

**ANGOLA**  
**COUNTRY FINANCING PARAMETERS**

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### SUMMARY

1. This note describes application of the new policy for expenditure eligibility in World Bank financing to the Angola program, and proposes a corresponding set of country financing parameters. The new framework allows the Bank to finance expenditures needed to meet the development objectives of the operations it supports, within an overall framework that addresses risks to fiscal sustainability and the appropriate use of Bank resources, in a way that is consistent with the Articles of Agreement. The new policy increases the Bank's flexibility to allow the use of Bank loan proceeds for a number of expenditures.

2. The Government has been consulted on the new policy and has indicated that it welcomes the increased flexibility in the World Bank's approach to financing of investment projects under the new policy. Discussions with stakeholders and the Government have taken place under the overall coordination of the World Bank Country Manager in Angola. In addition, task managers of projects likely to benefit from the new procedures have discussed the parameters with their counterparts – as, for example, in the case of the HAMSET project appraised in September 2004.

3. The main principles that led to the establishment of the following set of proposed guidelines were:

- i. *Flexibility* – In the course of project preparation the team should have the maximum flexibility to determine the financing pattern, subject to sustainability considerations and consistency with the policy outlined in OP / BP 6.00.
- ii. *Sustainability* – The project preparation team should explicitly consider the implications for long-term sustainability of their proposed financing pattern.
- iii. *Lower Transaction Costs* – Currently the Bank finances approximately 85 percent in the case of local civil works and goods, 85 percent in the case of consultants (the latter being determined by the “Standard Disbursement Percentage”), and 100 percent in the case of foreign civil works and goods, which means that the Bank finances the cost of the items only, leaving the Government to pay the tax component. The requirement that the Government pay counterpart funds and/or the tax component of projects can at times become a major difficulty as the lack of such payments may hold up project implementation. Greater flexibility on the part of the World Bank financing may in some cases accelerate implementation. This factor may be taken into account when determining the financing pattern in a particular project.

- iv. *Forward-looking Perspective* – Financing certain recurrent costs in the short to medium term may have, in some cases, a positive effect in feeding economic growth which could then increase the Government's capacity to support much larger recurrent costs in the long term.

## **BANK SUPPORT TO THE GOVERNMENT'S REFORM EFFORTS**

### **The Government's Development Strategy**

4. The Angolan government's development strategy is set forth in the poverty reduction strategy paper (PRSP), termed the ECP (Estratégia de Combate à Pobreza – Strategy for Fighting Poverty), which was approved by the Council of Ministries in December 2003 and shared with the Bank, the Fund and the donor community in January 2004. The ECP proposes a three-year public expenditure program focusing on ten priority areas: (i) social reinsertion; (ii) demining; (iii) food security and rural development; (iv) HIV/AIDS; (v) education; (vi) health; (vii) basic infrastructure; (viii) employment and vocational training; (ix) governance; and (x) macroeconomic management. The estimated costs of the ECP for 2003-2006 total \$3.2 billion.

### **The Bank's Transitional Support Strategy**

5. The World Bank has supported the PRSP process in Angola since its early stages through a US\$125 million Transitional Support Strategy (TSS) presented to the Board in March 2003. The three pillars of the TSS are: (i) enhancing transparency, efficiency and credibility of public resource management; (ii) expanding service delivery to war-affected and other vulnerable groups; and (iii) preparing the ground for broad based pro-poor economic growth.

6. To achieve these goals, the TSS combines lending and non-lending instruments. The analytical instruments focused on: (i) transparency/governance issues (oil sector study, procurement review, public expenditure and financial management accountability review), (ii) broad-based private sector led growth (public-private partnership in infrastructures, corporate social responsibility in the oil sector). In particular, the analytical program includes a Country Procurement Assessment Review (CPAR), a Public Expenditure Management and Financial Accountability Review (PEMFAR), a Corporate Social Responsibility Study (CSR), a Country Framework Report on Infrastructure (CFR), a capacity building program on PRSP with the World Bank Institute (WBI), an Oil Revenue Management Study and a Post-Conflict Rehabilitation and Reconstruction Technical Assistance (PCRRP). These activities have been completed in the course of FY04 and FY05 and a Country Economic Memorandum (CEM) is under preparation.

7. The Bank also helped the GoA in articulating a priority phase for its reconstruction program. The lending instruments prepared during the TSS period focused on: (i) complementing the GoA demobilization activities with a reintegration project (ADRP), (ii) expanding service delivery by funding community driven small public investments (FAS), (iii) supporting implementation of reforms linked to

transparency and efficiency of public resources management (EMTA); and (iv) supporting national policies in the area of HIV/AIDS complementing activities from the HIV Global fund, Malaria and Tuberculosis (HAMSET).

8. At the request of the Government, the World Bank is preparing an Emergency Multisector Rehabilitation Project (EMRP), addressing the most immediate reconstruction needs based on the PCRRP TA completed in FY04. The operation will include a first phase of \$50 million, to be delivered in January 2005, and a second phase, possibly for \$150 million, to be delivered in early FY06. The scope of the overall program is subject to availability of IDA resources.

### **Public Financial Management**

9. Expenditure controls in Angola are weak but are undergoing major reform through the government's Public Finance Modernization Program (PFMP). There are weaknesses in the budget preparation stage; the budget execution process is not circumscribed to the formal system as a result of practices inherited from the war period; and auditing arrangements, internal and external, are weak due to a lack of capacity. However, the Government has recognized these weaknesses and is addressing them through the PMFP. Particularly noteworthy is the roll-out of Angola's integrated financial management information system IFMIS, the SIGFE in Portuguese (*Sistema Integrado de Gestão das Finanças do Estado*), that ties up the whole accounting stage of the budget cycle. The Bank is helping the Government to move forward with its PFM reform agenda through its lending and advisory services. The Economic Management and Technical Assistance Project (EMTA) is providing financial support to the PMFP while the Public Expenditure Management and Financial Accountability Report (PEMFAR) is providing technical guidance to the reform process.<sup>1</sup>

### **THE NEW COUNTRY FINANCING PARAMETERS**

#### ***Cost sharing***

10. The current cost-sharing limit for Angola is 90%. This is applied on the rolling three-year overall lending program (as per OP 6.30, *Local Cost Financing and Cost Sharing*). For individual projects, the Bank usually expects the borrower to make a 10 percent minimum contribution to project cost (net of taxes and duties).

11. Under the new policy, cost sharing arrangements are determined taking into account the borrower's commitment and ownership to Bank-financed activities, including the borrower's funding from its own resources of its overall development program. The Government is committed to its poverty reduction program, which was issued in 2003. Angola's overall spending on development projects is around 9 percent of GDP and the

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<sup>1</sup> Considerable analytical work of the main issues concerned with public finance management in Angola has been undertaken recently by the Bank, including a comprehensive Public Expenditure Management and Financial Accountability Review (PEMFAR) that combines elements of a Country Financial Accountability Assessment (CFAA) and a Country Procurement Assessment Report (CPAR).

Government funds roughly 60 percent of this amount with its own resources. All projects funded by the World Bank are aligned with the poverty reduction strategy and are integrated in the annual budget. Given past shortcomings in fiscal management, the Government and the Bank are working together to improve the integration of the development and recurrent budgets, as well as the central and the provinces' budgets. The Bank's ongoing EMTA credit and the Government's PMFP are contributing toward addressing these issues.

12. Given the above, Bank financing for individual projects may be up to 100 percent of project costs. Allocations of the Bank's overall financing envelope to individual projects will continue to be determined by the prioritization outlined in the Transitional Support Strategy and in any future Bank's strategic documents. The allocations across projects will not be changed in the light of this new policy on financing; however, it is recognized that, within each project's financing envelope, higher level of Bank financing may lead to smaller size of individual projects, including smaller components or a smaller number of components. At the project-level, information on the borrower's use of own resources to fund its development program for the sector concerned will also be taken into account.

13. Some projects may be financed up to 100%, especially those that support social development. Financing of up to 100 percent will be applied on a selective and case-by-case review of merit/justification. Typically, most projects executed by the Central Government or by entities with own sources of income are expected to include contributions from Government, and would therefore not have 100 percent Bank financing.

### ***Local cost financing***

14. Capital expenditures represent only 9 percent of GDP, which is far below the country's reconstruction needs. The financing requirements for Angola's development program considerably exceed the public sector's own resources from taxation and other sources. The country's average financing gap for the next 5 years is estimated at US\$ 1.1 billion per year.

15. The Bank has been financing approximately 85 percent of local costs of civil works and of goods, depending on the tax component, and 85 percent of consultants (foreign or local). The Bank has been financing a significant amount of local costs in Angola: these accounted for 51 percent, 85 percent and 97 percent of disbursements for investment projects in FY01, FY02 and FY03 respectively. This trend is expected to continue with the projects that are expected to enter the portfolio, many of which have a high element of local expenditure, including those in the social sector and infrastructure. Financing foreign costs alone would not enable the Bank to assist with individual projects, because the local cost element in Bank-funded projects is substantial.

16. Overall, Angola meets the criteria for Bank financing of local costs. Therefore, the Bank can finance local costs in any proportions required by individual projects. No

distinction needs to be made between foreign and local expenditures in individual projects, unless needed for project-specific considerations.

### ***Taxes and duties***

17. The Angolan tax system does not yet contemplate a value-added tax<sup>2</sup>. Firms, local or foreign, are subject to an overall company profit tax rate (Imposto Industrial) of 35%<sup>3 4</sup>. However, foreign companies that do not have a representation (“sucursal”) in Angola are liable to pay taxes on only 15% of the value of the invoice. Angolan nationals are subject to income taxes<sup>5 6</sup> within the range between 4% - 15%, depending on the level of income. The IMF’s trade restrictiveness index currently gives Angola a rating of 3.0 on 0-10 scale, meaning that Angola is “moderately open”. The mean import tariff is of 19 % with tariffs ranging from 0 to 35%. There are some export duties, with an average rate of nearly 4%; crude oil and coffee are exempt. The tax rates attracted by World Bank-funded projects are no higher than the generally applicable ones. There are no taxes and duties that are unreasonable and therefore the Bank may finance all taxes and duties associated with project expenditures. At the project-level, the Bank would consider whether taxes and duties constitute an excessively high share of projects costs.

### ***Recurrent cost financing***

18. The Bank is already financing recurrent costs in several projects. Examples of recurrent cost financing include training in technical assistance operations, material and supplies in social sector projects, as well as funding of PIUs, and training of civil servants. The average Bank financing percentage (disbursement percentage) for such recurrent cost financing is 85%. Ongoing projects that finance the aforementioned types of recurrent costs include the social action fund (FAS II and FAS III) and the EMTA projects. As for new projects, the HAMSET would finance only a small amount of infrastructure, and when possible rehabilitation rather than construction. As a result, the incremental recurrent costs of the HAMSET project would be negligible. However, given Angola’s current state of transition and reconstruction, the Bank may need to finance recurrent costs in the future.

19. Sustainability of Bank operations so far can be considered satisfactory overall, although uneven across sectors. Sustainability is deeply linked to Government’s commitment to reforms and capacity issues.

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<sup>2</sup> A tax reform is underway since 2000. A British consulting firm, Crown Agents, has been hired by the Government to help streamlining the country’s tax structure and customs management. A single property tax as well as a value-added tax are expected to be introduced in 2004-5.

<sup>3</sup> Law 35/72, modified by Law 18/92, Executive Decree 84/99, and Law 5/99.

<sup>4</sup> There is no international agreement on dual taxation. The fact that a foreign company pays profit taxes in their headquarters does not exempt it from paying Angola’s profit tax.

<sup>5</sup> Law 10/99 (“Imposto sobre o Rendimento do Trabalho”).

<sup>6</sup> Article 7, item 1, line b of Law 10/99 suggests that PIU staff may be legally exempt from taxation of their project-related income.

20. Angola's external debt is estimated at US\$9.7 billion or 70 percent of GDP at end-2003. The NPV of the external-debt-to-exports ratio for 2004 is estimated at 185 percent. External debt service as a share of exports of goods and services is currently around 33 percent. This suggests an extremely fragile debt situation that needs to be addressed by both increasing oil revenues, having access to more concessional borrowing, and possibly some debt relief. On the other hand, Angola is the second largest oil producer in Africa and its oil production is expected to double by 2007 reaching nearly 2 million barrels per day. On the fiscal side, total expenditures are 44 percent of GDP and are projected to fall to 36 percent by 2006. Government revenues are now at 33 percent of GDP and are expected to remain in that range over the next few years as exploration costs in new oilfields are higher in the early phase of oil extraction. With increased production and rising oil prices, the expected increase in revenues is a comforting factor in terms of fiscal sustainability. All Bank financing is integrated into the budget (though not yet fully reflected in the quarterly budget execution reports), and is taken into account in fiscal and debt sustainability analysis. The Government has also recently embarked on public expenditure management and public sector reform, which are widely supported by donors, including the Bank and the Fund.<sup>7</sup> In addition, the Government is making visible efforts to gain access to external concessional borrowing and the Bank and the Fund are collaborating closely with the authorities to support its debt and fiscal sustainability efforts.

21. All of the above suggest that Bank financing of recurrent costs per se would not have an adverse impact on the country's fiscal and debt sustainability. Nonetheless, it is very important that the Bank continues to monitor the fiscal adjustment programs (working closely with the IMF) and public expenditure management and public sector reforms to ensure that recurrent cost financing is embedded in a credible and sustainable government macroeconomic strategy. The Bank will also carry out general and sector-specific Public Expenditure Reviews, where issues of sustainability will be identified.

22. Enhanced flexibility in recurrent cost financing would also contribute to an important goal of the Bank's PEMFAR and of the Government's PMFP, namely more transparent reporting of public expenditures through proper classification of recurrent items in the budget. In addition, financing some recurrent costs in the short to medium term could have a stimulating effect on the economy and thus contribute to increase the Government's capacity to support larger recurrent costs in the future.

23. Given the above factors, no country-level limit on recurrent cost financing is proposed per se. Given Angola's need for recurrent cost financing at this stage of transition and the country's reconstruction needs, there is scope for more flexibility as regards the financing of recurrent costs in certain circumstances, with careful consideration of risks to sustainability. Recurrent costs may be financed as needed in individual projects. Recurrent cost financing will be applied on a case-by-case basis, subject to project or program-level assessment. In determining Bank financing of

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<sup>7</sup> The reforms are largely based on the World Bank funded Public Expenditure Management and Financial Accountability Review (PEMFAR) conducted in 2003 with the collaboration of DFID.

recurrent costs in individual projects, the Bank will take into account sustainability issues at the sector and project levels, including a consideration of implied future budgetary outlays.