+			-
Hiring and firing regulations	+	+	+	+		+	+			+			-	+		+			-
Hiring regulations and minimum wage	+	+			+	+	-	+	+	+			-	+	+	+		+	
Mandated cost of worker dismissal	-		-		+		-	-		-	+	-		-		-		-	
Government effectiveness	+	+		+		+	+			+	+	+	+	+		+		+	+
Bureaucracy quality	+	+	+		+	+		+	+			+	+	+	+		+	+	
Bureaucracy costs	-	+		+	-		+	+		+		+		+		+	-	+	
Administrative requirements	+		+	+	-					+			-	+	+	+			-
Control of Corruption	+	+		+	-	+	+				+	+	+			+		+	
Human capital formation																			
Primary school enrollment	+	+	+	+	-	+		+		+	-	+			+	-	-	-	-
Life expectancy at birth (years)	+		+	-	-	-	-	-	-	-			+	-			-		
Tertiary School enrollment	+	+				-	-	+			-	-	-	+			-	+	
Upper secondary pupil-teacher ratio	-	-		-	-			-		-	-			-			+		-
Current education expenditure (% of total expenditure)	+	+		+		+		+		+	+		-	+			+		
Capacity for innovation	+				-		+		+	-	-			-	+	-	-	+	+
Availability of latest technologies	+			+	+	+	-		-	+				+		+		+	-
Gini coefficient	+		-		+	-					+	+		-	-	-	+	+	-
Financial development																			
Domestic credit to private sector (% of GDP)	+	+		+		+	+	+		+	-	+		+		+	-	+	
Capital controls	+	+	-	+	-		-	+		+				+		+	+	+	-
Bank credit to bank deposits (%)	+	+		+	-		+	+		+	-		+	+		+	-		+
Financial system deposits (% of GDP)	+	+		+	+	+				+	-		-	+			+	+	-
Herfindahl-Hirschman index	+	-			+	-	-	-			+	+		-	-	-	+		
Foreign banks (% total banks)	+	+	-	+	-	+	+				-		+				-		+
Controls of the movement of capital and people	+	+	-	+			-	+		+				+			+	+	-
Bank deposits (% of GDP)	+			+	+	+	+				-		-	+			-	+	-
Ease of access to loans	+	+		+	-		+	+	+		-						-		+

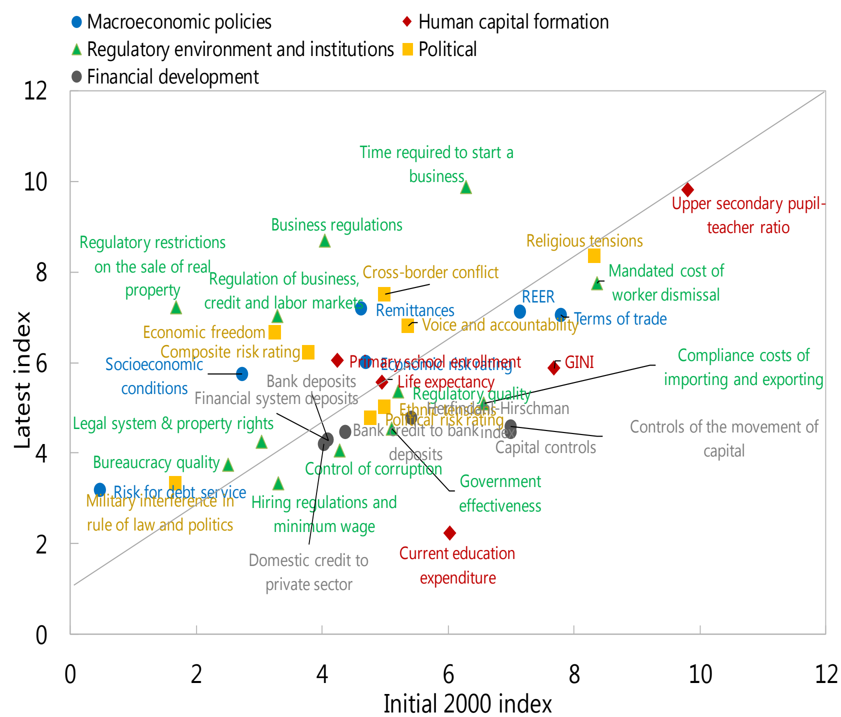
Note: Results from fixed effects panel regressions. Dependent variable is one of the 6 diversification indices for each group of countries. The sample consists of 182 countries for the period 1962-2015. "All" stands for the whole sample of countries, "LIC" for Low Income Countries and "SSA" for Sub-Saharan African countries. Plus and minus signs represent the coefficient result. Red indicates significance at the 1 percent level, green at 5 percent and yellow at 10 percent level. Bolded variables are those for which at least for 3 measures are significant at 1 percent level for SSA group and have the expected sign.

8. **The results are in line with the existing literature.** There is a large body of research that documents how policies that improve the quality of institutions or reduce barriers to innovation, technological adoption, and trade—together with political stability and the right mix of macro policies—are associated with higher growth and diversification (Acemoglu and Robinson, 2008;

Christiansen and others, 2013; IMF, 2014; Ostry and others, 2009; Prati and others, 2013). In addition, productivity payoffs have been found to vary across countries and stages of economic development, thus requiring different sets of reform priorities (Dabla-Norris, Ho and Kyobe, 2016).

9. The plethora of results implies that there are many routes to diversification. A large set of measures can help promote diversification. At the same time, challenges vary by country and over time, suggesting that optimal policies will vary widely as well. The timing and sequencing of reform will also matter: some reforms, such as agricultural and capital market development, are associated with productivity growth in the short-term, while others, such as trade liberalization and labor market reform take longer to bear fruit.

Figure 7. Guinea-Bissau (Index, higher=better)



Sources: Fraser Institute, IMF, IFS, WEO, PRS Group, World Economic Forum, World Bank, Doing Business Database, Governance Indicators, and World Development Indicators.

10. Figure 7 shows Guinea-Bissau's progress on indicators found to be associated with diversification. There has been most progress on indicators related to macroeconomic policies and political stability, while the picture is more mixed on financial development and the regulatory environment. Least progress has been made on human capital formation: for instance, current education expenditure has fallen considerably since 2000 and income inequality deteriorated.

D. Case Studies

11. Country experiences illustrate how certain policies have worked in particular circumstances. A complimentary approach to the cross-country regressions is to look at country experiences. Diversification seems to follow different paths depending on country endowments and circumstances. We focus on two countries: Mauritius and Burkina Faso (Box 2), which share some similarities to Guinea-Bissau's starting point and circumstances. IMF 2017, McMillan and others (2017) and Easterly and Reshef (2010) describe several SSA examples in more details.

Box 2. What Works — Diversification Strategy in Mauritius and Rwanda

Mauritius: Emerging from a mono-crop economy by targeting increased diversification and sophistication.

Context. At independence in 1968, Mauritius was a poor country heavily dependent on one basic commodity; sugar made up 70 percent of its exports. By 2012, it had one of the highest per capita incomes in SSA. It had significantly diversified both its economic output and geographical dependence on markets. Agriculture represented less than 4 percent of GDP, a lower share than that of education. The categories "Finance and Insurance" and "Wholesale and Retail Trade" each represented more than a tenth of the economy, and "Manufacturing and Construction" represented nearly a quarter. At the same time, Mauritius had expanded as a regional financial and trade hub and reduced its dependence on European markets.

Policies. The diversification strategy began at independence with efforts first into other agricultural primary products, including tea and tobacco. Starting in the 1970s, this effort was expanded to other sectors, including textiles and tourism, and was supported by the development of national infrastructure (road networks, airports, ports, water, and electricity) and human capital (free education and healthcare combined with social safety nets). As Mauritian enterprises moved into more advanced manufacturing and service sectors in the 1980s and 1990s, they were further supported by growth-friendly institutions that promoted a favorable business environment and maintained the rule of law and social stability.

Progress to date includes:

- Leveraging its favorable position on trade routes, Mauritius negotiated preferential access to markets, including the EU, USA, COMESA, and SADC, and established freeport status for manufacturing exports (Mauritius Freeport) in 1992.
- Tax reforms increased the share of revenue in GDP and made the system progressive. These reforms included a simplified tax regime with tax holidays and generous depreciation schedules, applied equally to all sectors, a moderate non-distortionary property tax, sharp reductions in import taxes, and reductions in official discretion.
- Proactive measures were undertaken to support small and medium-sized enterprises (SMEs), with a greater openness to foreign capital, skills, and ideas.
- Labor market reforms promoted flexibility, while targeted social safety nets were reinforced.
- Other measures included removing barriers to travel; extending double taxation avoidance and investment promotion and protection agreements; fast tracking regional integration; and launching the Africa Center of Excellence for Business in 2012.

Burkina Faso: increasing productivity in agriculture by overcoming financial, infrastructure, and scale constraints.

Context: The history of large-scale cotton production in Burkina Faso goes back to the colonial era. Burkina-Faso managed to achieve a three-fold increase in productivity from late 1990s to mid-2000s (IMF 2014b). This contributed to a doubling of per-capita GDP between 1995 and 2006. The cotton sector employs nearly twenty percent of the active labor force. Moreover, with virtually all cotton produced destined for foreign markets, improvements in the sector provided an important source of export growth.

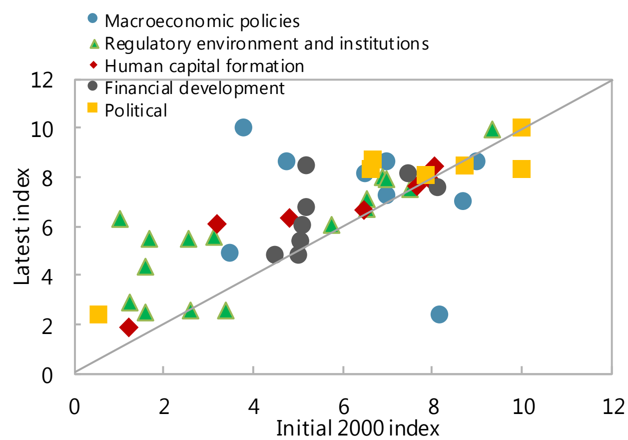
Policies. At the heart of the success of cotton in Burkina Faso is a reform model that deliberately tried to overcome financial, infrastructure, and scale constraints. Small-scale cotton producers, large cotton purchasing (and export) companies, and government collaborated in these efforts. The reform model was based on a mix of institution building, partial privatization, and the creation of complementary financial support mechanisms. Reforms struck a balance between promoting competition, overcoming market failures, and establishing structures to facilitate cooperation. Diversifying from the cotton sector, the government has recently introduced promotion of crop diversity combined with a focus on large-scale production of oil seed and fruits.

Box 2. What Works — Diversification Strategy in Mauritius and Rwanda (concluded)

A pre-financing fund was set up to overcome the financial constraints of small scale cotton producers in accessing credit. The Input Fund guarantees farmers access to seeds, fertilizer, etc., at the start of the planting season on affordable terms. Farmers are guaranteed a price floor for their cotton, which provides an important source of risk-minimization. The price floor is guaranteed by a Price Stabilization Fund, operated by the cotton association, which pays out when global prices are below the floor and replenishes when prices are above, thus providing an important source of hedging for producers who would be unable to do so individually. Both the Input Fund and Price Stabilization Fund are designed to operate in a financially sustainable manner, but government and donor support was necessary at the inception, and, at times, to maintain capital buffers.

12. **Mauritius is one of the most successful countries in diversifying its economy given its low starting point.** By adopting a well-defined strategy, aligned with the country's comparative advantage at different stages of its development and executing it in several "waves" of reforms, it transformed itself. Starting out as a mono-crop economy, Mauritius developed its agriculture sector, branched into textiles and tourism, and eventually becoming a regional financial center. A strong focus on a conducive business environment and investment in human capital combined with social stability facilitated the transition. Reflecting the country's strong policy determination, almost all indicators that are positively associated with diversification have improved (Figure 8).

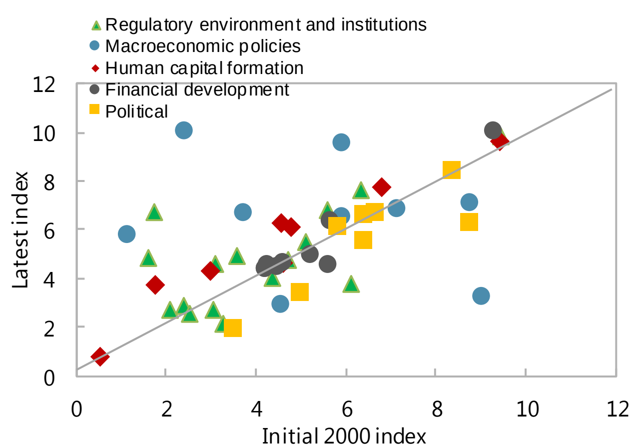
Figure 8. Mauritius (Index, higher=better)



Sources: Fraser Institute; IMF; PRS Group; WEF; World Bank.
Notes: Each category contains several indicators.

13. **Burkina Faso has successfully raised agricultural productivity and made the sector more competitive.** Cotton is the dominant agriculture product and was an important factor in doubling the country's GDP per capita between 1995 and 2006. Burkina Faso embarked on a reform model based on a mix of institution building, partial privatization, gradual delegation, and creation of complementary support mechanisms. A strong focus on consensus building throughout the reform process has helped. A substantial share of indicators associated with diversification (Figure 9) have improved over the last decade.

Figure 9. Burkina Faso (Index, higher=better)



Sources: Fraser Institute; IMF; PRS Group; WEF; World Bank.
Notes: Each category contains several indicators.

14. Country experiences illustrate that successful diversification does not happen by accident. Some common threads emerge: successful diversification coincided with political stability, sound macroeconomic policies, and investment in people. Many countries have pursued not just a few interventions, but rather a range of interventions in different areas. Successful cases highlight the need for focused strategy and sound planning. All countries have faced evolving challenges that required different sets of reforms, with successful countries exploiting their comparative advantage while considering changing external conditions. Countries that are similar in terms of fundamentals (quality of institutions, human capital, natural endowments, geography, etc.) may end up with different patterns of specialization. Haussmann and others (2007) argue that specialization patterns are shaped by idiosyncratic elements and that government policies play an important role in shaping the production structure.

15. The empirical analysis as well as the case studies highlight possible components to successful diversification but there is no preset road map. Countries need to consider their own path, while at the same time addressing weak fundamentals, focusing on improving the quality of institutions and human capital; pursuing stable and sound macroeconomic policies; balancing between market and state, and limiting interventions while playing a sufficiently active role in addressing market failures. A diagnosis of impeding constraints can help (Hausmann and others 2005), but it is important to adopt a strategy and pursue it with sound planning, recognizing that some reforms take a long time.

E. Policy Considerations for Guinea-Bissau

16. The small size of Guinea-Bissau places special importance on a potential trade-off between product diversification and quality upgrading. The small size of the country limits its potential to exploit economies of scale and hence the number of new products can branch into. Moreover, international experience shows that new export goods tend to be products that are located close to each other on the network map. This suggests that focusing on generating more value-added in cashew production (e.g. by expanding local processing) and moving into export of other crops might be the first step towards diversification.

17. Another consideration is the importance of a stable and conducive environment for business. Guinea-Bissau's history of conflict and political instability has largely prevented long term planning and sustained policy implementation. This also means, however, that incremental steps to institute greater policy stability, transparency, and predictability can make a large difference. Indeed, the low starting point suggests a focus on easy wins. Guinea-Bissau managed to improve its position by 5 ranks in the World Bank's survey-based "Doing Business Index" moving from the 177th position in 2016 to 172nd in 2017 (see Annex V External Stability Assessment for details about the current business environment and governance indicators), and there is clearly scope for continued advancement in this area.

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RECENT CREDIT DEVELOPMENTS AND OBSTACLES TO FINANCIAL DEEPENING[1]

A. Background

1. Guinea-Bissau has a small and rather underdeveloped financial system. There are five banks, all foreign-owned though the largest has local minority shareholders. Within corporate credit, banks mostly finance the trading sector, particularly cashew exporters and importers of fuel and foodstuffs, and mostly at short maturities. With credit amounting to only about CFAF 125 billion, the banking system is the smallest in the WAEMU region, accounting only for 0.8 percent of total credit, and relative to the size of the economy it is also on the small end. Activity on the interbank market is low, and financial markets are underdeveloped. Further, credit has not grown noticeably in recent years.

2. Credit risk is elevated and holds back financing of the economy. Rising levels of non-performing loans (NPLs) following the 2012 *coup d'état* exacerbated bank lending and led in 2015 to an ill-conceived bailout by the government of two banks with particularly high NPLs. This bailout was subsequently voided by the government. Although the two banks are contesting that decision in the court system, they are de-risking their portfolios to comply with more stringent regulation, including a higher minimum capital requirement, and have consequently put a lid on new lending. In general, credit risk remains high because of political instability, economic volatility, and the perceived weak rule of law. Banks have resolved to screen potential clients carefully, seeking to avoid a build-up of further credit risk. Also, they have invested in government bonds on the regional securities market, taking advantage of the spread between government bond yields and the BCEAO refinancing rate (IMF, 2016).

3. Low financial development appears to be obstructing broader economic development. Guinea-Bissau shows particularly low numbers in financial deepening, both from the perspective of credit penetration (credit-to-GDP ratio) and the state of development of financial institutions and financial markets (financial development index). Scarcity of longer-term lending seems to reflect both demand and supply factors: for one thing, some economic sectors are too volatile or simply not developed enough to have stable demand for bank credit; for another, banks themselves have only a small base of longer-term funding at their disposal. Even so, anecdotal evidence, gathered by the mission in interviews with the banks and from their responses to a questionnaire, indicates that there is sizable unmet credit demand.

B. Recent Credit Developments

4. Credit developments have been uneven, both over time and lately within the banking sector. The 2012 coup put an abrupt end to a period of rapid credit expansion. Together with poor harvests and falling cashew prices, the crisis led to sharply rising NPLs and eventually the 2015

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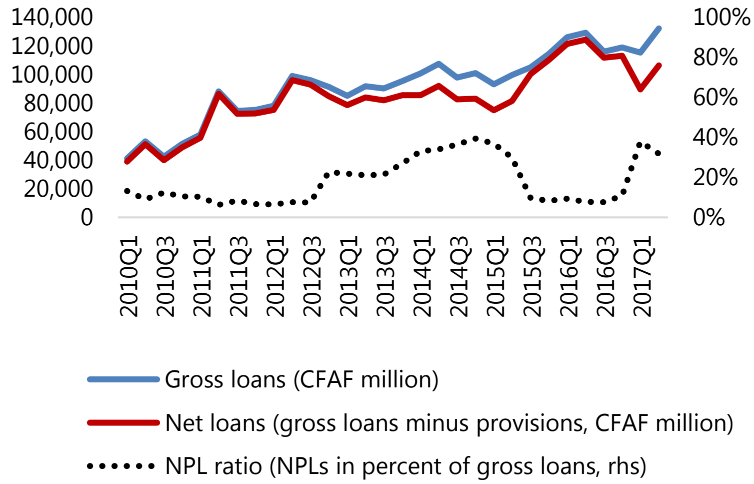
[1] Prepared by Torsten Wezel.

bailout. The evolution of net loans—the BCEAO's primary credit concept—reflects the impact of the NPLs via loan loss provisions, particularly during the bailout period in 2015–16. Net credit rose in 2015, as the bailout removed bad loans from the two banks' balance sheets and allowed them to release the provisions already made on the NPLs. In early 2017, following the government's voiding of the bailouts, net credit fell due to increased provisions required by the regional banking commission. At the same time, aggregate credit growth has masked opposing tendencies among individual banks: while the two bailout banks deleveraged and shrank their loan exposures, their competitors, including a new entrant bank, partially took up the slack in lending. The rapid expansion of credit by the sounder banks is testament to robust credit demand associated with high rates of economic growth since 2015.

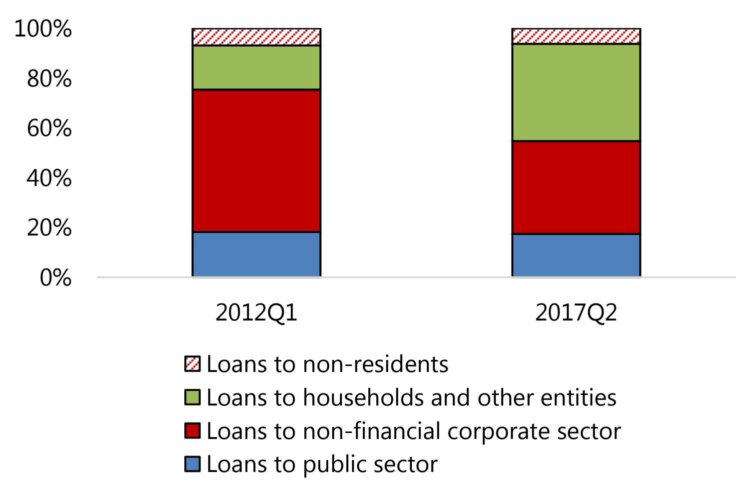
Figure 1. Bank Credit and NPL Ratio



Sources: BCEAO; and staff estimates.

5. The composition of bank credit has partly changed relative to pre-crisis times. While exposures to the public sector and to non-residents have broadly kept their shares in total loans from early 2012, credit to the non-financial corporate sector has been cut in half in relative terms. Banks have shied away from the riskier exposures that many companies represent according to banks' rating systems. This has especially been the case for the cashew sector, which was the main cause of the run-up in NPLs and is still seen as excessively risky by some banks. Instead, banks have been diversifying their private sector lending, turning increasingly to consumer credit and some even delving into mortgage credit.

Figure 2. Credit by Major Sector

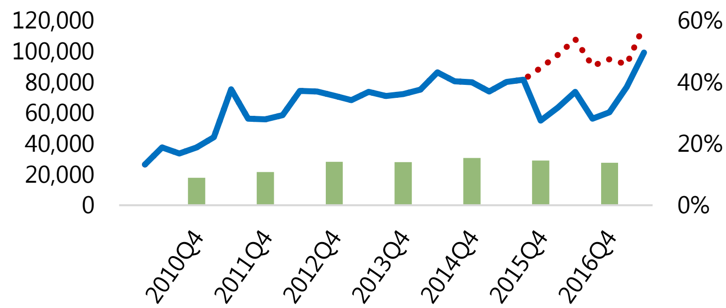


Sources: BCEAO; and staff estimates.

C. Obstacles to Financial Deepening

6. Financial development is very low in Guinea-Bissau, even when making allowances for the country's relatively weak fundamentals. At end-2016, the total credit-to-GDP ratio stood at 17.2 percent. Credit to the private sector has lately receded slightly in relative terms, amounting to 13.6 percent of GDP. In Figure 3, the effect of the 2015 bailout on private sector credit has been undone (dotted line).[2] The private sector credit-to-GDP ratio is below the average of other fragile states (22.1 percent at end-2016) and also lower than the average of fragile SSA countries for which the ratio is available (17.8 percent, end-2016; Figure 4).

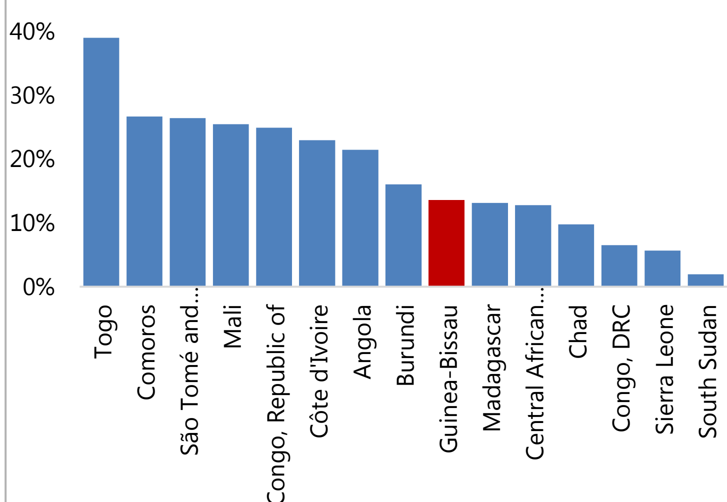
Figure 3. Bank Credit to the Private Sector



Sources: BCEAO; and staff estimates.

7. The level of credit in the economy is lower than what would have been expected from a cross-country perspective. Based on a World Bank methodology calculating a financial possibility frontier beyond which financial stability risks may arise, Guinea-Bissau, at the end of a short-lived credit acceleration in 2013, still showed a slight gap between the actual credit ratio and the frontier ratio (Marchettini and Maino, 2015). Another World Bank source, the Financial Development Index, which assesses financial institutions and financial markets, suggests that financial development in Guinea-Bissau is as low as it was in 1980, while many other non-resource-intensive countries in Sub-Saharan Africa (SSA), such as Mauritius and Seychelles, have advanced considerably from that same low level (Figure 5).

Figure 4. Private Sector Credit-to-GDP, SSA Fragile States, End-2016



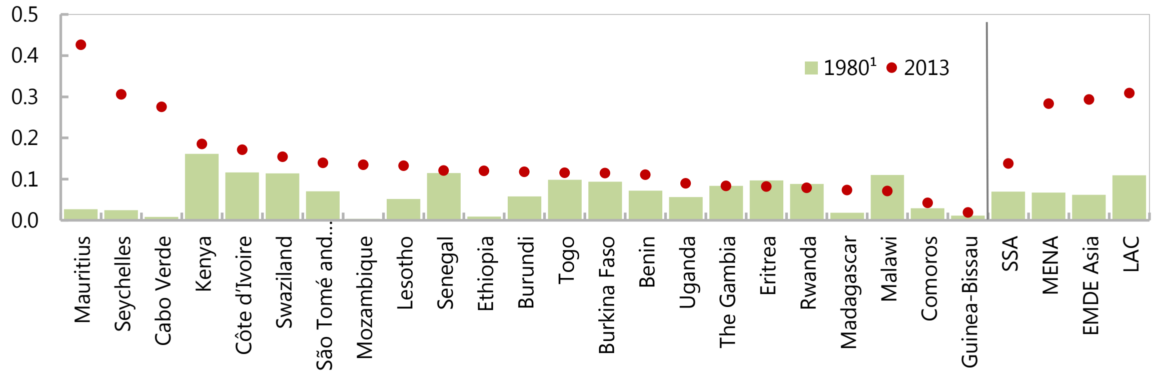
Sources: IFS; and WEO.

[2] While one of the bailout banks, per the order of the Banking Commission, removed the bailout loan from its balance sheet in 2017Q1 and re-instated the non-performing loans, the other done has not do so. For this reason, there is still a difference between official and corrected private sector credit in 2017Q2.

IMF research (IMF, 2016, based on Sahay et al., 2015) suggests that Guinea-Bissau could experience lower volatilty of economic growth if it made more progress with financial development.

Figure 5. Financial Development Index

(1980/2013)



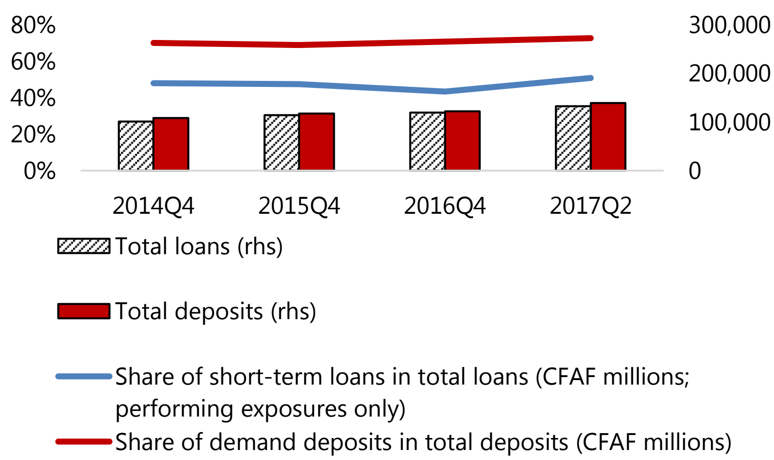
Source: IMF (2016a).

Note: EMDE Asia = emerging market and developing Asia; LAC = Latin America and the Caribbean; LIC = low-income countries; MENA = Middle East and North Africa region; SSA = sub-Saharan Africa.

[1] 2000 for Eritrea; 1990 for Mozambique and São Tomé and Príncipe.

8. **Banks are constrained in longer-term lending by a lack of bankable projects and a high share of short-term funding.** Loans with medium- and longer-term maturities account for only about 50 percent of total performing exposures. Banks appear to have an appetite for longer-term lending but cite a lack of viable projects outside commerce. While short-term lending for trading mainly of cashew and imported goods remains relatively large (with some seasonal fluctuations, Figure 3), longer-term lending remains relatively low, reportedly due to a scarcity of bankable infrastructure and industrial projects, and uncertain prospects due to persistent political instability. Another reason is the high share of demand deposits, accounting for more than 70 percent of total customer deposits. More generally, lending is constrained by limits to bank funding, as there is not enough saving to support higher lending. In fact, almost all deposits are already intermediated into credit, considering that the loan-to-deposit ratio is just below 100 percent.

Figure 6. Maturity Structure of Loans and Deposits



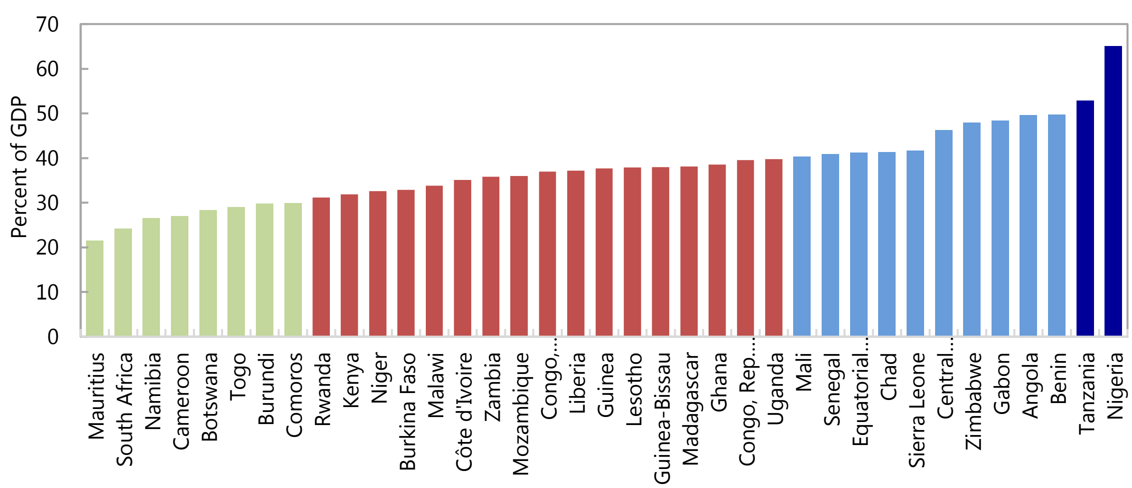
Sources: BCEAO; and staff estimates.

9. Some banks avoid longer-term credit also due to difficulties in executing collateral through the judicial system. Although banks have proper methodologies for screening loan applicants in place and regularly use external sources of debtor information, they also generally require tangible collateral despite difficulties in executing it. Some banks engage in short-term lending exclusively because the collateral underlying these loans, typically inventory, can be obtained and sold more easily than pledged property. The insistence on real collateral appears somewhat paradoxical in view of the lengthy foreclosure process and perceived weaknesses in the rule of law. Indeed, the value of collateral pledged to the banks appears questionable because upon loan default the execution of the security through the judicial system is slow and costly, thereby diminishing the net present value of the collateral considerably. These difficulties are borne out by the persistently high stock of NPLs and low recovery rates.

10. The economy's high degree of informality obstructs further financial deepening. The informal economy generally consists of household enterprises that have some production at market value but are not registered and consequently avoid compliance with regulation and the payment of taxes (IMF, 2017a). Although measuring the incidence of informality is difficult, IMF estimates based on observable drivers of the informal economy (IMF, 2017a), suggest that Guinea-Bissau's degree of informality is near the SSA average of 38 percent of GDP (see "GNB" in Figure 7), which in turn is higher than in Asia and in the Middle East and North Africa. Entities in the informal economy are at a disadvantage in obtaining bank credit because they typically lack registration, proper bookkeeping, and stable revenue.

Figure 7. Estimates of the Informal Economy in SSA

(2010–14, average)



Source: IMF (2017a).

Note: Excludes Cabo Verde, Eritrea, Ethiopia, The Gambia, São Tomé and Príncipe, Seychelles, and South Sudan due to lack of informality measure.

11. Segmentation in Guinea-Bissau's banking sector leaves clients from the informal sector with few financing options. Three out of the five banks reported that they do not provide credit to clients from the informal sector, or only do so if firms formalize first by producing proper bookkeeping and other required paperwork. This position extends to small and medium sized enterprises (SMEs) at some banks. A few banks even help applicants in the formalization process. Microfinance can be an alternative for informal entities, but in the case of Guinea-Bissau the microfinance sector is seemingly in disarray, with only a few institutions being fully operational.

12. Private sector participants complain about hurdles to accessing bank financing. Representatives from the private sector, including the chamber of commerce, mentioned the loan approval process and loan terms as major obstacles to financial deepening. Such hurdles reportedly include banks' unwillingness to finance certain firms or specific sectors, banks' insistence on the provision of specific collateral, short maturities of bank loans granted, and excessively high interest rates.

13. Financial deepening is also hindered by relatively weak financial inclusion. Guinea-Bissau is among the fragile states with difficult access to financial services (IMF, 2016) in terms of number of branch offices and ATMs. While typical financial access/inclusion indicators are not available for Guinea-Bissau,[3] anecdotal evidence gathered by the mission points to only gradual improvements in this respect. Branches and ATMs outside the capital are scarce, credit cards do not exist, and even debit cards are held by only a small fraction of the population (though on the rise of late). Compared to some other SSA countries, mobile banking products are still in their infancy in Guinea-Bissau, with some banks in the process of marketing such applications. Finally, gender inequality in financial inclusion continues to be an issue, although two banks reported to have financed women entrepreneurs in some sectors (e.g. fisheries).

D. Policies to Promote Financial Deepening

14. Several steps to foster financial development have been taken, both at the national and the regional level. The government has put in place incentives for SME credit, in accordance with measures adopted by the WAEMU Council of Ministers in September 2015: re-financing of claims on eligible SMEs with the BCEAO, and reduced risk weights on claims on such enterprises as a regulatory incentive toward higher SME credit. Moreover, the government continues to maintain a credit registry to aid financing decisions of banks and to enhance access to credit. At the regional level, a credit information bureau (BIC) has been established that unlike the domestic credit registry includes negative information about debtors and covers all of WAEMU. Coverage of debtor information is being improved, as banks tie loan decision to debtors' consent to release credit-relevant information to the BIC. Other regional initiatives that promote financial stability and hence intermediation comprise the establishment of a deposit insurance fund (first phase expected to be

[3] The World Bank Findex database with financial inclusion indicators currently only lists the number of deposit accounts for Guinea-Bissau.

concluded by end-2017) and the introduction of elements of the Basel II/III framework effective January 2018 (IMF, 2017b).[4]

15. Banks have also acted to promote financial deepening and inclusion. Several banks have been opening branch offices in rural areas to serve the local economy and be closer to cashew producers, some of which receive pre-financing from buyers and so have not requested much bank credit. In addition, in line with policies to promote consumer credit and thus diversify away from trade financing, banks are promoting debit cards, mobile banking products, and mortgage credit.

16. Additional measures could be taken to promote financial development and inclusion. As banks uniformly criticize the inefficient foreclosure process and weak rule of law, government could take legislative steps to improve creditor rights, make the court system more efficient, and more generally safeguard an independent judiciary. Government could also promote sectoral policies in infrastructure and energy as well as in cashew processing, which would enable banks to co-finance investment projects at longer maturities. Also, further development of the agricultural sector would enable banks to lend more to that sector. In line with the framework for a regional strategy promoting financial inclusion and an associated action plan adopted by the WAEMU Council of Ministers in June 2016,[5] the authorities could also develop a national strategy for financial inclusion and spell out specific measures that complement those already taken to foster SME credit, notably measures to promote financial literacy and inclusion of a larger share of the population in banking services, especially in rural areas.

17. Banks could also take further steps to promote financial inclusion. They could further improve their credit scoring and risk management system to lessen the reliance on collateral and increasingly serve clients from the informal sector whose creditworthiness needs to be ascertained differently. At the same time, collateral valuation should be kept up to date to ensure adequate provisioning of doubtful or defaulted claims. Banks could also promote term deposits and seek longer-term funding, including from their parent institutions. The early success in financing cooperatives run by women should encourage more banks to lend to women entrepreneurs and so help narrow the gender financing gap.

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[4] The current capital adequacy regulation covers only credit risk, and the minimum capital adequacy ratio is 8 percent of risk-weighted assets. The new requirements, applicable from 2018 in a phased-in manner, will be based on the Basel II Standardized Approach for credit risk, the basic indicator approach (or standardized approach) for operational risk, and the standardized approach for market risk. The new capital requirement of 9 percent will comprise a minimum of 5 percent common equity Tier 1 capital, and 6 percent total Tier 1 capital. The new regulations will also include capital buffers and surcharges (mainly a common equity capital conservation buffer of 2.5 percent). In addition, the single large exposure limit will be reduced to 25 percent of banks' Tier 1 capital.

[5] This five-year strategy aims at expanding access and use of financial services and products to 75 percent of the WAEMU adult population (IMF, 2017b).

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