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IDA/R2016-0215/1

August 19, 2016

Closing Date: Tuesday, September 13, 2016 at 6 p.m.

FROM: Acting Vice President and Corporate Secretary

Kiribati - Third Economic Reform Development Policy Operation

Additional Financing

Program Document

Attached is the Program Document regarding a proposed additional grant to Kiribati for the Third Economic Reform Development Policy Operation (IDA/R2016-0215), which is being processed on an absence-of-objection basis.

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The World Bank

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Report No. 107231-KI

INTERNATIONAL DEVELOPMENT ASSOCIATION

PROGRAM DOCUMENT FOR A PROPOSED DEVELOPMENT POLICY GRANT

IN AN AMOUNT EQUIVALENT TO US$2 MILLION TO

THE REPUBLIC OF KIRIBATI

FOR THE

THIRD ECONOMIC REFORM DEVELOPMENT POLICY OPERATION

August 16, 2016

Macroeconomic and Fiscal Management Global Practice
East Asia and Pacific Region

Republic of Kiribati

GOVERNMENT FISCAL YEAR

January 1 – December 31

CURRENCY EQUIVALENTS

(Exchange Rate Effective as of June 30, 2016)

Currency Unit
US$1.00 = A$1.40
SDR 1 = US$ 1.39884

ABBREVIATIONS AND ACRONYMS

ADB	Asian Development Bank
CPIA	Country Policy and Institutional Assessment
DFAT	Department of Foreign Affairs and Trade in Australia
DPO	Development Policy Operation
CEO	Chief Executive Officer
GDP	Gross Domestic Product
GNI	Gross National Income
ICT	Information Communications Technology
IDA	International Development Association
IMF	International Monetary Fund
JICA	Japan International Cooperation Agency
LDP	Letter of Development Policy
MFAT	Ministry of Foreign Affairs and Trade in New Zealand
MoFED	Ministry of Finance and Economic Development
PER	Public Expenditure Review
PEFA	Public Expenditure and Financial Accountability
PFM	Public Financial Management
PFTAC	Pacific Financial Technical Assistance Center
PPP	Public Private Partnership
PUB	Public Utilities Board
RERF	Revenue Equalizing Reserve Fund
SOE	State Owned Enterprises
TA	Technical Assistance
VAT	Value Added Tax
VDS	Vessel Day Scheme
WBG	World Bank Group
WEO	World Economic Outlook
WDI	World Development Indicators

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REPUBLIC OF KIRIBATI

THIRD ECONOMIC REFORM DEVELOPMENT POLICY OPERATION

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The Third Kiribati Economic Reform Development Policy Operation was prepared by an IDA team consisting of Mizuho Kida (TTL, GMFDR), Natasha Beschorner (GTIDR), Ekaterina Gratcheva (FABRP), Stephen Hartung (GGODR), Kamleshwar Prasad Khelawan (GEEDR), and Xavier Vincent (GENDR). The team was supervised by Robert Utz (EACNF). Overall guidance was provided by Mathew Verghis (GMFDR) and Franz Drees-Gross (EACNF).

SUMMARY OF PROPOSED GRANT AND PROGRAM
REPUBLIC OF KIRIBATI
THIRD ECONOMIC REFORM DEVELOPMENT POLICY OPERATION

Borrower	Republic of Kiribati
Implementation Agency	Ministry of Finance and Economic Development
Financing Data	IDA Grant; IDA terms; amount: SDR 1.5 million (US$2 million equivalent)
Operation Type	Programmatic (1 of 2), single-tranche Development Policy Operation.
Pillars of the Operation And Program Development Objective(s)	The program development objective is to (i) strengthen public financial management, through greater transparency in managing fisheries revenue, improved governance of the sovereign wealth fund, and better reporting and monitoring of public debt and contingent liabilities; and (ii) create an environment for inclusive and private sector led growth, through reducing the costs, improving the quality, and expanding the coverage of essential public utilities services (electricity, water, sewage, and telecommunications).
Result Indicators	Strengthening public financial management: 1. All fisheries joint ventures are annually reviewed following a formal process and based on transparent evaluation criteria to ensure value for money and consistency with national and regional fisheries policies (baseline: No formal review or transparent evaluation criteria in 2015). 2. The Revenue Equalization Reserve Fund is managed according to the prevailing market standards with substantially reduced costs of around 0.08 percent of the Fund's market value (baseline: 0.2 percent in 2015). 3. Public debt is managed based on an up-to-date public sector debt database, with all debt and debt related transactions recorded within a three-month lag (baseline: the database covers the central government's external debt only). Creating an environment for inclusive and private sector led growth: 4. The telecommunications market in Tarawa is served by at least two mobile service operators competing for customers, with the mobile phone penetration rate reaching at least 50 percent (baseline: 12 percent in 2014) and the cost of a three-minute peak-hour mobile-to-mobile call within Tarawa falling to at least A$0.75 (baseline: A$0.90 in 2013). 5. The operational efficiency of the Public Utilities Board is improved with an increased bill collection rate to more than 97 percent (baseline: 85-90 percent in 2014), reduce power losses to less than 11 percent (baseline: 18 percent in 2014), and reduced water losses from the distribution system to 41 percent (baseline: 50 percent in 2014).
Overall risk rating	Substantial
Climate and disaster risks (required for IDA countries)	(i) Are there short and long term climate and disaster risks relevant to the operation (as identified as part of the SORT environmental and social risk rating)? - Yes **No X** If yes, (ii) summarize briefly these risks in the risk section and what resilience measures may help address them?
Operation ID	P155540

IDA PROGRAM DOCUMENT FOR A
PROPOSED DEVELOPMENT POLICY GRANT
TO THE REPUBLIC OF KIRIBATI

1. INTRODUCTION AND COUNTRY CONTEXT

1. **The proposed Third Economic Reform Development Policy Operation of US$2 million equivalent is the first in a new series of two programmatic development policy operations.** It follows a series consisting of the first and second Kiribati Economic Reform Programmatic Development Policy Operations which were approved in 2013 and 2014, providing the government a total of US$ 8.2 million equivalent (see Box 1). The series supports the government's fiscal and structural reform programs to improve public financial management to safeguard fiscal sustainability and to create conditions for more inclusive and private sector led growth. While the government has run a large fiscal surplus over the last two years owing to record fishing license fee revenue, ensuring fiscal sustainability in the medium term in the context of large spending needs requires improved transparency in the management of revenue and expenditure and continued prudence in the management of public debt and the sovereign wealth fund. Ongoing efforts to improve the performance of the country's large number of state owned enterprises, including through management reforms and privatization, need to be accelerated to improve access to basic public services, reduce high costs of living for the bottom 40 percent, and encourage job creation and private sector activities.

2. **Kiribati is one of the smallest, remotest, and most geographically dispersed countries in the world.** It comprises 33 atolls and islands, which have a total land area of less than 800 square kilometers and are spread across 3.5 million square kilometers of ocean—an area larger than India. About half its population of around 110,000 lives in the capital, South Tarawa. The country is thousands of kilometers away from the nearest markets—about 4,000 kilometers from Australia, Hawaii, and New Zealand. Kiribati's low-lying atolls rise little more than 1.8 meters on average above sea level, and as such, are at the forefront of climate change. According to a recent survey of experts, if the sea level continues to rise at its current rate, Kiribati will disappear by 2100.

Box 1. Main achievements under the first and the second Development Policy Operations

The first and second Kiribati Economic Reform Programmatic Development Policy Operations were approved in 2013 and 2014, providing the government a total of US$ 8.2 million equivalent. The first operation in the series was US$ 5.2 million equivalent and disbursed on March 18, 2014; the second operation in the series was US$ 3.0 million equivalent and disbursed on March 18, 2015.

The operations supported the government actions in three main policy areas: (i) improving the management of fisheries revenues; (ii) improving the management of public assets and liabilities; and (iii) expanding private sector opportunities. The main achievements under the each pillars were:

(i) Improving fisheries revenue. The government approved the first national fisheries policy to strengthen the sustainable management of fisheries resources, and began publishing an annual fisheries revenue report identifying sources of all fisheries revenues, which is jointly developed by the Ministry of Fisheries and Ministry of Finance.

(ii) Improving the management of State Owned Enterprises (SOEs) and public debt. The government adopted a new SOE Act, enforced the compliance with the new legislation of all SOE board appointments, and mandated the annual financial reporting by the five largest SOEs. The government approved the key RERF management reforms to restructure the investment portfolio to reduce its risk exposure to better align with the Fund's long term investment objectives, and has undertaken a management performance review against global benchmarks. The government approved a debt policy establishing a clear set of criteria for non-concessional borrowing.

(iii) Expanding private sector opportunities. The government has privatized the state-owned Otintaai Resort Hotel, approved the merger of two Copra SOEs, and began privatizing the telecommunications SOE.

Sources: World Bank First Economic Reform Development Policy Operation (Report No. 76876-KI), and Second Economic Reform Development Policy Operation Report No. 91374-KI).

3. **With such extreme physical challenges, growth prospects are limited.** The private sector remains small, mostly consisting of small firms in the wholesale, retail, and transport sectors. The public sector dominates the economy, which includes 16 state owned enterprises (SOEs), and accounts for as much as 50 percent of GDP and nearly 80 percent of jobs in the formal sector (see Box 2). Only 20 percent of the labor force is employed in the formal sector, however. The rest is employed in subsistence agriculture (mainly, government-subsidized copra production), fisheries, and informal services. The private sector has struggled to grow because of the inherent lack of economies of scale due to remoteness and dispersion of population across dozens of islands—problems compounded by the country's severe infrastructure deficits (roads, ports, and airports). Firms are further held back by the country's difficult investment climate: Kiribati ranked 149th out of 189 economies in the world in the World Bank's 2016 Doing Business report. Open unemployment exceeds 30 percent, and youth unemployment, 50 percent.

Box 2. The SOE sector in Kiribati

There are 16 state-owned enterprises (SOEs),[i/] representing A$176 million in assets and generating around 12 percent of GDP. They operate in sectors where private firms would normally be expected in other countries—including hotels, airline, banking, shipping, and inter-island transport. The remoteness, dispersion, and small population lead to a lack of scale and high costs, constraining private sector development.

The government has made significant progress in reforming the SOE sector and reducing costs. Recent progress includes the adoption of the SOE Act in 2013, privatization of the telecom monopoly, commercialization through public private partnerships (hotel, shipping, and shipyard), and a merger of two copra SOEs.

Nevertheless, fiscal costs and risk remain substantial. The total government spending on subsidies and transfers was A$29m (14 percent of GDP) in 2015 and is expected to rise to A$41 million (18 percent of GDP) in 2016. The government allocates A$5 million a year for the Community Service Obligations (CSO)—subsidies to SOEs for providing agreed levels of services that are unprofitable. These figures, however, likely underestimate the true fiscal costs of the SOEs. For example, although the CSO is now explicitly included in the budget, the figure is said to be unrealistic—the true cost is said to be more than double the amount allocated by the government—and the disagreement between the government and the SOEs on the appropriate level of CSO payments means that even as the CSO budget remains underspent, implicit losses are building up elsewhere, in the forms of operating losses, no or low quality of service provision, unpaid bills, or inter-ministerial arrears. The lack of a consolidated public debt database also means that the monitoring of SOE debt and contingent liabilities is inadequate (see section 4.2).

Note: [i/] These include Air Kiribati Limited, Broadcasting and Publications Authority, Captain Cook Hotel Limited, Central Pacific Producers Limited, Development Bank of Kiribati, Kiribati Copra Cooperative Society (KCCS), Kiribati Copra Mill Company Limited (KCML), Kiribati Copra Development Limited (KCDL), Kiribati Housing Corporation, Kiribati Insurance Corporation, Kiribati Oil Company, Kiribati Ports Authority, Kiribati Solar Energy Company, Public Utilities Board, and Plant and Vehicle Unit. KCCS and KCML are being merged to form KCDL, pending asset and staff transfers.

4. **The country is highly vulnerable to shocks.** Like many countries in the region, Kiribati is vulnerable to tropical storms. Its narrow export base (copra, fish, and seaweed) and heavy dependence on imported food and fuel leave it highly exposed to volatility of global commodity prices. Internally, underdeveloped domestic infrastructure exposes the population to frequent shortages of water, food, and fuel supplies. The country's main sources of income—fishing license fees paid by foreign companies to fish in Kiribati's Exclusive Economic Zone, investment income earned on the country's sovereign wealth fund (Revenue Equalization Reserve Fund, or RERF),[1] and foreign aid—are extremely volatile. At the same time, there is limited flexibility on the expenditure side, with a large public sector wage bill and subsidy payments to SOEs constituting nearly 65 percent of current expenditures. The combination of volatile revenues, exposure to shocks, and high expenditure rigidity have resulted in large fiscal deficits and frequent

[1] The RERF was established in 1950s to invest royalties from now depleted phosphate reserves. Its current estimated value is about A$772 million (370 percent of GDP), or about A$6,500 per capita.

drawdowns from the RERF in previous years, significantly reducing its per capita value.

5. **Poverty is widespread.** With 22 percent of the population in extreme poverty, Kiribati has the highest extreme poverty rate in the Pacific. Moreover, as much as 66 percent of the population are at risk of falling into extreme poverty. With a Gini coefficient of 0.39, however, inequality in Kiribati is relatively low in international comparison. Expenditures of the richest quintile of households are 4.7 times expenditures of the poorest quintile. The lack of panel data prevents the study of poverty and inequality dynamics.

6. **Geography, gender, and disability pose challenges to inclusive growth.** The incidence of poverty varies geographically. The highest incidence of poverty is found in the capital, South Tarawa (24 percent), followed by the rest of the Gilbert Islands (22 percent). The lowest poverty is found in the Line and Phoenix islands (9 percent). The nature of poverty also differs geographically. In the capital, the majority of the population lacks access to basic services, such as improved water, sanitation, drainage, and solid waste management.[2] The poor in the capital are more likely to suffer from preventable diseases than those in the rest of country, and they have limited access to land. In the outer islands, food poverty is rare because of subsistence agriculture, but the poor have less access to basic public services such as education, health care, electricity, and telecommunications. Women account for a disproportionate share of the poor: whereas one in five households are headed by females, in the poorest quintile, one in four are female-headed. People with disabilities—are also particularly vulnerable.

7. **Since independence in 1979, Kiribati has maintained a stable and democratic government.** After 12 years under Mr. Anote Tong, the presidential election on March 9 returned a new president, Mr. Taneti Maamau, a candidate from the former opposition Tobwaan Kiribati Party, winning 60 percent of the vote. The newly elected parliament, many of them independent MPs, have joined the president's party and the government has a stable majority in the parliament.

2. MACROECONOMIC POLICY FRAMEWORK

2.1 RECENT ECONOMIC DEVELOPMENTS

8. **Recent economic performance has been strong.** After a period of volatility, Kiribati had its fifth year of consecutive growth in 2015. After reaching close to 4 percent in 2014, real GDP growth in 2015 has moderated to an estimated 3.4 percent and is expected to moderate to 3.0 percent this year, reflecting the winding down of major donor-financed infrastructure projects financing road, airport, and water and sanitation investments.

[2] The country's high population growth—estimated around 4 percent a year—and a continuing urbanization has resulted in the acute overcrowding and service delivery challenges in the Capital. See section 4.2 for more detail.

9. **Inflation has risen but remains low.** Following two years of deflation (-3 and -1.5 percent in 2012-13), inflation has risen to 2.1 percent in 2014 and is expected to average around 1.4 percent this year, as lower prices of imported food and fuel offset inflationary pressure from a weaker Australian dollar and above-average growth. Kiribati uses the Australian dollar as its official currency, which has provided a strong nominal anchor given Kiribati's close link with Australia.

10. **The current account balance remains in net surplus despite large trade deficits.** The country's trade deficits (40-47 percent of GDP in the last five years) are expected to have worsened to 50 percent in 2015 on continued strengths of capital imports relating to donor-financed infrastructure projects. Remittances, which are dominated by transfers from seafarers, have been on a declining trend with slowing world shipping activity, although it has picked up in 2015. Meanwhile, relatively favorable yields on Australian assets ensured steady income flows on the RERF. The record fishing license revenues have kept the current account balance in net surplus in the last three years.

11. **The fiscal position has markedly improved due to sharply increased fishing license fee revenue.** The fiscal outcome in Kiribati is dominated by volatile fishing license fee revenue, which has reached A$197.8 million in 2015, surpassing the record levels reached in the two previous years (A$89 million and A$142 million in 2013 and 2014, respectively). The favorable El Nino weather, the implementation of the Vessel Day Scheme, and more recently, the appreciation of the US dollar against the Australian dollar, have contributed to the increase. Efforts to increase domestic tax revenue have also borne fruit. The government has successfully introduced a VAT in mid-2014 to replace distortive tariffs and trade taxes, and maintained the VAT despite its politicization during the election year in 2015. A number of items considered essential to livelihoods on the outer-islands were exempted from the VAT at introduction, and the government has added essential public services to the list of exemptions in 2015 to manage the perceived and actual regressivity. The revenue from VAT has risen by 71 percent in nominal terms in 2015, raising the share of tax revenue to total revenue (excluding fishing revenue) to 85 percent.

Table 1. Selected Macroeconomic Indicators, 2013-2018

	2013	2014	2015 est.	2016 proj.	2017 proj.	2018 proj.
Real Economy	Annual percentage change, unless otherwise indicated					
GDP (USD million)	187.0	186.0	160.8	158.5	163.3	168.1
Real GDP growth	2.4	3.7	3.5	3.0	2.4	2.1
Consumer prices (period average)	-1.5	2.1	1.4	0.3	0.8	1.2
Fiscal Accounts	Percent of GDP, unless otherwise indicated					
Revenue and grants	94.4	127.3	154.1	109.9	101.1	100.6
Total domstic revenue	65.6	86.1	115.8	63.2	62.6	61.9
Grants	28.8	41.1	38.4	46.7	38.5	38.7
Expenditure	84.9	101.7	94.6	105.3	100.3	99.4
Current	56.5	60.1	52.9	60.5	58.1	57.0
Wages and salaries	27.9	18.9	20.5	20.6	20.4	20.2
Development	28.4	41.6	41.7	44.9	42.2	42.5
Overall balance	9.5	25.5	59.5	4.5	0.8	1.2
Financing	-9.5	-25.5	-59.5	-4.5	-0.8	-1.2
Revenue Equalization Reserve Fund (RERF)	5.3	4.1	-2.3	-2.2	0.0	0.0
Balance of payments	Percent of GDP, unless otherwise indicated					
Current account balance after grants	9.3	24.5	25.6	18.7	-2.9	-1.0
Current account balance after grants (USD million)	17.3	45.5	41.2	29.7	-4.7	-1.7
	Percent of GDP, unless otherwise indicated					
External debt	8.5	12.9	22.9	27.1	26.0	25.0
External debt (USD million)	15.9	24.0	36.9	42.9	42.5	42.1
External debt service	0.5	0.0	0.0	0.5	0.5	0.5
External debt service (USD million)	0.8	0.5	0.5	0.8	0.8	0.8
Memorandum items:						
Fishing revenue (AUD millions)	89.0	141.6	207.0	100.0	102.0	104.0
Exchange rate (AUD/USD, period average)	1.0	1.1	1.3	1.4	1.4	1.4
GDP (AUD millions)	194.0	206.0	214.4	222.3	229.0	236.4
GNI (AUD millions)	323.9	381.5	452.8	363.7	385.0	404.6

Sources: IMF, MoFED, WDI, and staff estimates.

12. **With strong revenue performance, expenditure has also risen.** The increase was mainly driven by development expenditure—mostly donor financed—on large infrastructure projects including road, airport, and water and sanitation rehabilitation projects (Figure 1). Recurrent expenditure has also risen, reflecting increases in public sector wages and subsidies (Figure 2). The 2016 budget, announced on May 2nd, has been formulated under a fairly conservative revenue forecast (after A$200m in 2015, A$100m forward estimates for fishing revenue in the medium term) and maintained the balanced budget, while increasing pro-poor spending on education and health, increasing budget allocations for maintenance of infrastructure and government assets. The budget included an increase in the subsidized price of copra from 1 dollar to 2 dollar per kilogram, which is expected to cost the government additional A$9.3 million a year, bringing the total cost of the copra subsidy to an estimated A$17 million a year (about 8

percent of GDP) (see Box 3).

Box 3. Copra subsidy reform

The copra subsidy, which began in the mid-1990s, has multiple objectives. It is an agricultural subsidy to maintain copra production (a main export after fish), a cash transfer to ensure a supply of cash in outer islands to maintain a monetized economy, an unemployment benefit to provide cash income to those who are otherwise unemployed, a form of conditional cash transfer to encourage people to remain on the outer islands in order to slow urban migration, and one of the key transfer mechanisms that the government uses to redistribute its rising resource wealth (fishing license fee revenue) to the outer islands population.[i/] [ii/]

Under the previous DPO, consistent with the recommendation of the technical assistance from the World Bank, the government has pursued the merger of the two copra SOEs to reduce costs of handling the copra subsidy. The existence of two SOEs in the sector was identified as the cause of substantial duplication of functions, higher handling costs, and weakened accountability for effective copra purchasing, processing, and exporting.[iii/] It was expected that reduced leakages and efficiency savings from merging the two copra SOEs would reduce the government spending on the copra subsidy.[iv/] The objective has not been achieved,[v/] however, and instead, the spending on the copra subsidy increased from A$7.3 million in 2013 to an estimated A$17.2 million in 2016.vi/

The new government has come in power in March this year with a strong mandate to raise the living standard of the outer island population,[vii/] and has shown willingness to taking a more holistic look at the government support to outer islands while addressing the issues of equity, efficiency, and effectiveness. This involves, on one hand, looking at various government initiatives that aim to help create jobs and diversify income opportunities in outer islands and evaluating their effectiveness in achieving these goals; and on the other hand, looking at inequalities in public spending that creates biases against population in outer islands (e.g., spending on health and education, investment in infrastructure, subsidies on supplies of energy, water, sewage, fuels, transports, communications that do not benefit outer islands, and advantages in finding work in the public sector, receiving overseas scholarship, and getting on the overseas seasonal workers schemes).

The World Bank is investing in strengthening the knowledge base to support the policy dialogue with the government in this important area. The World Bank has in the past undertaken some preliminary work on potential alternatives to the copra subsidy that could replace its role as a social protection scheme—looking at possibilities of cash for work, recalibrating the eligibility criteria for the existing social protection scheme (e.g., Elderly Fund), increasing the post-secondary scholarships, and providing transport grants to seamen for boarding foreign vessels.[viii/] To strengthen the evidence and knowledge base to effectively advise the government in this important area, the World Bank is carrying out additional knowledge work, including the new household survey (the first in more than 10 years), the impact analysis on growth, poverty, and shared prosperity of various government programs targeting populations in the main and outer islands, and the identification of priority investment to underpin the government's medium term expenditure programs to promote shared prosperity.

NOTE: [i/] Australian Agency for International Development (AusAID), 2012. Kiribati Country Case Study. Canberra: AusAID. [ii/]The main mechanisms for redistributing the wealth in the main island population are instead the public sector benefits (80 percent of the employment is provided by the public sector) and subsidies to a large number of SOEs that deliver most public services to the population in the main islands. [iii/] World Bank, 2013. Republic of Kiribati First Economic Reform Development Policy Operation. Report No. 76876-KI, Washington, D.C.: World Bank. [iv/]World Bank, 2014. The Republic of Kiribati Second Economic Reform Development Policy Operation. Report No. 91374-KI, Washington, D.C.: World Bank. [v/] World Bank, 2016. The Republic of Kiribati First and Second Economic Reform Development Policy Operation Implementation Completion and Results Report (Draft), Washington, D.C.: World Bank. [vi/] The increase in the government spending primarily reflects increases in the subsidized price of copra, rather than increases in the operational costs of the copra SOEs. The information on the operational costs of the merged SOEs is not yet available. [vii/] Government of Kiribati, 2016. Kiribati Development Plan 2016-19: Towards a better educated, healthier, more prosperous nation with a higher quality of life. South Tarawa: Kiribati. [viii/] World Bank, 2013. Policy Brief: Some Thoughts on Social Schemes for Protection and Promotion in Kiribati, Preliminary Draft. May 7, 2013. Sydney: World Bank.

13. **Despite recent increases in shares of wages and subsidies, Kiribati's expenditure composition is similar to other low income countries (LICs) and generally more flexible compared to other small states.** The rigid part of public expenditure (wages, salaries, pensions, and interest payments) has remained largely stable at around 41 percent of current spending between 2010 and 2014 for which comparable data are available (Table 2). Although subsidies have risen from 13 to 22 percent of current spending over the period, they remain relatively low compared to nearly 31 percent in LICs and 29 percent among other small states (Figure 3).

14. **Nevertheless, because of the country's high vulnerability to external shocks, it is important for Kiribati to maintain more flexible expenditure as well as larger buffers.** Growth in Kiribati has been much more volatile than other LICs and this is true even compared to other small states (Figure 4). With nearly 70 percent of current spending in the difficult-to-reduce categories (wages, salaries, subsidies, pensions, and interest payments), any shocks to revenue or expenditure would likely result in ad hoc cuts in development spending or a large fiscal deficit to be financed by the RERF. Over the medium term, the expenditure growth needs to be limited to a rate commensurate with the country's long term growth rate or the rate of population growth (around 2-4 percent). Growth in public sector wages and SOE subsidies should also be contained to create room for pro-growth and climate-related expenditures.

15. **Increased fishing revenue has allowed the government to partly replenish the RERF, which is the main mechanism to save wealth for future generations and a buffer against shocks.** The RERF has accumulated substantial savings in its early decades thanks to sound fiscal policy, but persistent fiscal deficits in the last two decades—financed by drawdowns from the RERF—have jeopardized its sustainability. As a result, the current per capita value of the RERF is down to around A$5,200 (in 2006 dollars) from around A$ 9,300 in 2000. Even after the fiscal deficits turned surplus in 2013, the government has struggled to replenish the RERF, citing pressing expenditure needs. Only in 2015 did the government managed to transfer A$50 million to the RERF. In June 2016, the new government, in one of its first cabinet meetings, made the decision to transfer A$70 million to the RERF—the single largest transfer the country has made in over two decades. Still, the fiscal surpluses in 2014-15 have led to a large build-up of cash balance outside the RERF—of around A$56 million in the government deposits—about three to four months of the current expenditure. However, this level of cash reserve is consistent with the IMF's recommendation to the government to deal with revenue volatility and external shocks. Going forward, the policy for drawdown from the cash buffer should be made more transparent and the government should ensure replenishment for the RERF when revenues exceed

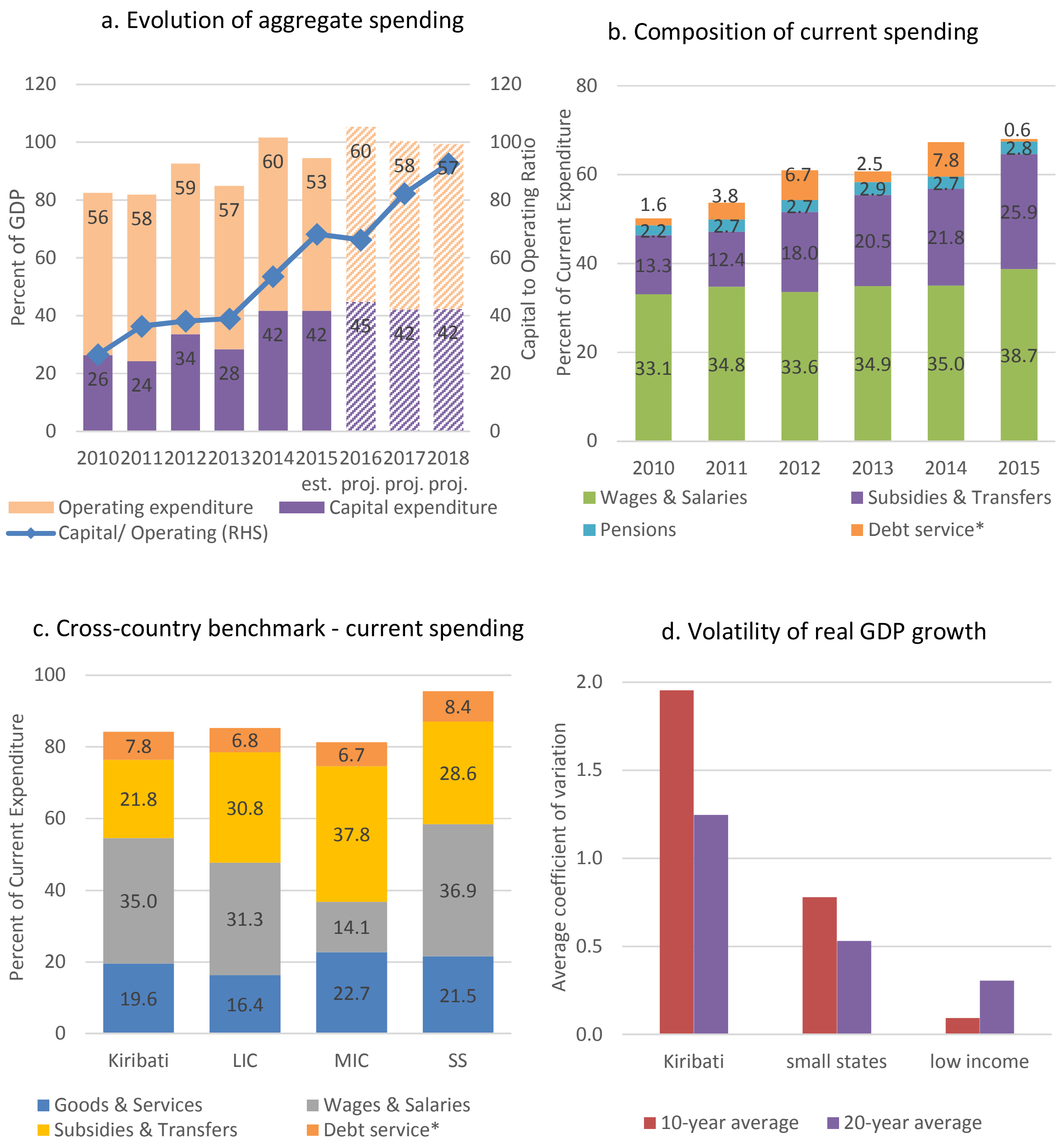
expectations. Any fiscal surplus after replenishing the cash reserve buffer should be transferred to the RERF to expand the principal base.

Table 2. Selected Fiscal Indicators, 2013-2018

	2013	2014	2015 est	2016 proj.	2017 proj.	2018 proj.
	Percent of GDP, unless otherwise indicated					
Revenue and grants	94.4	127.3	154.1	109.9	101.1	100.6
Revenue	65.6	86.1	115.8	63.2	62.6	61.9
Tax revenue	15.8	13.8	16.3	14.8	14.7	14.6
Direct taxes	6.5	5.6	6.7	6.6	6.5	6.5
VAT		4.1	6.8	5.5	5.4	5.4
Non-tax revenue	48.6	70.9	98.4	47.3	46.8	46.3
Fishing revenue	48.0	69.3	96.6	45.6	45.2	44.6
Grants	28.8	41.1	38.4	46.7	38.5	38.7
Expenditure	84.9	101.7	94.6	105.3	100.3	99.4
Current	56.5	60.1	52.9	60.5	58.1	57.0
Wages and salaries	19.7	18.9	20.5	20.6	20.4	20.2
Pension	1.6	1.5	1.5	1.5	1.5	1.4
Other employee benefits	5.8	5.5	5.6	5.7	5.6	5.4
Subsidies, grants, & other commitments	11.6	13.1	13.7	18.4	17.9	17.5
Copra subsidies	3.9	4.0	3.7	7.7	7.5	7.3
Development	28.4	41.6	41.7	44.9	42.2	42.5
Overall balance	9.5	25.5	59.5	4.5	0.8	1.2
Financing	-9.5	-25.5	-59.5	-4.5	-0.8	-1.2
Revenue Equalization Reserve Fund (RERF)	5.3	4.1	-2.3	-2.2	0.0	0.0
RERF	Current AUD in millions unless otherwise indicated					
Closing balance	661	679	756	776	811	842
Per capita value (constant AUD in 2006)	5,017	4,863	5,181	5,095	5,078	5,013
Memorandum items:						
Exchange rate (AUD/USD, period average)	1.0	1.1	1.3	1.4	1.4	1.4
Nominal GDP (AUD million)	194.0	206.0	214.4	222.3	229.0	236.4

Note: Given Kiribati's small size and the importance of revenue from fishing license fee, GNI is arguably a better measure of the country's income.
Sources: IMF, MoFED, WDI, and staff estimates.

Figure 1. Evolution of Expenditure and Expenditure Composition



Note: *Debt service for Kiribati includes principal and interest payments (separate estimates not available).

Sources: WDI, WEO, and the World Bank staff calculation.

16. **The long term sustainability of the RERF depends on fiscal discipline and the commitment to regularize the transfers to the RERF.** According to the simulation study carried out by the IMF as part of the 2015 Article IV report, even if revenues from fishing license

fees stay high (an average A$100 million per year over 2015-35), the historical pace of spending would lead to a depletion of the RERF in about 20 years. Containing the expenditure growth to less than 2 percent per year would be required to ensure that the RERF real per capita balances would recover to around A$6,000, thus effectively saving part of the windfall fishing revenue and improving intergenerational equity. Until recently, the government had been reluctant to regularize the transfers to the RERF and resisted the adoption of a well-defined target or rule for RERF transfers/drawdowns. However, the government has recently requested the IFIs to provide technical input on how to strike a better balance between the welfare of the current and future generations in the management of the RERF, as well as how to regularize the transfers to and withdrawals from the RERF to ensure its long term sustainability.

2.2 MACROECONOMIC OUTLOOK AND DEBT SUSTAINABILITY

17. **The outlook is broadly favorable**, although growth is expected to moderate in 2016–18 to around 2.5 percent per year as work on infrastructure projects is completed. Inflation should remain low on continued softness in international food and commodity prices bar significant further weakening of the Australian dollar against the US dollar.

18. **The fiscal outturn will largely depend on fishing license fees which can be volatile.** The license fee revenue is expected to also moderate from recent peaks but remain above the historical trend in the medium term on the assumption that the implementation of the "Vessel Day Scheme"—a regional agreement that establishes the minimum price of a vessel day and limits the total number of vessel and fishing days—has caused a structural shift in the revenue stream.[3] Even if the US were to withdraw from the South Pacific Tuna Treaty—negotiations for which are still ongoing—is not expected to significantly affect Kiribati's fishing license fee revenue as others in the market, such as China and Korea, could relatively easily absorb the fishing days.

19. **The current account balance will likely return to small deficits in the medium term.** High import demand related to donor-funded projects is likely to come down. The weaker Australian dollar is expected to have a limited net impact on the country's exports and imports as trade dynamics are dominated by structural factors. The structural trade deficit will be offset by the fishing license fee revenue, investment returns on the RERF, and remittances. Remittances have declined in recent years but should pick-up with global recovery in shipping activities and as employment overseas increases with the creation of additional employment schemes.

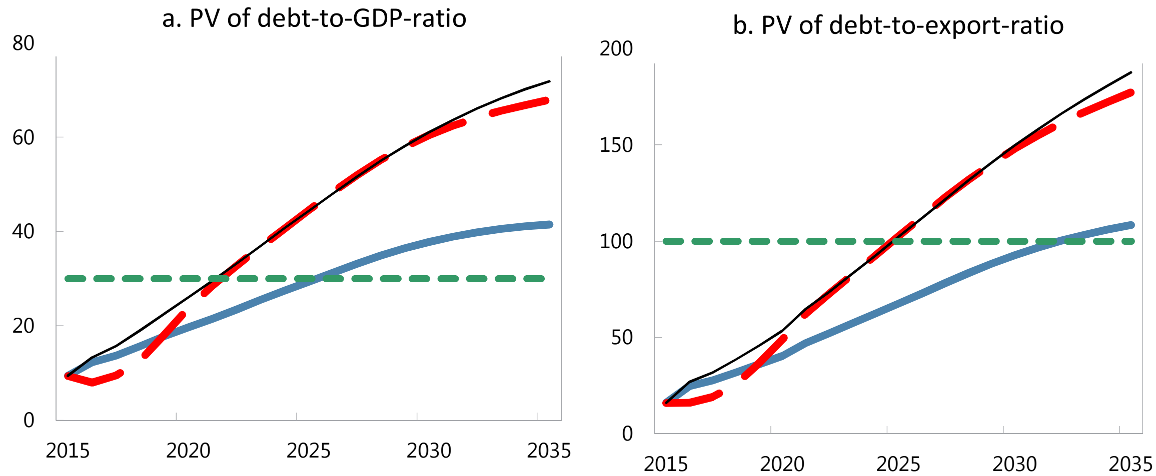
20. **Risk to the outlook is substantial.** The revenue from fishing license fees, which has been very high in the last few years, could decline again in the future even as it remains above historical

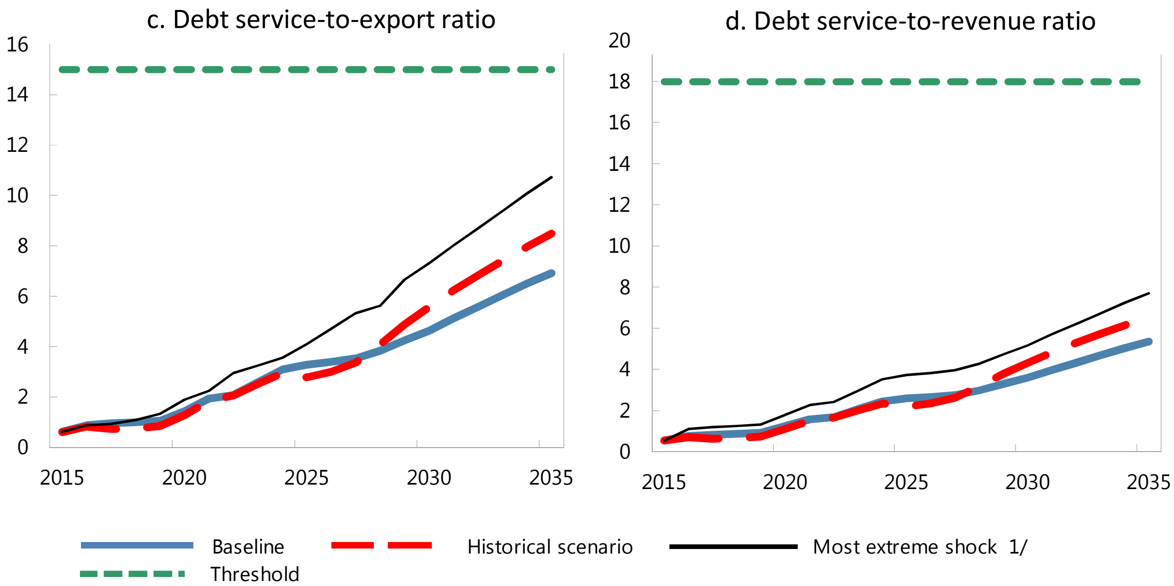
[3] The recently-concluded IMF Article IV mission to Kiribati (May 9-19) and the staff assessment support the view that the fishing license fee revenue would likely be lower than the recent peak but remain above the historical average based on the structural shift, with the projection of A$100million per year in the medium term.

trend. Both the fishing license fees and seamen's remittances could be negatively affected if a sharper-then-expected slowdown in China spills over to the rest of the Asia Pacific. Heightened volatility in the global financial markets—for example, in response to a frontier market currency crisis or default on sovereign bonds, or terrorist attacks in major financial capitals—could have a negative impact on returns to the RERF. Further, extreme weather events could disrupt supplies of imported food and fuel by causing damage to the country's fragile infrastructure and leading to acute shortages and inflation.

21. **Despite relatively low debt, Kiribati remains at high risk of debt distress**, according to the latest IMF/ World Bank Debt Sustainability Analysis (July 2015). Government domestic debt is estimated at 4.5 percent of GDP, while gross external debt is estimated at about 27 percent of GDP. The assessment of high risk of debt distress reflects Kiribati's limited capacity to service debt, given its historically low average growth and narrow export base. Even moderate borrowing can easily result in an unsustainable debt trajectory even under the relatively benign baseline scenario, with continued above-average fishing license fee revenue, moderate expenditure growth, small fiscal deficits, and continued availability of highly-concessional loans and grants to finance development expenditure. Combined with Kiribati's vulnerability to external shocks, high import dependence, limited export base, low potential growth, the limited administrative and governance capacity—reflected in the relatively low CPIA rating—has kept the country at a high risk of debt distress. Containing the risk requires securing grants rather than concessional loans to finance the country's large development needs, maintaining fiscal discipline and building buffers, and implementing structural reforms to encourage the private sector and raise long-term growth.

Figure 2. Indicators of Debt Sustainability under Baseline and Alternative Scenarios





1/ The most extreme stress test is the test that yields the highest ratio on or before 2025. In figure b. it corresponds to a Terms shock; in c. to a Terms shock; in d. to a Terms shock; in e. to a Terms shock and in figure f. to a One-time depreciation shock

Source: World Bank and the IMF.

22. **The current macroeconomic policy stance is adequate for the operation.** The government has achieved substantial fiscal surpluses in recent years, although the improvement was mainly driven by record-high fisheries revenue which could be volatile. Recent increases in expenditures are partly explained by the weather-related crisis response, although there were also increases in recurrent spending (e.g., public sector benefits, copra subsidies) which will be difficult to unwind. The existence of the RERF supports Kiribati's capacity to deal with shocks over the short-term. In the medium-term, however, ensuring fiscal and external sustainability requires containing the growth of nominal expenditure, implementing the reform of SOEs to improve their efficiency and contain the drain on public finances, and maintaining prudent and transparent management of the RERF and fisheries revenue.

3. THE GOVERNMENT'S PROGRAM

23. **Kiribati Development Plan.** The recently launched Kiribati Development Plan (2016–19) identifies key priority areas for the medium term. Building on the achievements under the previous Plan (2012–15), the focus remains on four key themes—investing in human capital, expanding connective infrastructure, building climate resilience, and strengthening public sector management. With respect to public sector management, the specific areas of focus had been on improving governance and accountability through greater disclosure and publication of

government information, such as timely production and publication of the annual accounts and improved financial reporting by SOEs.

24. **Strategic plan.** The strategic plan of the Ministry of Finance and Economic Development for 2016–2019 identifies the following as priorities: (i) better tax and customs compliance, (ii) improved sustainability of government finances; (iii) improved efficiency of SOEs; (iv) greater support to private sector development, and (v) better collection of data for monitoring public sector performance. Under (ii), improved sustainability of government finance, the government is committed to improving the management of the RERF through regular performance reviews of the asset managers, and better monitoring of public debt using improved data and regular reporting. Under (iii), improved efficiency of SOEs, the government plans to continue to restructure underperforming SOEs and to commercialize others.

25. **National Fisheries Policy.** Kiribati's National Fisheries Policy 2013–2025 outlines a broad range of policy and institutional reforms the government plans to undertake to improve returns from the exploitation of Kiribati's fishery resources. The reform priorities include (i) strengthening compliance with regional conservation and management measures, including the VDS, through review and updating of access agreements, license conditions, and other regulations; (ii) updating the Fisheries Act and other relevant acts as required to clarify and strengthen coastal and oceanic fisheries management; and (iii) building the capacity of the Ministry of Fisheries and Marine Development to better execute existing responsibilities as required under the Act (e.g., licensing, implementation of international treaties, monitoring and compliance, reporting, etc.).

4. THE PROPOSED OPERATION

4.1 LINK TO GOVERNMENT PROGRAM AND OPERATION DESCRIPTION

26. This operation has two pillars:

I. Strengthening public financial management, and
II. Creating an environment for inclusive, private sector led growth.

Reforms in these areas correspond directly to the priorities in the government's reform programs discussed above. Specifically, strengthening public financial management is vital to protect fiscal space for public provision of essential services and required investments in climate change adaptation. Accelerating reforms of SOEs, especially those responsible for delivering essential public services, will be critical for ending the health and sanitation crisis and reducing wide-spread poverty. With an estimated 2,000 young people entering the labor market each year, better management and investment in essential infrastructure (water, electricity, and telecommunication) would also be critical for encouraging job creation led by the private sector to curb high and rising unemployment.

27. The proposed operation has incorporated lessons from the World Bank's Development Policy Operations to date, and especially those completed in other small Pacific Island countries:

- **Selectivity.** Given Kiribati's small size and limited implementation capacity, operations should focus on a few areas. The proposed operation focuses on two areas: improving public financial management and creating an environment for inclusive, private sector led growth.
- **Government ownership.** Strong government ownership is critical for moving the reform agenda forward. The presidential election in March 2016 brought a new government into power. The preparation of this operation has been delayed to provide time to engage with the new government to ensure that the reform program reflects the incoming government's policy priorities.
- **Coordination among development partners.** The operation follows an established good practice in the Pacific of using a joint donor matrix for budget support. The World Bank team has worked closely with the Asian Development Bank (ADB), the Australian Department of Foreign Affairs and Trade (DFAT), and New Zealand Ministry of Foreign Affairs and Trade (MFAT) to prepare this operation. The team has also consulted Japan International Corporation Agency (JICA, which has long-standing grant and technical assistance in the fisheries and public utilities sectors) and the IMF and its Pacific Financial Technical Assistance Centre (especially in areas of public financial management and SOE reforms). The government-donor working group—chaired by the Permanent Secretary of Finance and comprising the Secretary to the Cabinet, representatives of the Ministry of Finance and Economic Development, and representatives of donors, established under the first DPO—will provide the forum for ongoing dialogue, monitoring progress, and coordinating technical assistance to support the proposed operation.

4.2. PRIOR ACTIONS, RESULTS, AND ANALYTICAL UNDERPINNINGS

Pillar I. Strengthening the public financial management

<u>Component 1: Improving the transparency of fisheries revenue</u>

DPO3 Prior Action #1. (a) The Recipient has reviewed all existing fisheries joint ventures to examine their financial performance, contribution to the economy, and consistency with the National Fisheries Policy and regional agreements; and (b) the Recipient's Cabinet has approved the restructuring or dissolution of the fisheries joint ventures as appropriate based on the findings and recommendations of the review.

DPO4 Trigger #1. The Recipient's Cabinet has approved a fisheries joint ventures policy outlining the criteria for evaluating existing and new fisheries joint ventures, and has approved a plan to annually review the performance of fisheries joint ventures against this policy.

28. **Fisheries revenue is the most important source of the government's own revenue**, representing around 70 percent of the revenue and 50 percent of GDP from 2010 to 2014. In the last two years, it has reached 71 and 99 percent of GDP, respectively. The revenue is extremely volatile, reflecting fluctuations in fish catches, market prices, and exchange rates. The difficulties of accurately projecting fishing revenue in the budget estimates are compounded by the lack of transparency. Until a few years ago, the Ministry of Fisheries and Marine Resource Development did not share with the Ministry of Finance and Economic Development information on this revenue source (e.g., whether generated under regional, bilateral, or joint venture agreements) or the causes of fluctuations and deviations from projections.

29. **To increase domestic value added from the country's vast fishing resources, the government is seeking joint ventures with overseas partners.** According to the Fisheries Policy 2013-25, the government plans to maximize the economic and employment opportunities from the development of the country's fishery resources, including through joint ventures. Some progress has been made in recent years. For example, Kiribati Fish Ltd., a joint venture for processing with Chinese and Fijian fishing companies, became operational at the end of 2012, and is now planning to expand production and employment. It processes sashimi for Japan and the US, and creates jobs for locals. To ensure a viable domestic fishing industry, however, would require better infrastructure and a better business climate. To compensate for the country's severe infrastructure deficits (in roads, ports, and airports), high costs of basic public services (electricity, water, sewage, and telecommunications), and more generally, difficult environment for doing business (149^{th} out of 189 economies in the 2016 World Bank Doing Business Report), the government provides concessions and incentives to attract potential investors.

30. **Details of joint venture agreements are not published nor readily shared by the Ministry of Fisheries.** The Ministry of Finance has limited information on the content of these agreements. With potentially a complex range of implicit and explicit subsidies involved, lack of analysis and transparent reporting raise concerns about the potential misallocation of resources. Under the proposed operation, the government has begun reviewing the existing joint venture agreements to examine their financial performance, contribution to the economy including the contribution to domestic employment, and compliance with regional agreements, and to ensure that these are not being formed merely to take advantage of the local vessel status and subvert limits imposed on international vessels. The review's findings and recommendations have been submitted to Cabinet, and Cabinet has approved the dissolution of one of the joint ventures and the substantial restructuring of another based on the recommendations of the review. As a trigger for the second operation, the government will institutionalize the formal review process by adopting a fisheries joint ventures policy outlining the criteria for evaluating the fisheries joint

ventures, requiring a formal annual review of the performance of the existing fisheries joint ventures, and extending the review to new joint venture proposals against the criteria.

31. **Expected results.** All fisheries joint ventures are annually reviewed following a formal process and based on transparent evaluation criteria to ensure value for money and consistency with national and regional fisheries policies, compared to the baseline of no formal review or transparent evaluation criteria in 2015. The government's revenue forecasts are based on improved information.

Component 2: Strengthening the governance of the RERF

DPO3 Prior Action #2. The Recipient has implemented the key reform actions to improve the management of the Revenue Equalization Reserve Fund by: (a) appointing two new external asset managers through a transparent and competitive selection process; and (b) executing the approved strategic restructuring of the RERF portfolio to better align with the RERF's long-term investment objectives.

DPO4 Trigger #2. The Recipient, through the Ministry of Finance and Economic Development, has developed and submitted to the Cabinet the reform options to regularize the transfers and withdrawals from the RERF.

32. **Strengthening the RERF is a policy priority to anchor Kiribati's economic and fiscal stability.** The country has a large structural trade deficit, highly volatile revenue, and frequent expenditure shocks. Amid declining remittances from seafarers and uncertain fisheries revenue, steady income flows from the RERF have ensured that large external financing needs are met, upholding confidence among trading partners. Domestically, it has provided the backstop to emergency spending in response to external shocks.

33. **Under the previous DPOs, the government has taken key decisions to improve the management of RERF and reallocate the Fund's assets to better align with its long term objectives.** In the aftermath of the Global Financial Crisis, the RERF suffered irrecoverable losses including through exposures to multiple Icelandic banks.[4] In 2011, with the technical assistance from the IMF, the government undertook a detailed review of the management of the RERF. The review identified a number of weaknesses, including the misalignment of the asset allocation with the RERF's long run investment objectives, and recommended a closer oversight of the performance of the external asset managers, a shift to a passive investment strategy, setting more realistic investment targets, and renegotiating the contract with the custodian. Beginning in 2013, with the technical assistance of the World Bank Treasury team, the government has begun

[4] During the Global Financial Crisis, the real value of the RERF assets declined by A$75 million, or around 12 percent of the Fund's total value, in part through its exposure to three largest Icelandic banks that defaulted on their debt in the fall of 2008 and the Krona became non-convertible.

implementing those recommendations, starting with the performance review of the external asset managers. This review, in turn, found that the incumbent asset managers have taken inappropriate risks while achieving returns that are persistently below market benchmarks over an extended period and charging management fees that are well above competitors' for no additional services. In 2014, the government issued a Request for Proposal to identify best-fit asset managers for the RERF, and through a competitive and transparent process, selected two asset managers on the basis of costs, sovereign fund experience, and abilities to provide capacity building services. Under the previous DPOs, the Cabinet has approved a reform to (a) reallocate the RERF's assets to new asset managers, and (b) restructure the portfolio to reduce its risk exposure. While the government has remained committed to completing the RERF management reforms, vested interests and political interference have at times delayed the implementation of key decisions, requiring continued technical assistance and policy dialogue.

34. **Under the proposed operation, the government has fully implemented the key reforms in the management of the RERF endorsed by the Cabinet in June 2014, January 2015, and September 2015**, by appointing the two new external asset managers selected by the RERF management review process and by executing the approved strategic reallocation of the assets to better align with the RERF's long term investment objectives.[5] Based on the World Bank Treasury's estimates, the implementation of these reforms is expected to save the government approximately A$1 million per year in RERF management costs. As a trigger for the second operation, the Ministry of Finance and Economic Development will develop and submit to the Cabinet the reform proposal for regulating the fiscal transfers to the RERF, identifying options and tradeoffs between the welfare of the current and future generations under each option.

35. **Expected results**. The financial and operational performance of the RERF will be close to market benchmarks, with the average costs of managing the Fund being reduced to around 0.08 percent of its market value, compared to the baseline of around 0.2 percent in 2015. As a result of the regularized transfers to the RERF, the balance in the government's external cash account outside of the RERF will be reduced to the level consistent with the approved policy, compared with the baseline of 60 percent of GDP (or over 100 percent of the current expenditure) in 2015..

<u>Component 3: Improving the management of public debt</u>

DPO3 Prior Action #3: The Recipient has improved management of its public debt by establishing a comprehensive database of public debt, including the debt of state owned enterprises and joint ventures.

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[5] Specifically, the revised investment strategy approved in 2015 limited the eligible asset classes to government bonds and pubic equities, set the strategic asset allocation to 50 percent government bonds and 50 percent global public equities, and shifted the investment strategy from active to passive investment.

DPO4 Trigger #3: The Recipient has improved monitoring of contingent liabilities, through: (a) quantifying the sovereign guarantees, (b) bringing up to date the external audits of the financial statements of SOEs including the Development Bank of Kiribati, and (c) submitting the financial statement of the Kiribati National Provident Fund to the external audits.

36. **Despite relatively low debt, Kiribati remains at high risk of debt distress.** Under the previous DPOs, the Cabinet has adopted a debt policy, committing the government to avoid expensive commercial borrowing and to follow the formal procedures for contracting new debt. In 2015, the government has continued to observe the debt policy, with no new commercial borrowing by the government and all requests for sovereign guarantees being submitted to the Cabinet for formal approval and the President's sign-off.

37. **Gaps remain, however, in the control of public debt and oversight of contingent liabilities.** First, debt recording and reporting is incomplete. The outstanding debt and debt service reported in the budget (and considered in the World Bank–IMF Debt Sustainability Analysis) relate to the central government only, and excludes debt owed by the SOEs. Second, as discussed above, the Ministry of Finance has limited oversight of the joint venture arrangements being negotiated by the Ministry of Fisheries, which sometimes involve establishment of government-guaranteed loan facilities with commercial banks. Third, and more generally, there is a problem of weak monitoring of contingent liabilities, including those arising from the Development Bank of Kiribati and the Kiribati Provident Fund. While the Development Bank of Kiribati has a small loan portfolio (around 5 percent of GDP), it has high share of non-performing loans (around 40 percent of total loans). The Kiribati Provident Fund, on the other hand, manages assets equal to about 60 percent of GDP, and has faced large balance sheet deficits (around 20 percent of its assets in 2015) due in part to the global financial crisis and in part to high rates paid to the members. Because of the absence of a national central bank, neither is subject to financial supervision nor meets international soundness standards (e.g., Basel Core Principles). Fourth and finally, building the capacity to monitor contingent liabilities is important in view of expanding Public Private Partnerships (PPPs). While so far there is only one PPP (relating to recently-privatized Otintaai Hotel), the number is expected to rise (including the Betio Shipyard concession, supported by the ADB, and the telecom concession to expand service to outer islands, supported by the World Bank: see below).

38. **Under the proposed DPO, the government has established a complete and up-to-date database of public debt including that of SOEs and Joint Ventures.** As a trigger for the second operation, the government will strengthen monitoring of contingent liabilities arising from the SOEs, joint ventures, the Kiribati Development Bank, the Provident Fund, and newly expanding PPPs.

39. **Expected results**. Public debt management is based on a comprehensive and up-to-date database, with all debt and debt related transactions (including repayments and disbursements)

recorded within a three-month lag. The Ministry of Finance has better oversight of contingent liabilities.

Pillar II. Creating an environment for inclusive, private-sector led, growth

Component 1: Encourage competition and expansion of the telecommunications services

DPO3 Prior Action #4. The Recipient has issued a second mobile operator license so as to introduce competition in the cellular mobile communications services in the Recipient's territory.

DPO4 Trigger #4. The Recipient's Cabinet has adopted a the revised Universal Access Plan, detailing costs, options, and the timeline to roll out the telecommunications services to the outer islands.

40. **Kiribati has high costs of living for the bottom 40 percent.** The government's main strategy for addressing the high cost of living has been a mixture of price control, subsidies, and public provision of goods and services. Despite huge government subsidies, the public provision through SOEs has resulted in limited supply or coverage and high costs. The costs of basic utilities—electricity, water, telecommunications—are said to be among the highest in the world.

41. **The high costs of telecommunication exacerbate the country's isolation, especially in the outer islands.** The majority of the population either has no access to telecommunications, and even if they live within the range of the existing services, they often face unreliable networks or are unable to afford the services. The cost of telecommunication services is high, even compared to similar countries in the region. The main reasons include limited competition in the market, a difficult operating environment, such as costly satellite bandwidth (Kiribati does not have access to a submarine fiber optical cable), and more fundamentally, the lack of scale and high costs of maintaining service on remote and sparsely populated islands.

42. **Under the previous DPOs, the government has completed the sale of the state-owned telecom monopoly.** The sale of Telecom Services Kiribati Ltd (TSKL) to Fiji's government-backed Amalgamated Telecom Holdings (ATH) has raised the hope of better service coverage, improved service quality, and lower prices to come. However, ensuring domestic competition and rolling out services to the outer islands remain key next steps to realizing the potential gains. In particular, ATH did not acquire TSKL's assets on the Outer Islands (which comprise all islands other than South Tarawa, Betio, and Kirimati) because of the difficult operating environment already mentioned. Under the proposed operation, the government will have undertaken key steps to increase access to telecommunications—by ensuring competition in the capital, and by extending the telecommunications services (which is currently nonexistent) in the outer islands. Specifically, as a prior action, the government has initiated the licensing of the second mobile operator to introduce competition in the Tarawa-Kiribati market. As a trigger for the second

operation, the government will develop a detailed strategy to roll out services to the outer islands. With the advice of the World Bank, the government is exploring the option of using a PPP for the rollout of services on the outer islands, whereby the government builds the network and the private sector operates the services.

43. **Expected results**. By end-2018, the telecommunications market in Tarawa would be served by at least two mobile service operators competing for customers on the basis of coverage, costs, and quality of services. The mobile phone penetration rate would have risen to at least 50 percent (from the baseline of 12 percent in 2014); and the cost of a three-minute peak-hour mobile-to-mobile call within Tarawa would have fallen to A$0.75 from the baseline of A$0.90 in 2013.[6]

Component 2. Reducing costs and improving delivery of public utilities services

DPO3 Prior Action #5. The Recipient has implemented short term measures to improve the operational performance of the Public Utilities Board, including appointing, through a competitive and transparent process, an international chief executive officer for the PUB to manage and implement the PUB's medium-term reform plan.

DPO4 Trigger #5. The Recipient's Cabinet has adopted a medium-term reform plan of the Public Utilities Board, detailing the reform options to achieve operationally and financially sustainable electricity, water, and sanitation services in South Tarawa, Kiribati, and has implemented key aspects of the first six months of the plan.[7]

44. **Kiribati has one of the lowest rates of access to safe water and basic sanitation in the Pacific.** High population growth is compounding the health and sanitation crisis, especially in the capital where the population pressure is most pronounced. Residents receive piped water for only two hours every two days because of high leakage from the system and limited freshwater supplies. Poorly functioning sanitation systems and sanitation practices contribute to groundwater pollution and high rates of infant mortality (among the highest in the Pacific). The government spends nearly A$8 million each year in subsidies to the Public Utility Board (PUB), an SOE providing three essential services: electricity, water, and sewage disposal. However, the service remains poor and unreliable.

[6] The target mobile penetration rate is similar to the rate achieved in Solomon Islands in 2011; the target cost of a three-minute local call (mobile to mobile) is similar to that achieved in Vanuatu in 2011. Solomon Islands and Vanuatu are reasonable comparators because, like Kiribati, these countries rely on satellite for international and remote island connections. Solomon Islands and Vanuatu liberalized their telecom markets in 2010 and 2008, respectively.

[7] The detail of the specific actions that will be implemented under the DPO 4 cannot be specified at this stage because the medium term reform plan has not been submitted to the Cabinet and because the decisions regarding the restructuring options for the PUB (discussed in the text) will have to be taken before the implementation of the plan.

45. **The government, with the help of the World Bank and ADB, is developing a medium term reform plan for the PUB** to achieve financially and operationally sustainable electricity, water, and sanitation services in South Tarawa**.** Based on a series of diagnostic studies, the Ministry of Public Works and Utilities has prepared a performance improvement plan identifying short term measures to quickly improve the operational performance of the SOE. The Ministry is now working on a comprehensive medium-term reform plan that sets out institutional options for reforming the SOE. Under the proposed operation, the government has implemented the short term measures to quickly improve the operational performance of the SOE, including an appointment of an international CEO for the PUB through a competitive and transparent process. Other measures included (i) enforcing an energy conservation policy among government ministries and SOEs to cut electricity consumption and water wastage, (ii) establishing a simple business management system such as timesheets, logbooks, and standard approval procedures for managing claims, (iii) providing a greater oversight for fuel purchase and consumption, (iv) improving the customer billing system, and (v) enforcing a more aggressive debt collection and disconnection policies to larger customers (mostly government ministries and the SOEs). As a trigger for the second operation, the Ministry of Public Works and Utilities will complete and submit for the Cabinet adoption the medium term reform plan for the PUB, detailing the reform options to achieve operationally and financially sustainable electricity, water, and sanitation services in South Tarawa. The key decisions the government must make includes the options for restructuring the PUB with regard to its governance structure (e.g., whether to maintain it as a single entity or to split into two or more entities providing power, water, and/ or sanitation services), and with regard to its management structure in order to improve its operational performance (e.g., whether to maintain the current management structure or introduce partial- or full-outsourcing, including the PPP, of the operation of the PUB).[8]

46. **Expected results.** The appointment of the international CEO and the short term measures that s/he will help implement are expected to bring about improvements in the operational efficiency of the PUB and its delivery of electricity, water, and sanitation services in South Tarawa by end-208, as measured by the billing collection rate (increased to over 97 percent from the baseline of 85-90 percent in 2014), total power losses (reduced to less than 11 percent from the baseline of 18 percent in 2014), and total water leakages from the distribution system (reduced to less than 41 percent from the baseline of 50 percent in 2015).

Table 3: DPO Prior Actions and Analytical Underpinnings

Prior actions	Analytical underpinnings
Pillar I. Improving the Public Financial Management	

[8] There are other reform options on which the government must make a decision, which will be articulated in the medium term reform plan, but many of them are expected to be contingent on the decisions regarding the governance and management structures of the PUB. The detail of the specific actions that will be supported under the subsequent DPO will be provided in DPO 4.

Prior actions	Analytical underpinnings
(a) The Recipient has reviewed all existing fisheries joint ventures to examine their financial performance, contribution to the economy, and consistency with the National Fisheries Policy and regional agreements; and (b) the Recipient's Cabinet has approved the restructuring or dissolution of the fisheries joint ventures as appropriate based on the findings and recommendations of the review.	Kiribati Public Financial Management-Performance Report (2010). Country Policy and Institutional Assessment (2014). Kiribati National Fisheries Policy 2013-25. Review of the Parties to the Nauru Agreement (PNA) Purse Seine Vessel Day Scheme (2015).
The Recipient has implemented the key reform actions to improve the management of the Revenue Equalization Reserve Fund by: (a) appointing two new external asset managers through a transparent and competitive selection process; and (b) executing the approved strategic restructuring of the RERF portfolio to better align with the RERF's long term investment objectives.	IMF Country Report No.15/207 (especially Box 3, p.10), IMF Country Report No.9/196 (Selected Issues Paper I), RERF Report to Investment Committee (June 19, 2015), World Bank Treasury Reserve Advisory and Management Program TA reports.
The Recipient has improved management of its public debt by establishing a comprehensive database of public debt, including the debt of state owned enterprises and joint ventures.	IMF Technical Assistance Report on Establishing a Structure for Public Debt Management (September 2013); Kiribati Debt Management Policy (2013); The 2015 World Bank–IMF Debt Sustainability Analysis.
Pillar II. Creating Environment for Inclusive, Private Sector Led Growth	
The Recipient has issued a second mobile operator license so as to introduce competition in the cellular mobile communications services in the Recipient's territory.	World Bank Kiribati ICT Development Project Appraisal Document (2012). World Bank Regional Connectivity Program Project Appraisal Document (2011).
The Recipient has implemented short term measures to improve the operational performance of the Public Utilities Board, including appointing, through a competitive and transparent process, an international chief executive officer for the PUB to manage and implement the PUB's medium-term reform plan.	A series of reports prepared under the Kiribati Utility Services Reform Project, including (i) Operational Performance Assessment; (ii) Financial Performance Assessment; and (iii) Service Levels and Operational and Capital Investment Needs Assessment.

4.3 LINK TO CPF, OTHER BANK OPERATIONS, AND THE WBG STRATEGY

47. **The proposed operation is aligned with the priorities identified in the existing Country Assistance Strategy and the new Systematic Country Diagnostic for the Eight Pacific Island Countries.** The country assistance strategy (developed in early 2011) has identified two central themes: (i) building resilience against external shocks, and (ii) mitigating economic isolation by encouraging regional and global integration. The proposed operation supports both of these themes. It supports the first theme by supporting reforms to improve public financial management (e.g., increasing the transparency of fisheries revenue, strengthening the management of the RERF, improving the management of public debt). It supports the second

theme by supporting reforms to encourage expansion of telecommunications services, including to the outer islands. The new Systematic Country Diagnostic for the Eight Pacific Island Countries identified four development priorities: Fully exploiting the limited set of economic opportunities; Fostering access to economic opportunities and public services; Protecting Incomes, Assets and Services for the poor; and Addressing selectively weaknesses in economic governance and the business environment. The proposed operation will contribute directly to these priorities by supporting reforms to improve the management of the RERF and the management of fisheries revenue, and by supporting reforms to reduce costs and increase access to utilities and telecommunication services, which will in turn improve the investment climate and encourage private sector led growth.

48. **Policy actions supported by this operation are also closely aligned with the priorities identified under the ongoing World Bank projects**: (i) Reserve Advisory and Management Program, led by the Treasury, which is helping the government improve the governance, asset allocation, and selection of external managers of the RERF; (ii) Telecommunications and ICT Development Project, led by the Transport and ICT Global Practice, which is helping the country achieve the transition to a market-driven telecommunications sector and expand services to the outer islands; and (iii) Utility Service Reform Project, led by the Energy and Extractives Global Practice, which is helping the government to develop and implement comprehensive reforms of the Public Utilities Board to ensure sustainable provision of essential public services.

4.4 CONSULTATIONS, COLLABORATION WITH DEVELOPMENT PARTNERS

49. **The Economic Reform Taskforce provides the forum for consultation and coordination.** Under the first Kiribati Economic Reform DPO, an Economic Reform Taskforce, a government-donor working group, was established. It is chaired by the Permanent Secretary of Finance and comprises the Secretary to the Cabinet, representatives of the Ministry of Finance and Economic Development, and representatives of donors. The Taskforce will continue to provide the forum for ongoing dialogue, monitoring progress, and coordinating technical assistance to support the proposed operation.

50. **The World Bank has collaborated closely with the ADB and New Zealand to prepare this operation.** Following an established practice in the Pacific, the operation uses a joint policy matrix to underpin the budget support.[9] This reduces the transactions costs for the authorities while increasing the policy impact. In addition, the World Bank, along with the ADB, consulted JICA, and the IMF and its Pacific Financial Technical Assistance Centre to coordinate policy

[9] In the context of Kiribati, the joint policy matrix is an instrument used by the government and the donors to identify and agree on priority reform actions, to monitor reform progress, and to coordinate donor support including but not exclusive to the budget support operations (i.e., including investment loans and grants, and technical assistance). The Joint Policy Matrix in 2015-16 will serve the basis of the budget support operation of the World Bank as well as by the ADB and the New Zealand MFAT that are currently under preparation.

advice and technical assistance, in particular, in areas of fisheries revenue, SOE reform, and pubic financial management.

5. OTHER DESIGN AND APPRAISAL ISSUES

5.1 POVERTY AND SOCIAL IMPACT

51. **Policies supported by the proposed operation are expected to have a positive impact on poverty and shared prosperity.** Improving public financial management and safeguarding fiscal sustainability will ensure that the government can maintain public investment in physical and human capital. More predictable and transparent revenue will enhance the government's ability to focus on the medium-term priorities and allocate the budget accordingly. Strengthening the RERF will help anchor the country's fiscal and external stability. Improving public debt management will help avoid unsustainable borrowing, costly mistakes, and ultimately, a debt crisis which would disproportionately hurt the poor who cannot easily accumulate buffers, insure against risk, or migrate and escape the brunt of ensuing economic hardship.

52. **Ensuring competition in the telecommunications market is also expected to be pro-poor** as it targets improving services and lowering prices for the population living in the capital, where the highest incidence of poverty is found. Rolling out the telecommunication services to the outer islands is expected to help reduce isolation and improve the quality of education and health services. In so doing, it is expected to reduce the major causes for internal migration to the capital which, in turn, could positively impact poverty by moderating the population pressure, environmental degradation, and health and sanitation crisis in the capital.

53. **Similarly, improving the efficiency and service delivery of the Public Utilities Board should help reduce poverty**, by improving access to most basic utilities services—electricity, water, and sanitation—in the capital.

54. **Improving access and reducing costs of utilities and telecommunications services should also help improve the business climate**, encourage private investment, and create jobs, which are "the best insurance against poverty and vulnerability" (World Development Report 2011). Because smaller domestic businesses are more reliant on the public/ locally provided services than larger transnational companies, these improvements will likely disproportionately benefit smaller businesses, encouraging them to expand, which will also help create more jobs.

55. **Where there are potential negative impacts, the World Bank is helping the government to assess the impact on the poor based on a distributional analysis.** For example, the reform of the Public Utility Board might introduce basic user charges to improve the access, quality, and sustainability of the public utilities services. This might, in the event of a decision to introduce such charges, have a negative effect on the poor. The risk will be mitigated by

undertaking a careful analysis of tariff affordability based on distributional analyses of potential tariff increases and examinations of options for mitigating the impact on the poor.[10]

5.2 ENVIRONMENTAL ASPECTS

56. **Policies supported by the proposed operation are expected to have some positive indirect effects on the environment and natural resources**. Policies to support transparency of revenue, sound management of the RERF and the public debt, and more competitive telecommunication are unlikely to have any physical impact on the environment or regulation thereof. The improved public utilities services is not expected to have significant direct impact on the environment as the expected result is more effective management of the utilities. Indirectly, the proposed operation is expected to have some positive environmental impacts. Greater availability of water and sanitation services in the overcrowded capital will reduce environmental degradation by easing water contamination and solid waste problems. Similarly, strengthening the transparent management of the fisheries revenue will promote efficient and sustainable allocation of fishing licenses, ensuring sustainable fish stocks.

57. **The country's institutional capacity for environmental assessment and climate risk management is rated 3.0 according to the latest 2016 CPIA, indicating that the legal and regulatory framework are in place for effective environmental assessment system but weak capacity constrains monitoring and enforcement.** The Environment Act 1999 (with 2007 Amendments) and the Environment Regulations 2001 provide the legal and regulatory framework for the country's environmental assessment system. The draft Environmental Regulation 2009 is currently being redrafted to update the processes for environmental impact assessment. The Environment and Conservation Department is responsible for implementation and enforcement. The department has had an increase in staff numbers in 2014 but the capacity remain weak due to staff turnover, inadequate allocations to monitoring and enforcement in the budget, and a lack of capacity to perform technical review of complex applications. With respect to mainstreaming climate change management in the national policy, Kiribati is well known for its commitment to integrating climate risk awareness and responsiveness into the country's economic and operational planning. In vulnerable areas, such as fresh water management and coastal protection, climate risks are integrated into projects and plans.[11] While the capacity of the Department is weak, the existing environmental regulatory framework, expected net positive environmental impact, and the regulatory nature of the reforms support the conclusion that the environmental risk for this operation is moderate.

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[10] The analyses have been conducted under the technical assistance provided by the World Bank jointly with the ADB, DFAT, and MFAT.

[11] An example is the management of the fresh water reserves and the protection of coastal areas using sustainable structures and mangrove planting under the World Bank Kiribati Adaptation Program.

5.3 PFM, DISBURSEMENT, AND AUDITING ASPECTS

58. Overall, the fiduciary risk of this operation arising from Kiribati's public financial management framework is substantial.

59. **The 2010 Public Financial Management Performance Report identified relative strengths in Kiribati's public financial management in several areas**, including: (i) credibility of the expenditure program; (ii) transparency of inter-government fiscal relations; (iii) predictability of taxpayer obligations and liabilities; and (iv) external scrutiny and audit with regard to the legislative scrutiny of external audit reports (all scoring B or better).

60. **At the same time, it highlighted a number of weaknesses**, including: (i) revenue estimates in the budget, (ii) classification of the budget, (iii) oversight of aggregate fiscal risk from other public sector entities, (iv) timeliness and regularity of accounts reconciliation, (v) availability of information on resources received by service delivery units (all scoring D).

61. **From 2011 to present, the government has worked closely with donors to systematically improve its public financial management system.** Many donors, in particular the European Union, Australia DFAT, ADB, World Bank, IMF, and PFTAC, have expressed interest in supporting this effort. With technical assistance from the European Union, the government developed the multi-year Kiribati PFM Reform Plan, identifying five strategic priorities to guide all PFM related activities: (i) better expenditure control, (ii) enhanced revenue management, (iii) improved internal and external audit, (iv) increased use by donors of the Kiribati PFM system, and (v) a stronger PFM regulatory framework. Progress has been made in specific elements of the reform plan, including better expenditure control through improved accounting systems and the move toward more standard budget classification, formulation of medium term budgets, publication of annual budgets, and elimination of the backlog of financial statements of the government and increasingly, that of the SOEs. The government publishes its annual budget on its website.

62. **External audit functions reasonably well in Kiribati.** The Audit Office is considered to function well, although it struggles with limited resources and capacity, and its recommendations are not consistently implemented. While audit reports on the government's financial statements are available within 8 months of their receipt, there are often long delays before the Audit Office receives the government's financial statements ready to be audited. Approximately 50 percent of expenditure is audited annually. There is strong parliamentary scrutiny of the audit reports. Parliament reserves one day per session for debate of the reports and the government is required to table a response to the Public Accounts Committee's recommendations. Parliamentary proceedings are broadcast on public radio, which has wide listenership. Nevertheless, the issues relating to the coverage of the budget—e.g., limited information on public debt and guarantees, details of the financial operations of the SOEs, lack of disclosure on fishing license and joint

venture agreements signed and fees received—limit the extent to which public scrutiny of the report provides a full picture of the government's operations. The government is currently pursuing reforms to strengthen the oversight and transparency of SOE-related financial activities, such as an additional breakdown in the budget relating to transfers to SOE (separately identifying transfers to meet non-commercial service obligations from other transfers), and quasi-fiscal operations relating to SOEs (e.g., provision of sovereign guarantees).

63. **Kiribati does not have a central bank or its own national currency.** The disbursement measures proposed are to ensure that the grant funds disbursed by the World Bank are deposited in a dedicated account at a commercial bank, and then an amount equivalent to the grant is credited to an account of the government available to finance budgeted expenditures. The grant will be disbursed according to IDA disbursement procedures for development policy operations. The full grant amount of US$ 2 million equivalent will be disbursed against satisfactory completion of the specified policy actions as listed in Table 3, the government agreement as summarized in the letter of the development policy, and adequacy of the macroeconomic policy framework, and is not tied to any specific purchases. Once the grant is approved by the Board and becomes effective, the proceeds of the grant will be deposited by IDA in one tranche, in Australian dollars, at the request of the Recipient, into a dedicated Local Currency Deposit Account at the ANZ. ANZ Bank is a large Australian Bank and they own 75 percent of the Banking Company which operates in Kiribati. The government owns the other 25 percent. This is the only commercial banking network operating in Kiribati. All investment lending funds to Kiribati which require a Designated Account have used the ANZ.

64. **Flow of funds is subject to the government's regular financial management processes.** Grant proceeds will flow into a dedicated Local Currency Deposit Account and from it to the budget of the government, and are thus subject to the government's regular PFM processes and procedures. As a due diligence measure, the Borrower will provide, by way of a letter, confirmation to the World Bank that the grant amount has been credited to a Local Currency Deposit Account used to finance budgeted expenditures within 30 days of receipt of the IDA funds. Disbursement would not be linked to specific purchases. The proceeds of the operation would not be used to finance expenditures excluded under the Agreement. If, after being deposited in a government account, the proceeds of the operation are used for ineligible purposes as defined in the Financing Agreement, IDA will require the Borrower to refund the amount directly to IDA. Any such amounts refunded to IDA shall be cancelled.

65. **As an additional mitigation measure, the World Bank will require the auditors of the government, in this case the Kiribati National Audit Office, to conduct a special audit of the dedicated Local Currency Deposit Account.** The audit will cover the following: (i) the accuracy of the summary of the transactions of this account, including accuracy of exchange rate conversions; (ii) that this account was only used for the purposes of the operation and that no other amounts were deposited into this account, including confirmation from corresponding

bank(s) involved in the funds flow; and (iii) that payments from this dedicated Local Currency Deposit Account were in a timely manner (normally within 30 days of disbursement) transferred to an account available to finance budgeted expenditure. The audit will be provided to the Bank as soon as available, but not later than six months after the last disbursement from the Association, and will be made publicly available in a timely fashion.

5.4 MONITORING, EVALUATION, AND ACCOUNTABILITY

66. **The Economic Reform Taskforce provides the structure for monitoring and evaluation.** Monitoring and evaluation will be supported by the data provided by relevant government ministries and agencies, donors, and those available from publicly available sources. Progress against actions and outcomes will be collaboratively tracked, and any necessary remedial actions identified and executed, jointly by the members of the taskforce.

6. SUMMARY OF RISKS AND MITIGATION

Table 4. Systematic Operations Risk-Rating Tool

Risk Categories	Rating (H, S, M, L)
1. Political and governance	S
2. Macroeconomic	S
3. Sector strategies and policies	M
4. Technical design of project or program	M
5. Institutional capacity for implementation and sustainability	S
6. Fiduciary	S
7. Environment and social	M
8. Stakeholders	M
Overall	**S**

67. **Macroeconomic risk.** Sharper than expected slowdown in fisheries revenue, e.g., through disorderly slowdown in China or disruptions in the regional trade from rising tensions over the South China Sea, could weaken the macroeconomic stability and could distract the government from moving ahead with reforms to regularize fiscal transfers to and from the RERF. A heightened volatility in the global financial markets—e.g., in response to further monetary policy divergence between major developed economies, defaults in some emerging markets, or heightened security risks in the region (e.g., owing to increasing terrorist attacks)—will negatively impact on returns to the RERF assets, which could make the government more risk averse and slow the ongoing

management reforms and the restructuring of the asset portfolio of the RERF. In addition, Kiribati is vulnerable to extreme weather, which could reduce growth and revenue, increase expenditure pressure, and divert the government's administrative capacity. Ongoing growth-enhancing structural reforms, continuing strong policy dialogue, and financial support and technical assistance from the World Bank, ADB, Australia, and other development partners will help mitigate the macroeconomic risk.

68. **Political and governance risk.** The presidential election in March 2016 returned the new president and a former-opposition party in the government. Moreover, the reform program supported under this DPO includes areas that have previously been politically sensitive, such as strengthening transparency of the fisheries revenue, the reform options to regularizing fiscal transfers to and withdrawals from the RERF, and improving management of the SOEs. To mitigate the risks, the proposed operation focuses on the areas where the government has already established a strong track record, identified prior actions that are consistent with the reform program of the new government, and selected options for policy triggers in the subsequent operation that would help maintain reform momentum but allow some flexibility to respond to new opportunities for policy dialogue with the new leadership.

69. **Institutional Capacity.** As in many developing small states, Kiribati struggles with thin capacity with a small number of civil servants called upon to implement many tasks. Those with relevant technical skills and experience are difficult to retain in the civil service as they find overseas opportunities, or are "poached" by the donor agencies. Program implementation can thus be significantly affected when civil servants leave their position or, for various reasons, are unable to perform their duties. This risk is mitigated somewhat by having a strong engagement with the government (this is the third programmatic DPO in four years), selecting the limited number of policy actions carefully, close alignment of policy actions with government priorities, and having dedicated technical assistance from various development partners that support implementation of specified actions.

70. **Fiduciary risk.** As noted in Section 5.3 above, fiduciary risk is substantial. The 2010 *Public Financial Management Performance Report* identified a number of weaknesses in the government's PFM systems, including budget classification and the timeliness and regularity of accounts reconciliation. In addition, although external audit functions reasonably well, the government often takes a long time to submit financial statements to the National Audit Office. As also noted above, several steps will be taken to mitigate this risk. The proceeds of the grant will be deposited into a dedicated account in the ANZ Bank which has been used in all World Bank investment grants to Kiribati that require a designated account. The National Audit Office will undertake and publish a special audit of this account. Ongoing efforts by the government to improve its public financial management with the financial support and technical assistance of the World Bank, ADB, Australia, and other donors will further mitigate the risk.

ANNEX 1: POLICY AND RESULTS MATRIX

Prior Actions under DPO3	Triggers for DPO4	Results
Pillar I. Strengthening the Public Financial Management		
1. (a) The Recipient has reviewed all existing fisheries joint ventures to examine their financial performance, contribution to the economy, and consistency with the National Fisheries Policy and regional agreements; and (b) the Recipient's Cabinet has approved the restructuring or dissolution of the fisheries joint ventures as appropriate based on the findings and recommendations of the review.	1. The Recipient's Cabinet has approved a fisheries joint ventures policy outlining the criteria for evaluating existing and new fisheries joint ventures, and has approved a plan to annually review the performance of fisheries joint ventures against this policy.	1. All fisheries joint ventures are annually reviewed following a formal process and based on transparent evaluation criteria to ensure value for money and consistency with national and regional fisheries policies. Baseline: 0 percent of existing and proposed joint ventures (Dec 31, 2015); Target: 100 percent of existing and proposed joint ventures (Dec 31, 2018).
2. The Recipient has implemented the key reform actions to improve the management of the Revenue Equalization Reserve Fund by: (a) appointing two new external asset managers through a transparent and competitive selection process; and (b) executing the approved strategic restructuring of the RERF portfolio to better align with the RERF's long-term investment objectives.	2. The Recipient, through the Ministry of Finance and Economic Development, has developed and submitted to the Cabinet the reform options to regularize the transfers and withdrawals from the RERF.	2a. The Revenue Equalization Reserve Fund is managed according to the prevailing market standards with substantially reduced costs. Baseline: 0.2 percent (Dec 31, 2015); Target: 0.08 percent (Dec 31, 2018). 2b. The balance in the government's external cash account outside of the RERF will be reduced to the level consistent with the approved policy. Baseline: Over 100 percent of the current expenditure (Dec 31, 2015); Target: No more than 50 percent of the current expenditure (Dec 31, 2018).
3. The Recipient has improved management of its public debt by establishing a comprehensive database of public debt, including the debt of state owned enterprises and joint ventures.	3. The Recipient has improved monitoring of contingent liabilities, through: (a) quantifying the sovereign guarantees, (b) bringing up to date the external audits of the financial statements of SOEs including the Development Bank of Kiribati, and (c) submitting the financial statement of the Kiribati National Provident Fund to the external audits.	3. Public debt is managed based on a comprehensive and up-to-date public sector debt database for effective monitoring of the debt including contingent liabilities. Baseline: The database covers the central government's external debt only (Dec 31, 2018); Target: The database covers the public sector external and domestic debt, with all debt and

Prior Actions under DPO3	Triggers for DPO4	Results
		debt related transactions (including repayments and disbursements) recorded within a three-month lag (December 31, 2018).
Pillar II. Creating environment for inclusive and private-sector led growth		
4. The Recipient has issued a second mobile operator license so as to introduce competition in the cellular mobile communications services in the Recipient's territory.	4. The Recipient's Cabinet has adopted a the revised Universal Access Plan, detailing costs, options, and the timeline to roll out the telecommunications services to the outer islands.	4. The telecommunications market in Tarawa would be served by at least two mobile service operators competing for customers on the basis of coverage, costs, and quality of services. Baseline: The Tarawa market is served by one mobile service operator, with the mobile phone penetration rate at 12 percent and the cost of a three-minute peak-hour mobile-to-mobile call within Tarawa at A$0.90 (latest available data as of December 31, 2015). Target: The Tarawa market is served by at least two mobile service operators (Dec 31, 2018), with the mobile phone penetration rate has reached at least 50 percent. The cost of a three-minute peak-hour mobile-to-mobile call within Tarawa have fallen to at least A$0.75 from the baseline of A$0.90 in 2013.
5. The Recipient has implemented short term measures designed to quickly improve the operational performance of the Public Utilities Board, including appointing, through a competitive and transparent process, an international chief executive officer for the PUB to manage and implement the PUB's medium-term reform plan.	5. The Recipient's Cabinet has adopted a medium-term reform plan of the Public Utilities Board, detailing the reform options to achieve operationally and financially sustainable electricity, water, and sanitation services in South Tarawa, Kiribati, and has implemented key aspects of the first six months of the plan.	5. The operational efficiency of the PUB and its delivery of basic public services have improved. as measured by the billing collection rate (increased to over 97 percent from the baseline of 85-90 percent in 2014), total power losses (reduced to less than 11 percent from the baseline of 18 percent in 2014), and total water leakages from the distribution system (reduced to less than 41 percent from the baseline of 50 percent in 2015). Baseline: The billing collection rate is 85-90 percent, total power losses from the distribution network is 18 percent, and total water leakages from the distribution system is less than 41 percent. .

Prior Actions under DPO3	Triggers for DPO4	Results
		Target: The billing collection rate is more than 97 percent, total power losses is less than 11 percent, and total water leakages is less than 41 percent.

ANNEX 2: LETTER OF DEVELOPMENT POLICY

GOVERNMENT OF KIRIBATI
MINISTRY OF FINANCE & ECONOMIC DEVELOPMENT
Phone: (686) 21806 or 21802, Facsimile: (686) 21307, Address: PO Box 67, Tarawa, Kiribati

File Ref: Date: 22 July 2016

Mr. Jim Young Kim
President
The World Bank
Washington, D.C., 20433

Dear President Kim,

Re: Letter of Development Policy

Kiribati faces important fiscal and economic challenges arising from frequent external shocks. In the last three years, Kiribati has enjoyed record fishing license fee revenue which helped boost growth, improve fiscal position, and strengthen the current account. At the same time, large donor-financed infrastructure projects have helped buoy domestic demand and mobilizing tax revenue. Low global food and commodity prices, too, have reduced import bills and kept down inflationary pressures. On the other hand, there were also challenges. Cyclone Pam and strong waves it generated pummeled many of our islands and damaged our fragile infrastructure. An outbreak of chikungunya affected a large segment of the population and required emergency government responses. Weakness in global trade and shipping activity has continued to weaken remittances from our seamen working on foreign vessels. And heightened volatilities in financial market, driven both by diverging monetary policies among advanced economies and sharp slowdowns in major emerging markets, has negatively affected the returns on the assets held in the Revenue Equalizing Reserve Fund (RERF).

To effectively deal with the frequent externals shocks, the government is committed to building fiscal resilience and diversifying economic opportunities. After coming to power in March this year, the government launched the 2016–19 Kiribati Development Plan (KDP) identifying key development priorities in the medium term. In May, the government introduced the 2016 budget, increasing pro-poor spending on education and health, and the financial assistance to outer islands population, while maintaining the balanced budget. In June, the government has made the decision to replenish the RERF by $70 million—the largest single transfer in more than a decade— to save wealth for future generations, and set aside $56 million as cash reserves to build an adequate buffer against the unexpected shocks to which Kiribati is highly vulnerable. The government is committed to maintaining fiscal discipline, continuing to improve the quality of expenditure, and managing its resource revenue carefully to support the country's long run development priorities.

As elaborated in the KDP, prudent management of resources and promoting private sector growth remain the government's key policy priorities. The government recognizes the importance of improving the management of the country's fisheries revenue, which is the most important domestic source of revenue. To improve the transparency of its management, the government has already undertaken important reforms, including the development of the national fisheries policy for 2013–2025 and the annual publication of a joint fisheries revenue report by the Ministry of Fisheries and Ministry of Finance. More recently, the government has begun reviewing the existing fisheries joint ventures to monitor their contribution to domestic employment and investment as well as sustainable management of fisheries resources. The government also recognizes the importance of prudent management of debt for safeguarding Kiribati's fiscal sustainability. To this end, the government has pursued a policy of no commercial borrowing, and strengthened the oversight of contingent liabilities arising from implicit and explicit guarantees to the SOEs. Finally, the government recognizes the importance of the RERF in anchoring Kiribati's economic and fiscal sustainability. With the support of the World Bank, the government has implemented a series of far reaching reforms to improve the management of the RERF, and most recently, appointed two new external asset managers to reduce management costs while improving the management standards to prevailing market benchmarks. At the same time, the government has completed the strategic reallocation of the RERF assets to better reflect the risk-return preference of the government and to ensure that the RERF's long term investment objectives will be met. The government has also requested the World Bank and the IMF to provide technical input on how to strike an appropriate balance between the welfare of the current and future generations in the management of the RERF, and options for making the transfers to and withdrawals from the RERF more predictable and transparent to safeguard its long term sustainability. The government looks forward to continuing its successful working with both institutions to strengthen the governance and the management of the RERF as well as the management of the cash reserves.

Private sector led growth remains a challenge as well as an opportunity for Kiribati. Because of its smallness, remoteness, and dispersed population across many islands, the country faces important constraints to private sector development. This government remains committed to expanding the opportunities for private sector led growth in the country, building on the successes of recent reforms. To reduce the communications and transport problems, the government is addressing the huge backlog in basic infrastructure with donor support, including roads, ports, and airports. To improve the business environment, the government is investing in improving telecommunications by encouraging domestic competition and expanding services to outer islands. The government is also pursuing a multi-year reforms to improve delivery of basic public services including electricity, water, and sanitation, which will be critical for encouraging local small businesses to take root, expand, and create jobs for the country's growing population.

The government welcomes the World Bank's assistance and continued engagement in Kiribati to maintain the reform momentum. The previous budget support operations have helped the government build the strong partnership with the World Bank as well as with the broader donor community, and to develop a shared vision and the consensus on priority reforms. The government looks forward to the World Bank's continued active engagement in Kiribati and its support for the country's ongoing reforms.

Yours sincerely

Hon Dr Teuea Toatu

Minister for Finance and Economic Development

ANNEX 3: FUND RELATIONS ANNEX

Kiribati—Assessment Letter for the World Bank

June 2, 2016

1. **Kiribati's growth momentum remains strong.** Record high fishing license fees following the introduction of the Vessel Day Scheme under the Nauru Agreement in 2012 have boosted growth, improved the fiscal position and strengthened the current account. Real GDP growth is estimated to have reached 3½ percent in 2015, supported by donor-financed infrastructure investment and increased budget spending. Growth is projected to moderate somewhat to around 3 percent this year, with real Gross National Income (GNI) declining by about 20 percent due to the projected decline of fishing revenue of 50 percent. Inflation remains subdued owing to low food and commodity prices.

2. **Risks to the economic outlook are largely related to external factors.** Climate change could increase uncertainty of fishing revenue over the medium term as the Vessel Day Scheme has not been tested in a low revenue environment for Kiribati. Should the external environment deteriorate, global financial market turmoil could feed into the domestic economy through the exposure to foreign assets of the sovereign wealth fund—the Revenue Equalization Reserve Fund (RERF) and the Kiribati Provident Fund (KPF). Given Kiribati's high reliance on imported goods, commodity price shocks and volatility in the Australian dollar could lead to large current account deficits. Without a central bank, fiscal policy is the only macroeconomic policy lever and buffer against such shocks. Continued engagement and financial support from development partners remains essential to mitigate the downside risks.

3. **Prudent management of resources and promoting private sector growth remain the key policy priorities for the new government that took office in March 2016.** The authorities have made remarkable progress in economic reforms including restructuring the RERF and privatizing several SOEs. The newly launched 2016–19 Kiribati Development Plan identifies key priority areas for the medium term, building on the success of recent reforms. To support the government's long run development agenda, budget decisions need to be taken in the context of a medium term fiscal framework assessing spending goals, revenue projections and wealth management targets, which is likely to imply saving much of the fishing revenue windfall. Further strengthening the RERF balance would also support its capacity to provide sustainable future income for intergenerational equity. Kiribati's geographical constraint underpins the high cost of public service delivery. As a result the government and SOEs dominate the economy and the labor market, while private sector activity remains limited. Long run growth prospects depend on overcoming weaknesses in infrastructure, access to finance and business environment to create conditions for private sector growth and employment.

4. **The IMF's 2016 Article IV mission took place on May 9–20, 2016.** Staff updated the medium term macroeconomic framework based on the newly passed 2016 Budget. Reflecting a projected decline in fishing revenue and increased spending on subsidies, infrastructure maintenance and public sector wages, the fiscal deficit is projected to widen over the medium term, leading to significant drawdown of the RERF starting from 2018. As such, staff advocated efforts to boost tax revenue collection through phasing out VAT exemptions, continuing to improve SOE efficiencies and reining in recurrent spending. The authorities noted that they would consider changing their

policies to maintain a small surplus over the medium term. Staff also proposed a three-pillar fiscal policy framework: achieving balanced budget in the medium term, strengthening the RERF as an anchor for long run fiscal sustainability, and maintaining a cash reserve buffer equivalent to three months of recurrent spending to deal with revenue volatility and climate change related shocks. In particular, staff recommends formulating a rule-based mechanism for RERF withdrawal with the aim to preserving the RERF as an endowment fund that can provide the population with a permanent and stable stream of income, with the government's spending plans aligned to this mechanism. The sustainable level of the RERF drawdown will depend on the government's wealth management target. If the goal is to preserve the real value of the fund after reaching a certain level, the withdrawal rate should be limited to around 1–2 percent of the overall balance, assuming an average nominal rate of return on the fund of 3–4 percent (reflecting the more conservative investment strategy of the RERF) and projected long run inflation of 2 percent. Staff's preliminary debt sustainability analysis also indicates that Kiribati remains at high risk of debt distress due to its reliance on external financing for development investment.

5. **Kiribati is one of the countries most affected by climate change.** Rising sea levels, warmer average temperatures and more frequent and severe storms are likely to have direct impact on potential growth as well as the fiscal position. In this regard, IMF staff recommends explicitly recognizing in the budget the climate change adaptation cost (including coastal protection, damage repairing and soil desalinization) of around 2 percent of GDP over the medium term. A holistic climate change and natural disaster management strategy with clearly identified priorities and long run goals, together with a strengthened PFM system, would help the country tap into global climate change financing sources.

6. **Maintaining the momentum of SOE reforms is important to support private sector growth.** The authorities have successfully privatized several SOEs, opening the door for commercial operation and employment. The SOE subsidies, however, may start to rise with higher commodity prices. Against this background, the authorities should consider further strengthening the commercial mandate of the SOEs and consolidating SOE ownership responsibility under a single minister responsible for both the operational goals of SOEs and their financial management. Continued divestment and outsourcing of SOE activities to the private sector will help improve efficiency and strengthen public finances.

7. **Efforts are needed to enhance financial deepening in a sustainable way.** Facilitating private sector access to credit would be best achieved by removing structural impediments and improving financial education, land access procedures, dispute resolution mechanism and recovery processes. The public financial institutions have supported access to financial services but long-term sustainability of their operations calls for strengthened risk monitoring and addressing deficiencies in financial supervision. Plans to expand the Development Bank of Kiribati activities into deposit taking should be carefully assessed against its track record in recovering nonperforming loans and its capacity to assume the increased liability risk. The crediting rates for KPF member balances should be more closely linked to its investment returns to ensure its ability to meet its contractual obligations, while the KPF's investment strategy should switch to a more conservative one.

8. **Further improvement in infrastructure, business climate and human capital remains critical for private sector development and employment.** Despite the substantial progress in improving physical infrastructure and connectivity, transportation needs remain considerable. Promoting air transportation and shipping services could facilitate development of tourism as well as support recent private sector efforts to develop fishing and agricultural industries. Effort to improve physical infrastructure should also go hand in hand with improving the business climate, in particular through further streamlining business licensing process and improving land registration. Given the growth potential in the fishing industry, building human capital especially through vocational and technical training would help Kiribati harness its marine resources. Further development in other domestic sectors including tourism and routine infrastructure maintenance would also offer employment possibilities.

Table 1. Kiribati: Selected Economic Indicators, 2012–18

Nominal GDP (2014): US$186.1 million
Nominal GNI (2014): US$371.8 million
Main export products: fish and copra

GDP per capita (2013): US$1,656
Population (2013): 109,366
Quota: SDR 5.6 million

	2012	2013	2014	2015	2016	2017	2018
				Est.		Proj.	
Real GDP (percent change)	5.2	5.8	2.4	3.4	3.0	2.7	2.0
Real GNI (percent change)	14.1	16.4	13.4	14.8	-21.3	1.9	2.6
Consumer prices (percent change, average)	-3.0	-1.5	2.1	1.4	0.7	1.8	2.1
Central government finance (percent of GDP)							
Revenue and grants	84.2	96.2	118.9	142.8	94.7	93.3	89.4
Total domestic revenue	50.3	64.5	86.0	113.1	61.5	57.8	57.5
Grants	33.9	31.8	32.9	29.7	33.2	35.6	31.9
Expenditure and net lending	92.6	85.8	95.6	107.0	102.8	103.0	98.3
Current	59.1	54.5	58.3	62.2	65.3	66.6	66.1
Of which: wages and salaries	26.4	26.9	26.0	26.9	27.0	26.8	26.5
Development	33.5	31.4	37.4	44.8	37.5	36.3	32.2
Current balance 1/	-8.8	10.0	27.7	50.9	-3.8	-8.9	-8.5
Overall balance	-8.4	10.4	23.3	35.8	-8.1	-9.6	-8.9
Financing	8.4	-10.4	-23.3	-35.8	8.1	9.6	8.9
of which Revenue Equalization and Reserve Fund (RERF)	23.0	-10.0	4.1	-22.8	-38.5	7.7	7.0
RERF							
Closing balance (in millions of Australian dollars) 2/	614	661	679	756	866	872	880
Per capita value (in 2006 Australian dollars)	4,872	5,018	4,933	5,305	5,832	5,625	5,430
Balance of payments							
Current account including official transfers (in millions of US dollars)	-8.4	15.5	44.7	65.9	-3.3	-2.4	2.1
(In percent of GDP)	-4.5	8.3	24.0	40.0	-2.0	-1.4	1.2
External debt (in millions of US dollars)	14.3	14.3	14.3	25.7	33.3	34.6	36.3
(In percent of GDP)	7.5	8.2	8.4	16.1	20.4	20.7	21.1
External debt service (in millions of US dollars)	7.5	2.7	8.3	0.5	0.8	0.8	0.8
(In percent of exports of goods and services)	30.5	12.2	39.4	2.9	4.3	4.2	3.9
Exchange rate (A$/US$ period average)	1.0	1.0	1.1	1.4	...	...	...
Real effective exchange rate (period average) 3/	101.0	94.0	89.3	78.0	...	...	...
Memorandum item:							
Nominal GDP (in millions of Australian dollars)	181.6	193.9	206.4	219.4	228.4	234.6	241.3
Nominal GDP (In millions of US dollars)	188.0	187.1	186.1	162.7	167.6	171.9	176.2

Sources: Data provided by the Kiribati authorities; and Fund staff estimates and projections.
1/ Current balance excludes grants and development expenditure.
2/ The Australian dollar circulates as legal tender.
3/ Index, 2005=100.