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November 1, 2017

Closing Date: Wednesday, November 22, 2017 at 6 p.m.

FROM: Vice President and Corporate Secretary

Kiribati - Fourth Economic Reform Development Policy Operation

Program Document

Attached is the Program Document regarding a proposed a development policy grant to Kiribati for a Fourth Economic Reform Development Policy Operation (IDA/R2017-0320), which is being processed on an absence-of-objection basis.

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The World Bank

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Report No. 120078-KI

INTERNATIONAL DEVELOPMENT ASSOCIATION

PROGRAM DOCUMENT FOR A PROPOSED DEVELOPMENT POLICY GRANT

IN THE AMOUNT OF SDR 3.6 MILLION (US$5 MILLION EQUIVALENT) TO

THE REPUBLIC OF KIRIBATI

FOR THE

FOURTH ECONOMIC REFORM DEVELOPMENT POLICY OPERATION

October 26, 2017

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, 2017)

Currency Unit
US$1.00 = A$1.30
SDR 1 = A$1.81

ABBREVIATIONS AND ACRONYMS

A$	Australian Dollar
ADB	Asian Development Bank
CEO	Chief Executive Officer
CPIA	Country Policy and Institutional Assessment
CPO	Chief Procurement Officer
CPU	Central Procurement Unit
CSO	Community Service Obligation
DBK	Development Bank of Kiribati
DFAT	Department of Foreign Affairs and Trade
DPO	Development Policy Operation
DSA	Debt Sustainability Analysis
ERT	Economic Reform Taskforce
GDP	Gross Domestic Product
GoK	Government of Kiribati
GRS	Grievance Redress Service
HIES	Household Income and Expenditure Survey
ICR	Implementation Completion and Results
ICT	Information and Communication Technology
IDA	International Development Association
IMF	International Monetary Fund
KDP	Kiribati Development Plan
KOIL	Kiribati Oil Limited
KPF	Kiribati Provident Fund
KPPRP	Kiribati Public Procurement Reform Plan
LIC	Low Income Country
MFAT	Ministry of Foreign Affairs and Trade
MFED	Ministry of Finance and Economic Development
MFMRD	Ministry of Fisheries and Marine Resources Development
PDO	Program Development Objective
PEFA	Public Expenditure and Financial Accountability
PFM	Public Financial Management
PFTAC	Pacific Financial Technical Assistance Center
PNA	Parties to the Nauru Agreement
PUB	Public Utilities Board
PV	Present Value
RERF	Revenue Equalization Reserve Fund
RFP	Request for Proposal
RPF	Regional Partnership Framework
SAIDI	System Average Interruption Duration Index
SAIFI	System Average Interruption Frequency Index
SOE	State-Owned Enterprise
SPC	South Pacific Community
US$	United States Dollar
VAT	Value Added Tax
VDS	Vessel Day Scheme
WDI	World Development Indicators
WEO	World Economic Outlook

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REPUBLIC OF KIRIBATI
FOURTH ECONOMIC REFORM DEVELOPMENT POLICY OPERATION

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

Recipient	Republic of Kiribati
Implementation Agency	Ministry of Finance and Economic Development
Financing Data	IDA Grant; IDA terms; amount of SDR 3.6 million (US$5 million equivalent)
Operation Type	Programmatic (2 of 2); single-tranche Development Policy Operation
Pillars of the Operation and Program Development Objectives	The program development objective is to: (i) strengthen public financial management; and (ii) improve the environment for inclusive growth. These two components correspond to the two pillars of the operation. The first pillar is supported through strengthening the management of public assets and liabilities, and improving public procurement. The second pillar is supported through improving oversight of joint ventures in the fisheries industry, improving the quality and expanding the coverage of essential public utilities, and facilitating competition and universal service provision in the telecommunications industry.
Result Indicators	<u>Strengthening public financial management</u>: 1. The return on the RERF portfolio is aligned with the relevant market benchmark (<u>baseline</u> return 8.29 percent below the benchmark; <u>target</u> return 0.25 percent below the benchmark or better). 2. The RERF is managed according to prevailing market standards with reduced costs (<u>baseline</u> costs 0.2 percent of market value; <u>target</u> costs of no more than 0.1 percent of market value). 3. Public sector debt, including contingent liabilities, is monitored effectively through a comprehensive and up-to-date public sector debt database (<u>baseline</u> database covers only central government external debt; <u>target</u> database covers public sector external and domestic debt, including contingent liabilities, and all transactions are recorded within a three-month lag). 4. The Central Procurement Unit (CPU) is operational, as indicated by the delegation of the relevant procurement powers to the Chief Procurement Officer (CPO) (<u>baseline</u> of no CPU; <u>target</u> of the CPO holding delegated procurement powers). <u>Improving the environment for inclusive growth:</u> 5. All fisheries joint ventures are reviewed annually based on the approved criteria and, for those found not to offer value-for-money, remedial actions are agreed (<u>baseline</u> two-thirds of joint ventures provided value-for-money; <u>target</u> all remaining joint ventures provide value-for-money, or have associated remedial actions agreed). 6. The telecommunications market in Tarawa is served by at least two mobile service operators competing on access and price (<u>baseline</u> one operator, 12 percent mobile penetration rate, A$0.90 standard call cost; <u>target</u> at least two operators, 50 percent penetration, A$0.75 standard call cost). 7. There is increased penetration of mobile telephones in the outer islands (<u>baseline</u> 12 percent penetration; <u>target</u> 20 percent penetration). 8. The financial and operational performance of the Public Utilities Board and the quality of electricity services has improved, as measured by the billing collection rate (<u>baseline</u> 85 percent; <u>target</u> at least 90 percent), total power losses from the distribution network (<u>baseline</u> 18 percent; <u>target</u> no more than 15 percent), SAIFI (<u>baseline</u> 7.9; <u>target</u> 6) and SAIDI (<u>baseline</u> 946; <u>target</u> 880). 9. There is an increase in the proportion of poor households (households consuming less than 100kWh) in Tarawa benefiting from the new electricity tariff structure (<u>baseline</u> 0 percent; <u>target</u> 70 percent).
Overall Risk Rating	Substantial
Climate and Disaster Risks	(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 ☐ If yes, (ii) summarize briefly in the risk section.
Operation ID	P161794

IDA PROGRAM DOCUMENT FOR A PROPOSED
FOURTH ECONOMIC REFORM DEVELOPMENT POLICY OPERATION
TO THE REPUBLIC OF KIRIBATI

1. INTRODUCTION AND COUNTRY CONTEXT (INCLUDING POVERTY DEVELOPMENTS)

1. **The proposed Fourth Economic Reform Development Policy Operation aims to support the Government of Kiribati (GoK) to strengthen public financial management and improve the environment for inclusive growth.** It is the second in a programmatic series of two development policy operations, following on from an earlier programmatic series of two development policy operations. The first operation in the current series provided grant financing of US$2 million equivalent, with the proposed second operation to provide grant financing of US$5 million equivalent. With the support of the GoK, the World Bank's development policy engagement is taking place jointly with other major development partners. The Asian Development Bank (ADB), Australian Department of Foreign Affairs and Trade (DFAT) and New Zealand Ministry of Foreign Affairs and Trade (MFAT) are each providing budget support against a joint policy matrix agreed between the GoK and this group of development partners.

2. **Kiribati is one of the smallest, most remote and most geographically dispersed countries in the world, which creates significant economic growth and service delivery challenges.** Kiribati consists of 33 islands spread over 5 million square kilometers of ocean (an area far larger than India). The population of about 114,000 people lives on 21 of the coral atolls and single volcanic island in the island groups, with a total land area of less than 800 square kilometers. Kiribati is extremely remote from its nearest markets – about 4,000 kilometers from both Australia and New Zealand. Kiribati's low-lying atolls rise little more than 1.8 meters above sea level on average and, as such, are at the forefront of climate change. Kiribati is highly exposed to the effects of sea level rise, storm surge, coastal erosion and saltwater intrusion.

3. **With such extreme economic geography challenges, economic growth prospects are limited.** Private sector development opportunities are highly constrained by the lack of economies of scale possible in such a small and fragmented domestic market that is extremely remote from large markets abroad. Severe infrastructure deficits in the areas of utilities, transport and communications compound these constraints. Economic activity is dominated by subsistence agriculture and fisheries (dominated by government-subsidized copra production), the public sector (including a large number of state-owned enterprises (SOEs)), and a service economy underpinned by the public sector in the capital of South Tarawa (where approximately half the population live). Public expenditure was equivalent to 112 percent of GDP in 2016, funded primarily by fisheries license fees (65 percent of GDP) and grants from development partners (33 percent of GDP). The public sector directly accounts for as much as 50 percent of GDP and some 80 percent of formal sector jobs (however, formal sector employment accounts for only 20 percent of the labor force). Beyond subsistence agriculture and fisheries, the private sector remains small, mostly consisting of small firms in the wholesale, retail, and transport sectors. The most significant opportunities for private sector development exist in the fisheries sector, with potential opportunities also in tourism. Open unemployment is estimated to exceed 30 percent, and youth unemployment, 50 percent.

4. **Kiribati's economic geography also makes service delivery very costly.** The small, dispersed and fragmented population significantly raises the cost of service delivery, affecting the affordability, scope and quality of infrastructure and services in the utilities, transport and communications sectors, as well as of public services more broadly. Kiribati's geography and exposure to natural hazards, particularly drought and loss of groundwater, also raises public sector costs and makes some areas of service delivery – like water and sanitation – very challenging. These factors have significant and

pervasive implications for living standards, and are likely to intensify with the effects of climate change.

5. **The program development objective is to: (i) strengthen public financial management; and (ii) improve the environment for inclusive growth.** The first pillar, on public financial management, focuses on strengthening the management of public assets and liabilities, and improving public procurement. Over time and in conjunction with other measures, these reform actions should contribute to wider improvements in the maintenance of fiscal sustainability, the containment of fiscal risks, and the quality of public spending. The second pillar, on the environment for inclusive growth, focuses on improving oversight of joint ventures in the fisheries industry, improving the quality and expanding the coverage of essential public utilities, and facilitating competition and universal service provision in the telecommunications industry. These measures should each contribute to improving the environment for inclusive growth – even if the overall magnitude of the improvement that is possible is highly constrained by Kiribati's fundamental economic geography characteristics.

6. **The overall risk rating for the proposed operation is substantial.** The main risks to achieving the program development objectives are: (i) institutional capacity risks arising from the extremely thin capacity of the public sector to implement the reform program and sustain it over time; (ii) political and governance risks arising from the politically-sensitive nature of key aspects of the reform program; (iii) macroeconomic risks arising from the inherently volatile economic and fiscal situation, with any large shock likely to detract from the policy focus on the reform program; (iv) environment risks arising from Kiribati's vulnerability to natural disasters and the impacts of climate change; and (v) fiduciary risk. Key risk mitigating measures include: (i) the relatively strong and established policy dialogue, which focuses on reaching shared understandings, building common platforms, and taking a step-by-step approach to reforms; (ii) the selection of a limited number of policy actions that are aligned with government priorities and to which the government is firmly committed; (iii) dedicated technical assistance supporting implementation of the policy actions; and (iv) regular missions to help maintain the momentum of the reform program.

7. **There is no recent data on poverty.** The World Bank in conjunction with the Secretariat for the Pacific Community (SPC) is supporting the GoK to undertake a Household Income and Expenditure Survey (HIES) in 2017/18. This will be the first HIES since the one conducted in 2006, which indicated that poverty was widespread. It showed food poverty (based on national poverty lines) to be low in Kiribati, at about 5 percent of the population, but basic needs poverty[1] (again based on national poverty lines) to be relatively widespread, at about 22 percent. Basic needs poverty was concentrated in South Tarawa, where the rate was about 24 percent. Poverty rates varied significantly by island group, depending on available economic opportunities, the extent of isolation, and the age structure of the population. For instance, about 16 percent of the population of the Southern Gilbert Islands were found to be below the food poverty line, reflecting isolation, limited agricultural potential, and vulnerability to drought. These islands had the highest proportion of elderly people in the country, thus a low proportion of working age adults and a high dependency ratio. In contrast, poverty rates were very low in the Line Islands, reflecting a younger migrant population and more abundant natural resources. Female-headed households and households headed by the elderly were over-represented in the poorest quintiles, and children were also more likely to experience poverty. A large proportion of the population was found to be vulnerable to falling into poverty. If the basic needs poverty line were 20 percent higher, the poverty rate would have been 34 percent. With a Gini coefficient of 0.39, the degree of inequality in Kiribati was found to be similar to that in other Pacific Islands.

[1] The 'cost of basic needs' approach defines the minimum resources needed for long-term physical well-being, usually in terms of consumption. The poverty line is the amount of spending required to obtain those resources – defined by a list of food and non-food (clothing, shelter and services) 'basic needs'.

8. **Though the lack of panel data on poverty prevents the study of its dynamics, indications of changes in wellbeing can be gleaned from other measures of deprivation.** Between 2010 and 2015, census data indicate that the proportion of households with access to piped or rain water increased from 38 to 58 percent, and the proportion with access to a flush toilet or pit latrine increased slightly from 57 to 62 percent. Over the same period, maternal mortality is estimated to have declined to 90 per 100,000 live births, and under-5 mortality to have declined to 56 per 1,000 live births, rates that are still high by regional standards. Access to electricity for lighting increased significantly between the censuses, mainly due to donor-funded solar programs. According to WDI, net primary school enrolment is relatively high, at 95 percent, but no historical data is available to identify trends. While there is no data to indicate trends in income distribution over the period since the HIES, real GDP per capita declined by just over 10 percent between 2006 and 2011, before rising again to return to its 2006 level by 2016 – making it possible that poverty has not declined much, if at all, since 2006.

2. MACROECONOMIC POLICY FRAMEWORK

2.1 RECENT ECONOMIC DEVELOPMENTS

9. **Recent economic performance has been relatively strong.** Though growth continues to be volatile, Kiribati had its sixth consecutive year of growth in 2016. After reaching 10.3 percent in 2015 on the back of strong wholesale and retail trade, and construction activity, real GDP growth slowed to an estimated 1.1 percent in 2016, reflecting the winding down of major donor-financed infrastructure projects and normalization of fisheries revenues after the record level in 2015. Growth is expected to pick up to 3.1 percent in 2017, again driven by construction and wholesale and retail trade.

Table 1: Key macroeconomic indicators

	2014	2015	2016	2017 est	2018 proj	2019 proj	2020 proj
Real Economy	*Annual percentage change, unless otherwise indicated*						
Real GDP growth	0.4	10.3	1.1	3.1	2.3	2.4	2.3
Consumer prices (period average)	2.1	0.6	1.9	2.2	2.5	2.5	2.5
Fiscal Accounts	*Percent of GDP, unless otherwise indicated*						
Revenues and grants	143.4	155.8	116.4	136.0	126.1	122.2	121.3
Revenues	89.9	110.4	83.7	79.1	69.2	68.3	67.4
of which Fishing revenues	72.3	92.0	65.1	58.6	48.9	48.1	47.4
Grants (excluding budget support grants)	53.6	45.4	32.7	56.9	56.9	53.9	53.9
Expenditures	118.8	113.2	112.3	145.1	133.4	133.0	131.4
of which GoK capital investment in outer islands				11.3			
Overall balance (excluding budget support grants)	24.6	42.6	4.1	-9.2	-7.3	-10.9	-10.1
Overall balance (including budget support grants)	29.9	44.7	6.1	-1.9	-2.5	-2.8	-5.7
PPG debt (end of period)	17.9	23.8	22.8	24.4	26.3	30.8	34.4
RERF	*Current AUD millions, unless otherwise indicated*						
Closing balance	679	756	868	923	949	976	1004
Balance of payments	*Percent of GDP, unless otherwise indicated*						
Current account balance	25.1	46.7	19.4	14.0	4.3	2.3	1.2
Exports	6.2	5.2	5.7	4.5	4.4	4.4	4.4
Imports	65.2	59.0	58.8	59.2	60.3	61.3	60.8
External debt	8.8	19.8	22.8	24.4	26.3	30.8	34.4
External debt service	4.7	0.3	0.4	0.6	0.3	0.9	1.5
Exchange rate (A$/US$, period average)	1.1	1.3	1.3	..	..	..	..
Memorandum items:							
Nominal GDP (US$ millions)	178.2	181.7	194.3	202.5	211.6	219.5	227.7

Source: IMF and World Bank staff estimates.

10. **The current account has remained in surplus despite large trade deficits.** In recent years, Kiribati's large structural deficits on merchandise trade and services have been offset by very strong receipts of fishing license fees, as well as aid flows, investment income on the sovereign wealth fund – the Revenue Equalization Reserve Fund (RERF)[2] – and remittances from seafarers. The merchandise trade deficit was an estimated 53 percent of GDP in 2016, driven by capital imports relating to donor-financed infrastructure projects. But the strength of fishing license fee revenue is estimated to have kept the current account in surplus.

11. **Inflation is moderately low, at around 2 percent, and private sector credit is expanding modestly.** The moderately low inflation is in line with trading partner inflation and international food and fuel prices, and reflects the relative stability of the Australian dollar – which Kiribati uses as its currency. The IMF regards Kiribati's use of the Australian dollar as providing a strong nominal anchor given its close trade links with Australia. The modest expansion in private sector credit has been driven by public financial institutions. The financial sector essentially consists of one commercial bank and two public financial institutions (the Development Bank of Kiribati (DBK), and the Kiribati Provident Fund (KPF)). The commercial bank primarily serves the public sector and larger private sector customers, with the public institutions financing most personal and small business loans, thus having a critical role in supporting access to finance. Ensuring long-term sustainability requires strengthened risk monitoring, improved financial supervision, and decisive efforts to address long-standing weaknesses in their balance sheets. Importantly, concrete steps have now been taken to address the persistent funding gap of KPF and to link the crediting rate more closely with the actual returns of the fund.[3]

12. **The fiscal position has improved markedly in recent years, due primarily to high fishing license fee revenue.** The fiscal outcome in Kiribati is dominated by fishing license fee revenue, which was low and volatile in the years to 2012, but which has been significantly higher (though still volatile) in the years from 2013. After peaking at A$207 million in 2015 (92 percent of GDP), fisheries revenue fell in 2016 but was still high by historical standards, at A$159 million (65 percent of GDP). The implementation of the Vessel Day Scheme (VDS) (see later), favorable – though still variable – weather conditions, and the appreciation of the US dollar against the Australian dollar in 2015, all contributed to the increase. Efforts to increase domestic tax revenue have also borne fruit. The GoK successfully introduced a VAT in mid-2014 to replace distortive tariffs and trade taxes, and has managed to maintain the VAT despite its politicization during the election in 2015. (A number of items considered essential to livelihoods on the outer-islands were exempted from the VAT at its introduction, and the GoK added essential public services to the list of exemptions in 2015 to address the perceived and actual regressive impact of the tax, but maintained the VAT nonetheless). Tax revenue is estimated to have risen in 2017, partly as a result of improved revenue administration and efforts to collect arrears. Scope for further improvement is now thought to be quite limited.

13. **With strong revenue receipts and pressing expenditure needs, public expenditure has also risen in recent years.** On the current side, spending increases have been driven by a hike in the copra subsidy in the 2016 budget, as well as increases in health and education spending. Though the increase in the copra subsidy has had a very significant fiscal impact and – anecdotally at least – some distortive effects on household production decisions, it is extremely important from a social and political perspective and very unlikely to be unwound in the near future (see Box 1). The recent increases in health and education spending, while significant in themselves, are still merely offsetting the significant declines in real per capita spending in these sectors after 2008 – with real per capita health spending now nearly restored to 2008 levels, but real per capita education spending still well below

[2] The RERF was established in the 1950s to invest royalties from the now-depleted phosphate reserves. Its current estimated value is about A$915 million (about 350 percent of GDP).
[3] The regional withdrawal of correspondent banking relations has so far had limited impact in Kiribati.

its level in the 2000s. Despite the recent increases in subsidies and public sector wages (mainly through health and education sector spending), Kiribati's recurrent expenditure composition is not too dissimilar to other low income countries (LICs) and other small states (Figures 1a and 1b). On the capital side, spending increases have been driven by large infrastructure projects financed by donors, including road, airport, and water and sanitation rehabilitation projects, as well as, in 2017, the government's commitment of A$30 million for outer island infrastructure investments (Figure 1c). Of the 30 percentage point of GDP increase in capital spending occurring this year, only 11 percent is due to the government's outer island infrastructure commitment: the remainder is due to donor spending, which tends to be quite volatile, in line with project implementation cycles. While the higher levels of public spending in 2017 obviously entail a trade-off, of lower potential public spending in future years, they contribute to growth (mainly directly) and have very little prospect of crowding out private sector activity (indeed, given the structural constraints on the private sector in Kiribati, public spending is more likely to crowd in private sector activity). The relatively high levels of public (including donor) spending also pose little risk to inflation in Kiribati, because of the very limited multiplier effect – particularly from capital spending – due to the high import content of public spending.

Table 2: Key fiscal indicators

	2014	2015	2016	2017 est	2018 proj	2019 proj	2020 proj
				Percent of GDP			
Total Revenues and Grants	143.4	155.8	116.4	136.0	126.1	122.2	121.3
Tax revenues	14.4	15.5	15.7	17.3	17.3	17.2	17.2
Direct taxes	5.8	6.4	7.0	7.7	7.7	7.6	7.7
VAT and excises	8.6	9.1	8.7	9.6	9.7	9.6	9.5
Non-tax revenues	75.5	94.9	68.0	61.8	51.9	51.1	50.2
Fishing revenues	72.3	92.0	65.1	58.6	48.9	48.1	47.4
Other non-tax revenues	3.2	2.9	2.9	3.2	3.0	3.0	2.8
Grants (excluding budget support grants)	53.6	45.4	32.7	56.9	56.9	53.9	53.9
Expenditures	118.8	113.2	112.3	145.1	133.4	133.0	131.4
Current expenditures	60.9	60.3	71.4	74.0	73.5	73.2	71.6
Wages and salaries	27.2	24.4	23.3	25.3	25.3	25.3	25.2
Subsidies, grants, other commitments	13.3	10.7	17.7	20.8	22.5	22.3	22.2
of which copra subsidies	2.7	3.3	9.0	8.7	8.3	8.0	7.7
Other current expenditure	20.4	25.2	30.4	27.9	25.7	25.6	24.2
Development expenditures	57.9	52.9	40.9	71.1	59.8	59.8	59.8
of which GoK capital investment in outer islands				11.3			
Overall balance (excluding budget support grants)	24.6	42.6	4.1	-9.2	-7.3	-10.9	-10.1
Overall balance (including budget support grants)	29.9	44.7	6.1	-1.9	-2.5	-2.8	-5.7
Financing	-24.6	-42.6	-4.1	9.2	7.3	10.9	10.1
Domestic financing	-34.2	-52.2	-14.3	-1.1	-0.5	-3.3	-0.3
RERF	4.2	-22.3	-12.3	0.0	0.0	0.0	0.0
Custodian account	0.0	-31.3	12.3	-12.0	0.0	0.0	0.0
Cash account	-42.5	1.4	-14.3	10.9	-0.5	-3.3	-0.3
Project loans (net)	4.3	7.5	8.2	3.0	3.0	6.0	6.0
Budget support grants	5.3	2.1	2.0	7.3	4.8	8.1	4.4

Source: IMF and World Bank staff estimates.

Box 1: Copra subsidy reform in Kiribati

The copra subsidy, which began in the mid-1990s, has multiple objectives. It is an agricultural subsidy to maintain copra production (a key export), a cash transfer to ensure a supply of cash in outer islands to maintain a monetized economy, an unemployment benefit to provide cash incomes to those who would otherwise be 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 population of the outer islands.

Consistent with the recommendations of technical assistance from the World Bank, the GoK has pursued the merger of the two copra SOEs to reduce the costs of handling the copra subsidy, a reform supported by the previous DPO series. 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. It was expected that reduced leakages and efficiency savings from merging the two copra SOEs would reduce the government spending on the copra subsidy. While efficiency savings may have been achieved, the overall objective of reducing expenditure on the copra subsidy scheme has not been achieved, due to significant increases in the amount of the copra subsidy itself. Having fallen from A$7.7 million in 2013 to A$5.3 million in 2014, public expenditure on copra subsidies rose to A$7.9 million in 2015 (when the copra subsidy was increased from A$0.80 to A$1 per kilogram), before increasing sharply to A$22.8 million in 2016 (when the copra subsidy was increased from A$1 to A$2 per kilogram during the first half of the year).

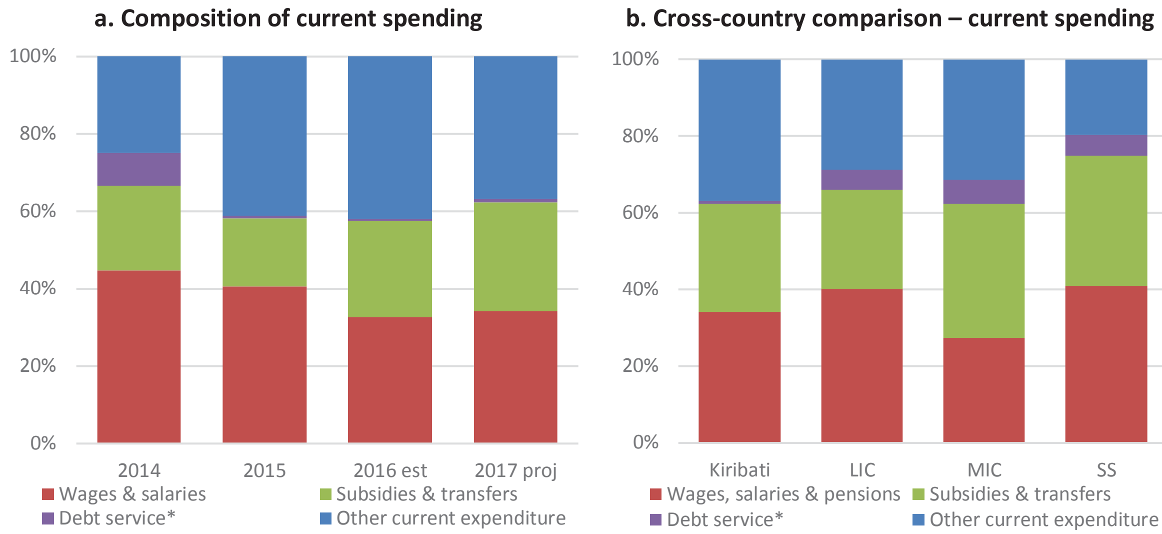
The new government that came to power early in 2016 has a strong mandate to raise the living standard of the population of the outer islands. It is considering government support to outer islands as a whole, including various government initiatives that aim to help create jobs and diversify income opportunities in outer islands, inequities in public spending against the population of the outer islands (for instance, public spending on health and education, infrastructure, and public utilities), the extent of connective infrastructure and services (both transport and communications), and the disadvantages facing people from the outer islands in finding work in the public sector, receiving overseas scholarships, and getting on overseas seasonal workers schemes.

The World Bank has previously invested in building a knowledge base to support the policy dialogue with the GoK in this important area. At the time of the first DPO series, the Bank undertook 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 for the elderly, increasing post-secondary scholarships, and providing transport grants to seafarers from the outer islands boarding foreign vessels. Preliminary indications were that these would be particularly advantageous as alternatives to the copra subsidy scheme. The trade-offs involved with the expenditure on the copra subsidy have risen very substantially since then, however, raising the importance of reassessing options to improve the poverty targeting of the scheme. To strengthen the evidence required for further advice in this area, the Bank is supporting the new HIES in Kiribati. The Bank will also contribute to planned analytical work on the copra sector to be led by MFAT, and may update the earlier public expenditure analysis the Bank supported.

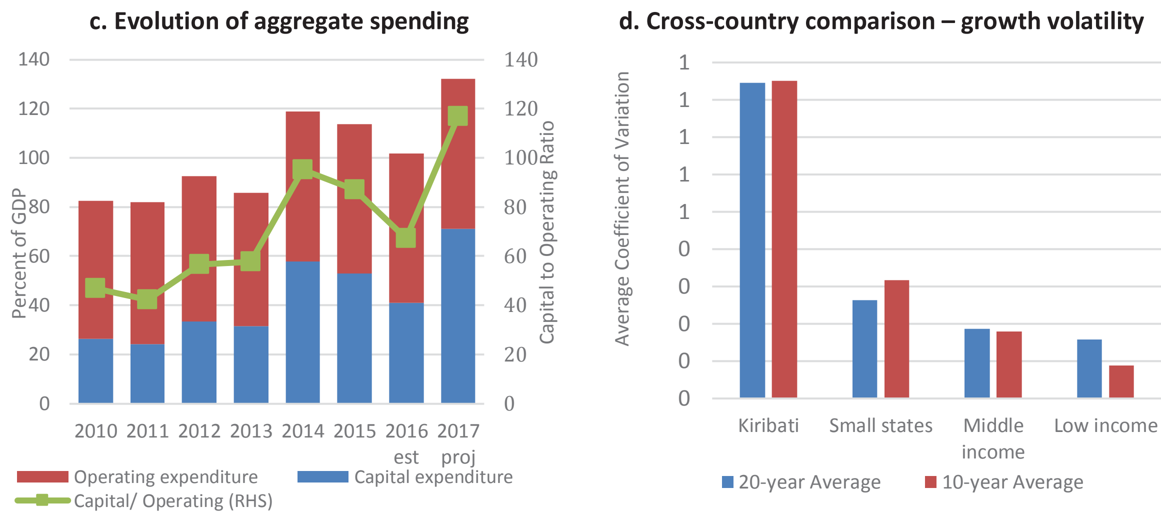
Sources: AusAID (2012) *Kiribati Country Case Study*, World Bank (2013) *Policy Brief: Some Thoughts on Social Schemes for Protection and Promotion in Kiribati*.

14. **Because of Kiribati's high degree of dependence on a volatile source of revenue and its broader vulnerability to external shocks, it is important for Kiribati to maintain as much flexibility on public expenditure as possible (at least until the 'new normal' for fisheries revenues is clearer), as well as larger fiscal buffers.** Growth in Kiribati has been much more volatile than other LICs, and even compared with other small states (Figure 1d). Although about two-thirds of current spending is in the difficult-to-reduce categories of wages, salaries, pensions, interest payments, and subsidies, this proportion is lower than the averages for LICs and small states. In addition, Kiribati has been attempting to contain the growth of expenditure by adopting conservative fisheries revenue forecasts in the annual budget, roughly in line with IMF recommendations. This has been a useful measure while the 'new normal' range of fisheries license fee revenue has been unclear. The IMF now recommends assuming A$130 million in real terms, going forward, which will provide Kiribati with a realistic anchor for the budget envelope, to frame expenditure priorities within.

Figure 1: Evolution of expenditure and expenditure composition



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



Source: WDI, WEO and World Bank staff estimates.

15. **In recent years, the higher levels of fishing revenue have allowed the government to make transfers into the RERF as well as accumulating large fiscal buffers.** The GoK has reinvested all RERF earnings, instead of withdrawing them to finance public expenditure. The RERF is Kiribati's main mechanism to serve as a buffer against current shocks and to provide for inter-generational equity. Once fishing revenues began to increase, and Kiribati's fiscal deficits turned to surpluses, the GoK did not immediately begin to make transfers into the RERF to replenish the significant drawdowns that had taken place over the previous decade. Given pressing expenditure needs, the GoK first began to increase public expenditure, but as fishing revenues grew further, the GoK accumulated significant cash reserves. In 2015, the GoK transferred A$50 million to the RERF. In 2016, the GoK transferred a further A$70 million to the RERF, leaving cash reserves of around 3-4 months of current expenditure (roughly in line with IMF recommendations). Continued strong fishing revenues mean the GoK has again accumulated significant cash reserves, which now stand at about A$110 million relative to the recommended buffer of about A$45 million. Rather than transferring the excess cash reserves into the RERF as in the previous two years, the GoK has made the decision to retain these as a source of funds to finance infrastructure projects in the outer islands – a key priority for the current government as part of its agenda for promoting growth and service delivery across the whole of the country. This approach avoids the costs and risks of debt financing. Over the next year or so, it will be important for the GoK to expand its capacity to evaluate, prioritize and sequence alternative project proposals in

line with implementation capacity. The World Bank's investment pipeline includes a commitment to outer island infrastructure projects, so the dialogue around these will provide an opportunity for Bank staff to share expertise on project assessment, prioritization and planning.

16. **Longer term, there is a need to determine an appropriate strategy for drawdowns from and transfers into the RERF, in line with the GoK's objectives for the RERF (which include striking a balance between benefits to current and future generations).** This is likely to involve estimating, on a periodic basis, 'normal' fishing revenues, and formulating an approach to transferring a share of excess or windfall fishing revenues to cash reserves or – if that buffer is already adequate – to the RERF. It will also involve estimating a sustainable approach to drawdowns from the RERF. With these parameters established, fiscal discipline sufficient to maintain expenditure within what is affordable on a medium-term basis – based on an estimate of 'normal' fishing revenues – will be needed, to ensure that the RERF grows in line with the GoK's objectives for it. If fishing revenues fall short of the 'normal' level, they could be supplemented from the cash buffer, to maintain budgeted expenditure.

2.2 MACROECONOMIC OUTLOOK AND DEBT SUSTAINABILITY

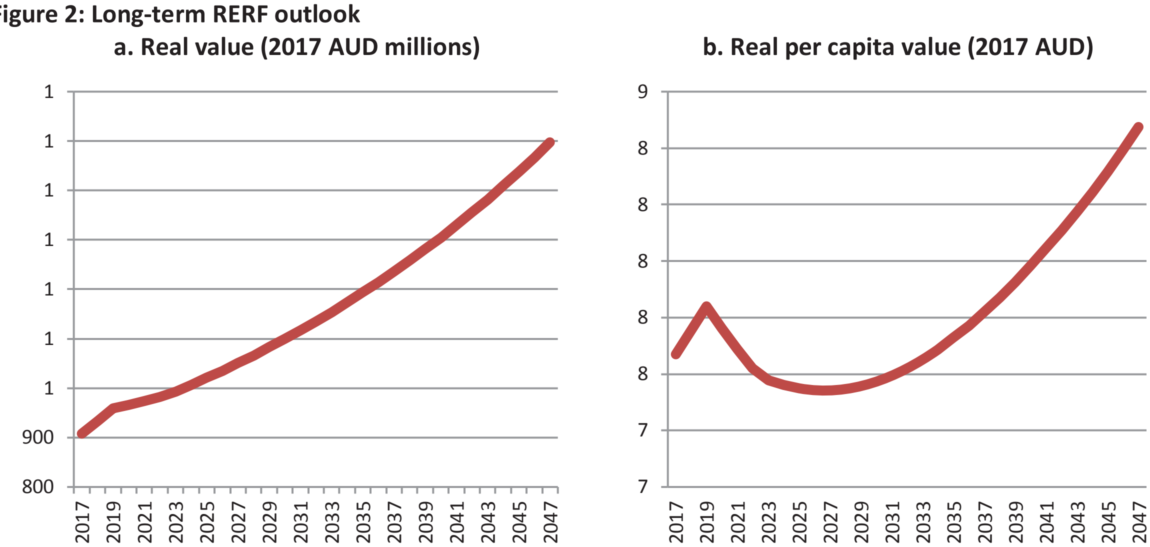
17. **The medium-term macroeconomic outlook is broadly favorable.** Growth is expected to be maintained at 2-2.5 percent over the medium term, higher than the historical average, from planned infrastructure investments by development partners and the GoK, and the expected 'new normal' level of fishing revenues. Inflation should remain contained on continued softness in international food and commodity prices, unless there is a significant further weakening of the Australian dollar against the US dollar. Although the size of the current account surplus is forecast to decline on lower fisheries revenues, the current account is expected to remain in surplus over the medium term, supported by still substantial fishing license fee revenue, aid flows, investment returns on the RERF, and remittances. Though they had earlier been on a declining trend, remittances have been picking up in the last three years, both with the global recovery in shipping activities and as employment opportunities for I-Kiribati overseas increases with the creation of additional temporary labor schemes – a trend projected to continue in the future.

18. **The fiscal outturn largely depends on fishing license fee revenues, grants from development partners, and the ability of the GoK to contain expenditure within what can be afforded with the 'new normal' fishing revenues.** Beyond the sense in which the VDS has led to a structural increase in fishing license fee revenues, their level in any given year is difficult to predict until weather patterns can be estimated with some degree of confidence. The fiscal projections rely on the IMF's reasonably conservative recommended approach, explaining the 10 percentage point of GDP drop in fisheries revenues between 2017 and 2018-2020. This is roughly offset by the A$30 million allocation for outer island infrastructure investment in 2017, which is not repeated in 2018-2020. The estimated deficit for 2017 is 1.9 percent of GDP, down from 9.2 percent as a result of the budget support provided by development partners (World Bank: US$5 million under the proposed operation, plus US$2 million from the previous operation withdrawn earlier this calendar year; ADB: US$5 million; MFAT: A$2.5 million; and DFAT: $A0.5 million). Relatively modest deficits are then projected for the period 2018-2020 (with the larger deficit in 2020 due to the lower budget support projections that year). The key risk to these fiscal projections is on the expenditure side. It is critical for the GoK to contain the growth of current spending and to avoid any further increases in the copra subsidy (allowing its current nominal costs to decline in real terms over time). The economic policy dialogue between the GoK and development partners offers one important avenue to address any fiscal challenges that may emerge over time, in line with the GoK's commitments to sustainable fiscal management and – in particular – the sustainable management of the RERF.

19. **The long-term outlook for the RERF is positive.** Figure 2a shows the projected trajectory of the real value of the RERF, based on the GoK's current investment strategy and using reasonably

conservative forecasts of market returns. The projections assume the reinvestment of returns and a drawdown of 1 percent per year of the total value of the fund to finance public investment priorities after 2020, once the GoK has achieved its nominal target for the fund. These assumptions align with the dominant thread in the Bank's dialogue with the GoK, though the decision on a possible drawdown rule has not yet been taken. Although it is expected that the GoK will also determine a framework to transfer excess or windfall fisheries revenues into the RERF when these arise, no such transfers are assumed in the forecasts shown except A$10 million per year in the years to 2020, to provide near certainty for the achievement of the nominal target. The positive outlook, given current management of the RERF and the structural shift in fisheries revenues that enables RERF returns to be reinvested (rather than the RERF being required to finance the recurrent budget), stands in stark contrast to the performance in the 2000s (see Figure 4). Figure 2b shows the outlook in real per capita terms. The upward trend pre-2020 becomes a downward trend when the GoK begins the 1 percent drawdowns to finance public investment, but as population growth slows, the real per capita value of the RERF begins to rise again – increasingly sharply with the slowing population growth rate. It is important to recognize that no assumption is being made here as to what the trajectory of the real per capita value of the RERF should be: the weight to be placed on the welfare and needs of the current generation relative to future generations is a valuation for the GoK to make, and the current government is demonstrating its ownership of this process as it works to clarify the objectives of the RERF. (Note that the projected trajectories shown in Figure 2 are subject to wide margins of error – they are based on a forecast market return, whereas in practice market returns may be subject to considerable variability potentially leading to very different outcomes from those shown here.)

Figure 2: Long-term RERF outlook



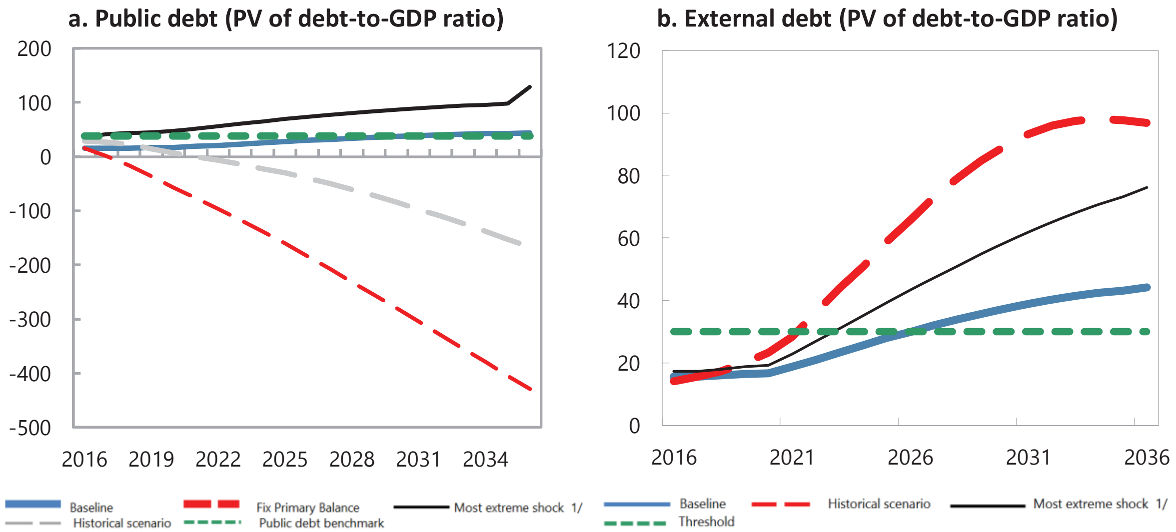
Source: World Bank staff estimates and UN Population Fund.

20. **Kiribati is assessed as being at high risk of debt distress, according to the latest IMF/World Bank Debt Sustainability Analysis (DSA), from August 2016.** This assessment reflects Kiribati's limited capacity to service debt, given its historically low average growth rate and narrow export base. Even moderate borrowing could result in an unsustainable debt trajectory under the baseline scenario, where fishing license fee revenue is assumed to remain above the historical average, there is moderate expenditure growth, fiscal deficits remain small, and there is continued availability of highly-concessional loans and grants to finance development expenditure. Containing this risk requires Kiribati to avoid any non-concessional borrowing, secure grants rather than concessional loans to finance its main development needs, maintain fiscal discipline, maintain adequate buffers against shocks, and continue to implement key reforms to support greater public sector efficiency and – to the extent possible – greater private sector development, to support Kiribati's growth prospects. The next DSA, scheduled for late 2017, is expected to bring risks from natural disasters and climate change

effects into the baseline scenario.

21. **Kiribati's macroeconomic policy framework is adequate for the purposes of the proposed operation.** In recent years, Kiribati has substantially improved the management of the RERF, a critical anchor for economic and fiscal stability. It has also avoided borrowing on non-concessional terms, in accordance with its debt policy. In the face of very significant increases in revenues from fisheries license fees, the GoK has contained the growth of public expenditure to a reasonable extent. As a result of the reasonable containment of expenditure in the face of sharply increased revenues, Kiribati has accumulated significant cash reserves over this period. Part of the accumulated cash reserves is now available as a buffer against shocks; another part – equivalent to about 50 percent of GDP – has been transferred into the RERF; and the final part is available to the GoK to finance planned outer island infrastructure projects. Kiribati is in the process of determining an appropriate strategy for drawdowns from and transfers into the RERF, in line with the objectives for the RERF that is formulating. It remains important for Kiribati to carefully target spending to its most pressing expenditure needs – of which there are undoubtedly many, given generally declining real per capita expenditure trends over the last decade and the substantial infrastructure gaps the country faces. Updated public expenditure analysis would be helpful in this regard, and the Bank should be able to assist with it as part of its macro-fiscal dialogue with the GoK.

Figure 3: Debt sustainability analysis



Note: 1/ In Figure 3a, a Combination shock, in Figure 3b, a Terms shock. Source: IMF/WB DSA.

22. **Risks to the macroeconomic outlook are substantial, and tilted to the downside.** Revenue from fishing license fees is inherently volatile, and could decline significantly as a result of unfavorable weather conditions. But as mentioned above, the key fiscal risk is on the expenditure side. The economic policy dialogue between the GoK and development partners offers an important means of mitigating this risk, through dialogue on the necessity of containing the growth of current spending and avoiding any further increases in the copra subsidy (a dialogue that will be supported by planned analytical work). Negative dynamics in global financial markets would have an adverse impact on returns to the RERF. The greater emphasis that the current government places on striking a balance between benefits from the RERF for the current and future generations, while by no means undue, also poses a risk to the long term macroeconomic outlook, if a balance is not similarly struck between a drawdown rule and a savings or transfers rule. This risk is mitigated by the Bank's specific engagement with the GoK on the RERF. Delays in the implementation of major investment projects would negatively affect growth, as would further natural disasters. Remittances from migrant workers could be negatively affected by a sharper-then-expected slowdown in China spilling over into declining global shipping activities, and lower-than-expected growth in New Zealand and Australia (where I-

Kiribati have emerging temporary labor opportunities). Higher-than-expected prices for imported food and fuel would have a significant impact on inflation, growth and poverty.

3. THE GOVERNMENT'S PROGRAM

23. **The Kiribati Development Plan 2016–19 (KDP) identifies key priority areas for the medium term, with the overarching vision, "Towards a better educated, healthier, more prosperous nation with a higher quality of life."** The KDP focuses on six priority areas: (i) human resource development; (ii) economic growth and poverty reduction; (iii) health; (iv) environment; (v) governance; and (vi) infrastructure. With respect to economic growth and poverty reduction, the strategies include: enhancing management of the RERF; ensuring effective public financial administration and debt management; placing SOEs on a more commercial footing; providing for the sustainable development of the fishing industry and maximizing economic returns from marine resources; and ensuring that that the most vulnerable groups in the population are cared for. With respect to the RERF and in keeping with the current government's electoral platform, the government is committed to ensuring that the RERF reaches A$1 billion by 2020. With respect to governance, the strategies include: timely audits of government ministries and SOEs; greater transparency and accountability in public service delivery; and the implementation of specific policies with respect to women, youth, children, people with disabilities, and gender-based violence. With respect to infrastructure, the strategies include: improving telecommunications connectivity for the outer islands, and reforming the Public Utilities Board to achieve operationally and financially sustainable electricity, water and sanitation services. The priorities in the KDP have been reinforced in the consultation version of the new Kiribati Vision 20 ("KV20") statement, which emphasizes the importance of fisheries and tourism development for economic growth, and the investment in infrastructure needed to realize this potential.

24. **Key aspects of the KDP priority area of economic growth and poverty reduction are reflected in the strategic plan of the Ministry of Finance and Economic Development (MFED) for 2016-19.** These include improving the sustainability of government finances, and in particular 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. These also include improving the efficiency of SOEs, and in particular continuing work to restructure underperforming SOEs and commercialize SOEs with the potential for private sector participation.

25. **With respect to the critical fisheries sector, the National Fisheries Policy 2013–2025 outlines a series of policy and institutional reforms designed to improve the returns Kiribati obtains from the exploitation of its fisheries.** The reform priorities include: (i) strengthening compliance with regional conservation and management measures, including the VDS, through the 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 Resources Development (MFMRD) to better execute its responsibilities (including licensing, implementation of international treaties, monitoring and compliance, and reporting). The GoK is also working to facilitate the growth of the transshipment industry, to generate greater domestic economic activity from oceanic fisheries.

4. THE PROPOSED OPERATION

4.1 LINK TO GOVERNMENT PROGRAM AND OPERATION DESCRIPTION

26. **The two pillars of the proposed operation are aligned with the second, fifth and sixth focus areas of KDP, on economic growth and poverty reduction, governance, and infrastructure.** The first

pillar, on strengthening public financial management (PFM), is closely aligned with the GoK's strategies on the RERF, PFM, debt management, SOE management, and transparency. Over time and in conjunction with other measures, this pillar should contribute to improvements in the maintenance of fiscal sustainability, the containment of fiscal risks, and the quality of public spending. This should help ensure that the government can maintain public services and public investment in human and physical capital, which are of disproportionate importance to the poor. The second pillar, on improving the environment for inclusive growth, is closely aligned with the GoK's strategies on returns from fisheries assets, telecommunications connectivity, and electricity, water and sanitation services. By improving the returns from fisheries assets, this pillar should benefit the poor (through the public services fisheries revenue funds) and promote shared prosperity (through the economic activity in the fisheries sector). By improving access to and the quality of telecommunications and utility services, this pillar should also benefit the poor (through access to these services) and promote shared prosperity (through the improvement in the business environment).

27. **The second pillar of the proposed operation, which corresponds to the second component of the PDO, has been revised since the first operation.** In the first operation, this pillar was, "Creating an environment for inclusive and private sector led growth." The team believes that this objective is broader than what could feasibly be achieved in Kiribati at the current juncture, through this DPO series. In particular, achieving the ambition of private sector *led* growth in Kiribati seems improbable in the near term, given that the main driver of growth in Kiribati is the public sector, funded by fisheries license fees and aid. That is, the bulk of the economic activity generated from Kiribati's fisheries assets is indirect through the public sector – in the form of the public sector employment, procurement and service delivery financed by the license fees – rather than direct through the private sector. While there are certainly opportunities for greater private sector development, and these need to be facilitated, private sector led growth appears improbable in the near term. Several of the reforms under the second pillar will improve the business environment, and will also improve the quality of life of the poorest in Kiribati, so a focus on improving the environment for 'inclusive growth' seems an appropriate reformulation of the pillar.

28. **The design of the proposed operation reflects the lessons learned in the implementation of the previous DPO series in Kiribati.** These include:

- *Budget support to small states with thin capacity can provide benefits far beyond the financial resources transferred* – in Kiribati, the policy dialogue afforded by DPOs is more significant than the specific actions in the policy matrix, with the current dialogue on RERF and debt issues in particular more than offsetting any weaknesses in the policy matrix.
- *Project-level engagements can assist in identifying key priorities to be supported through policy-based operations* – evident with the telecommunications and utility sector reforms.
- *Task teams must consider results indicators at the same time as they are working on policy actions* – several revisions to the results indicators are proposed, in an effort to ensure they will fairly reflect the achievements of the series.
- *The flexibility built into the Bank's approach to programmatic series of DPOs is vital in fragile states and very thin capacity environments* – several revisions to the indicative triggers are proposed, reflecting changing policy emphasis and/or capacity constraints that have affected the timeframes and ambition of the steps in the reform process.
- *Tackling more contentious policy areas – particularly in fragile states – involves taking greater risks, which the Bank should support* – this DPO series continues to work on RERF, fisheries and SOE management, significant yet contentious areas whose risks are acknowledged.

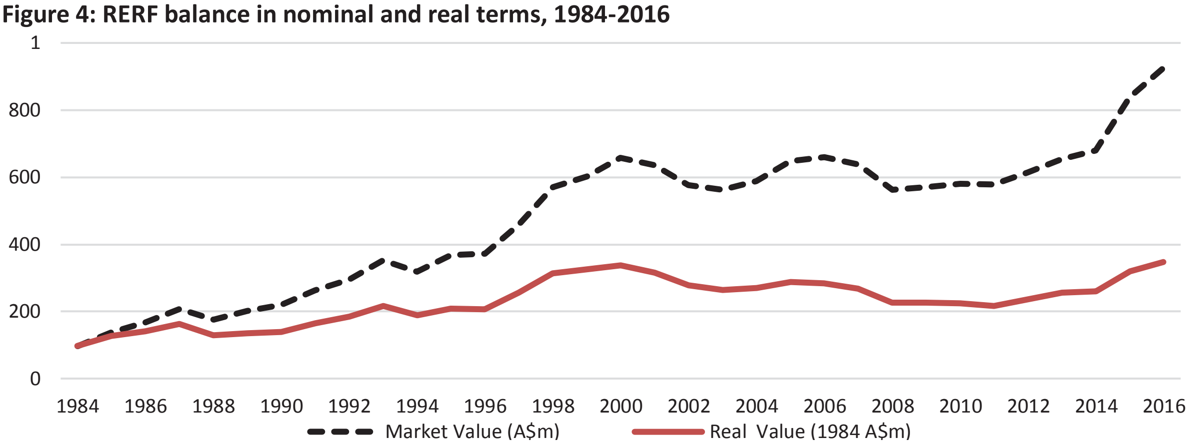
4.2. PRIOR ACTIONS, RESULTS AND ANALYTICAL UNDERPINNINGS

Pillar 1: Strengthening public financial management

Prior Action 1: (i) The Recipient, through its Ministry of Finance and Economic Development, has completed a review of RERF custodial arrangements to ensure that the services of the provider remain competitive with current market practice and benchmarks; (ii) the Recipient, through its Cabinet, has endorsed the recommendations of the review; and (iii) the Recipient has issued a request for proposal for custodial services.

29. **The RERF is Kiribati's main mechanism to serve as a buffer against current shocks and to provide for inter-generational equity.** In the first decade of the 2000s, the real value of the RERF declined significantly as a result of both unsustainable fiscal management and poor RERF management (Figure 4). On the fiscal management side, a combination of low and volatile fisheries revenues and relatively high public expenditure needs resulted in large fiscal deficits and frequent drawdowns from the RERF. On the RERF management side, a review conducted in 2011 with technical assistance from the IMF identified a number of weaknesses, including the misalignment of the asset allocation with the RERF's long-run investment objectives. The review recommended closer oversight of the asset managers, shifting to a passive investment strategy, setting more realistic investment targets, and renegotiating the contract with the custodian. In 2013, with technical assistance from World Bank Treasury, the government began implementing those recommendations, beginning with a review of the performance of the incumbent asset managers, which found they had taken inappropriate risks while achieving returns that were persistently below market benchmarks over an extended period and charging management fees that were well above competitors, for no additional services.[4]

Figure 4: RERF balance in nominal and real terms, 1984-2016



Source: World Bank staff estimates

30. **Strengthening the management of the RERF is an overriding policy priority for Kiribati, as an anchor for the country's economic and fiscal sustainability.** Supported by the ongoing engagement from World Bank Treasury, the GoK has taken key decisions to improve the management of RERF. These have included issuing a request for proposal (RFP) to identify best-fit asset managers for the RERF, selecting two new asset managers through a competitive and transparent process, and implementing the transfer of RERF assets to the new asset managers. The reforms have also included executing the approved strategic restructuring of the RERF portfolio to better align with the RERF's

[4] The inappropriate risks had included – among other things – exposure to multiple Icelandic banks, which led to irrecoverable losses in the aftermath of the Global Financial Crisis.

long term objectives.[5] These reforms have been supported by successive DPOs and represent one of their most significant achievements. In recent years, increased fishing revenue in conjunction with relatively prudent fiscal management has also allowed the GoK to make transfers into the RERF (A$50 million in 2015 and A$70 million in 2016).

31. **The current government has continued to implement the recommendations of the earlier IMF- and Treasury-supported reviews.** This has included completing a review of RERF custodial arrangements, to ensure the services Kiribati receives measure up to current market practice and benchmarks. The review identified a pressing need to renegotiate the contract for custodial services to strengthen the oversight role of the custodian on behalf of the GoK with respect to the asset managers. The review also found the fees charged to the GoK by the incumbent custodian to be the highest among all clients in the World Bank Treasury Reserves Advisory and Management Program (RAMP) (about three times the client average), with the incumbent unable to meet the market practice reporting requirements for the revised investment strategy, and experiencing significant staff turnover with a rotation of four relationship managers in the previous 18 months. In response to the review, Cabinet endorsed its recommendations, including the need to assess the custody services market to identify suitable parties with demonstrated capability to meet the future needs of the RERF, and select a suitably qualified institution to undertake the custody role. The custody RFP was issued in the first half of 2017, with the response process currently underway. In this process, the GoK has demonstrated a continued commitment to a transparent process that ensures a sufficient test of the custody services market. The involvement of World Bank Treasury has added significant value. The initial response to the RFP was limited, with few of the targeted global custodians sufficiently knowledgeable about the specifics of the RERF to be willing and able to bid – particularly because of de-risking considerations associated with anti-money laundering frameworks. In a resource-intensive but critical process, Treasury worked with multiple global custodians to educate them on the specifics of the RERF, using Treasury's expertise and convening power to get a genuine competition among suitable custodians for the benefit of Kiribati. The RFP process is expected to be completed and the selected party appointed by the fourth quarter of 2017.

32. **The review of RERF custodial arrangements and issuance of the custody RFP is proposed to replace the original trigger specified for this reform area.** The original trigger was the development and submission to Cabinet of reform options to regularize transfers to and withdrawals from the RERF. This trigger has not proven achievable. On the change of government in 2016, the new government supported the continued implementation of the recommendations of the earlier IMF- and Treasury-supported reviews, and thus continued to implement reforms to the management of the RERF. But the new government also decided to grapple with the overall direction and purpose of the RERF. After a period of due consideration, the GoK is now moving ahead to clarify the objectives of the RERF. Short term, the GoK will pursue a highly visible nominal target of reaching a balance of A$1 billion by 2020; after that, on the investment side, the GoK is likely to pursue a higher, long-term growth strategy for the real value of the RERF, and at the same time adopt some form of provisions to balance the benefits of the RERF accruing to both current and future generations (possibly including a drawdown rule for withdrawals to finance investments for the current generation and a savings rule for transferring windfall gains into the RERF for future generations). Over this period, the Bank has adapted and built an effective working relationship with the new government in support of its objectives for the RERF. At the same time, the government's support for the objective of strengthening the management of the RERF has remained strong, and the Bank's Treasury has supported the government to review RERF custodial arrangements, assess the custody market, issue a RFP for custodial services, and manage the RFP process. This process, involving competition for the provision of custodial services among targeted

[5] While the high management fees were only a small aspect of the rationale for changing asset managers, Treasury estimates that the change in asset managers and restructuring of the portfolio will save the government upwards of A$1 million per year in RERF management costs.

global custodians, should lead to a custodial arrangement that offers Kiribati an appropriate degree of oversight of the asset managers, fulfilment of market practice reporting requirements to Kiribati, and competitive fees. Particularly with respect to strengthened custodial oversight of the asset managers, the custody RFP process is a necessary step towards the sustainable management of the RERF, so represents a solid reform action to replace the original trigger in this reform area.

33. **The expected result in this reform area is that the financial and operational performance of the RERF will be close to market benchmarks.** This implies two things, first that RERF portfolio performance is aligned with market benchmarks (with the suggested results indicator of portfolio performance that is better than 0.25 percent below the benchmark). This indicator was not included in the original results matrix, but it is important since it captures the combined effect of the RERF reforms supported in the second operation of the first series and the first operation of the current series, which were closely related. This is the reason that it is appropriate for the baseline for this indicator to be drawn from 2014, just prior to the second operation in the first series when this sequence of reforms commenced.[6] Second, the restructuring of the RERF portfolio and issuance of the custody RFP is expected to result in a reduction in the average costs of managing the RERF (with a target for management costs of 0.1 percent of market value, compared to the baseline of around 0.2 percent in 2015). With the change in prior action for the second operation, it is not appropriate at this juncture to include the other results indicator from the original matrix, of cash balances held outside the RERF of no more than 50 percent of current expenditure, since this was associated with the original trigger of regularizing transfers to and withdrawals from the RERF.

34. **The GoK is now focusing on finalizing its objectives for the RERF and developing a strategy for their achievement that will have implications for transfers to and withdrawals from the RERF, reforms which the Bank could support in the future.** As stated, in the short term the GoK will pursue its A$1 billion by 2020 target and likely from there pursue a higher, long-term growth strategy for the real value of the RERF, and adopt provisions to balance the benefits of the RERF to current and future generations (such as a drawdown rule for withdrawals to support current public investment priorities and a savings rule for transferring windfall gains into the RERF). The Bank's Treasury team has been working closely with the Minister for Finance and Economic Development and the RERF Investment Committee to clarify the objectives and model alternative scenarios for how they could be achieved. The new objectives are expected to be presented to Cabinet for consideration by the end of 2017, with work to finalize the strategy continuing into the first half of 2018.

Prior Action 2: The Recipient has improved monitoring of contingent liabilities, through: (i) quantifying the Recipient's guarantees; (ii) accepting the financial statements of the five largest state-owned enterprises for the Recipient's financial year commencing January 1, 2016; and (iii) submitting the financial statement of the Kiribati Provident Fund for the Recipient's financial year commencing January 1, 2016 to the external auditor.

35. **In recent years, the GoK has taken important measures to improve fiscal management in the area of debt policy, reforms which have been supported by successive DPOs.** Kiribati has adopted a debt policy establishing criteria for concessional and non-concessional public borrowing and formal procedures for contracting new debt, consistent with sustainable macroeconomic management. It has also improved the management of public debt by establishing a comprehensive database of public debt, including the debt of SOEs and joint ventures. These reforms have gone hand in hand with reforms to SOEs themselves, which represent a significant share of economic activity in Kiribati and which have, in the past, imposed significant fiscal burdens on the GoK through requirements for direct and often ad hoc subsidies. The adoption and implementation of new legislative provisions for SOEs

[6] It is also not possible to calculate a baseline from between the two series, because that is when the restructuring of the RERF portfolio was being executed and the assets held in transitional accounts.

(also supported by successive DPOs) has helped to underpin improvements in their corporate governance and financial reporting. These reforms have, in turn, reduced the fiscal burden SOEs have imposed on the GoK, with ad hoc subsidies replaced by community service obligations, the costs of which have been well contained since.

36. **The next step in Kiribati's debt policy and management reform process is to strengthen the monitoring of contingent liabilities.** This includes quantifying sovereign guarantees and expanding the debt database to include them and other contingent liabilities. It also includes timely monitoring of the financial situation of large SOEs – where the major potential contingent liabilities lie. A final part of this reform area is strengthening the GoK's financial oversight of KPF, through the timely submission of its financial statements for external audit, in order to better position the GoK to evaluate the extent of this contingent liability. KPF manages assets equal to about 60 percent of GDP, and has faced large balance sheet deficits in recent years due in part to the impact of the Global Financial Crisis and in part to high rates paid to members. In the absence of a central bank, KPF is not subject to financial supervision. Timely external audits are a necessary step if the GoK is to be able to assess and monitor this contingent liability. These three components are reflected in the prior action for this operation.

37. **In the original formulation of this trigger, the second component on the financial statements of SOEs was specified as bringing the external audits of their financial statements up to date, but it is proposed that this be revised.** The SOE legislation sets a timeframe for the completion of financial statements rather than the completion of the external audits of these financial statements, and that is the indicator that the SOE unit in MFED monitors. At the current juncture, it is also the timely submission of financial statements to the external auditor where the weakness lies, rather than the promptness of the audits then conducted. Thus, it is proposed that the prior action should focus on bringing the financial statements of SOEs up to date, rather bringing their external audits up to date. The ICR for the first programmatic series argued that prior actions concerning the implementation of SOE legislation should have focused only on the largest SOEs, because that is where the key fiscal risks lie and, in the face of extremely scarce capacity, it does not make sense to stretch that capacity to cover all SOEs equally, however insignificant some of them are. Thus, it is also proposed that the prior action focus only on the major SOEs. Air Kiribati Limited, the Development Bank of Kiribati, Kiribati Ports Authority, Kiribati Oil Limited (KOIL) and the Public Utilities Board (PUB) together account for about 80 percent of the total assets and liabilities of the SOE portfolio. As such, there is something of a natural gap in the portfolio between these major SOEs and all the others. The exception to this is KOIL, whose assets and liabilities are small, but whose financial status is closely interconnected with that of the PUB, so warrants inclusion for that reason.

38. **As revised, the second component of this prior action is very similar to a prior action in the second operation of the first DPOs series (though since then, the telecommunications SOE has been privatized and KOIL added to the list of the 'big five').** At the time of the previous similar prior action, new SOE legislation had just been approved and the GoK was beginning to implement it. Its implementation did not have the chance to bed down before the change in government, and across that transition SOE reforms lost considerable momentum. The timely preparation of financial statements slipped during that transition, yet is critical to the monitoring of fiscal risks. This prior action is playing an important role in helping the GoK regain that momentum, by concentrating attention on the importance of keeping the financial statements of the largest SOEs up to date. Over the last year, the GoK has developed a new approach to monitoring budget support actions, that accommodates recurring items as well as new reforms. Once achieved, this action will shift to the set of recurring items, which should help to reduce the risks of further slippage in this area in the future.

39. **The expected result in this reform area is that public debt is managed based on a comprehensive and up-to-date public sector debt database that includes contingent liabilities, with all debt-related transactions recorded within a three-month lag.** This contrasts with the situation

prior to the commencement of this series, where the debt database covered only the external debt of the central government.

Prior Action 3: The Recipient: (i) through its Cabinet, has approved the Kiribati Public Procurement Reform Plan; and (ii) has made the Kiribati Public Procurement Reform Plan publicly available.

40. **Procurement has been recognized as an area of significant weakness in public financial management in Kiribati for some time, and the GoK has now committed to a reform it.** The key problem is that the procurement process lacks the regulatory framework and mechanisms to support efficiency, fairness and transparency. An inefficient process is especially problematic in a context like Kiribati, where administrative capacity is so scarce. The existing legislation does not establish a preference for open competition, and there are currently no procurement regulations, no standard bidding and contract documents (instead, a variety of different models are in use in different agencies), and no working-level procurement manual. Aside from reducing the prospects for best value in procurement, this situation makes each procurement unduly complicated thus preventing scarce administrative capacity from being directed to its most effective use. Opportunities for synergy and best value are further lost through decentralized procurement functions in line ministries and SOEs, most of which have very small volumes of procurement and no dedicated procurement officers. In the absence of established annual procurement planning, procurement tends to be transactional (buying quickly using the same process and suppliers as before) rather than strategic. The Public Expenditure and Financial Accountability (PEFA) assessment conducted in 2010 (the latest available), rated Kiribati's competition, value for money and controls in procurement at D+.

41. **With technical assistance from the ADB, the GoK recently completed a procurement review and formulated a reform program which has now been endorsed by Cabinet.** The reform program takes a fit-for-purpose approach to procurement reforms, taking into account the scarce public sector capacity in Kiribati and the experiences Fiji, Tonga and Tuvalu have had to date with the solutions they have adopted in somewhat similar circumstances. The reform plan includes establishing a Central Procurement Unit (CPU), to centralize common activities and build professional capacity, centralize procurement over a certain threshold, and manage consolidated purchases of commonly procured items that are currently being procured in a fragmented manner by numerous separate entities. Regulations, standard bidding and contract documents, templates and a procurement manual will be prepared, within the framework of revised legislation. The position of Chief Procurement Officer (CPO) will also be moved to be within MFED – currently, the Secretary for Cabinet is the CPO, which the GoK has agreed is an unnecessarily high level for this role to sit at. The reform plan has been carefully sequenced, such that changes in roles and powers will occur once the relevant entities have built up the necessary capacity to use them – to avoid disrupting procurement processes in the interim.

42. **Cabinet approval and publication of the Kiribati Public Procurement Reform Program (KPPRP) is proposed as a new prior action for this operation.** While it is unusual for the approval of a reform plan to be a prior action in the final operation in a programmatic series, in Kiribati (as in several Pacific Islands) the Bank's experience is that budget support engagements are best seen as one-plus-one arrangements: each operation specifies triggers for the subsequent operation, whatever that operation's position in a series. Cabinet's approval of the reform plan is a signal of its commitment to it, and its implementation will be supported by technical assistance from the ADB, adding to the level of confidence that the GoK will be able to follow-through on this commitment. The GoK is now beginning to implement the first phase of the KPPRP, which will include the institutional reforms establishing and providing a budget for the CPU, the appointment of the CPO, and the delegation of the relevant powers from the Secretary for Cabinet to the CPO (an interim arrangement, before the wider legislative changes are made, that would include reassigning these powers). With support from MFAT, the GoK is also embarking on an analysis of its asset management and maintenance needs and systems, which is a very challenging area in Kiribati and which is complementary to procurement

systems. This is expected to lead to a series of asset management reforms. It is important to note the significance of the timing of Cabinet's commitment to procurement reform and the commencement of its work on asset maintenance: with the GoK planning a significant new program of capital works in the outer islands, there is a premium on moving towards efficient, fair and transparent procurement and effective asset management and maintenance. Cabinet's approval of the KPPRP is a valuable to support as a signal of its commitment to the procurement reforms, whose implementation – alongside asset management reforms – the Bank could support in the future.

43. **Given that Cabinet approval of the KPPRP is a prior step to the actual implementation of procurement reforms, its inclusion as a prior action in the last operation in a DPO series does make it challenging to identify an appropriate results indicator.** In essence, the expected result from this high-level endorsement of the KPPRP is that it underpins the momentum for the KPPRP to be implemented in a timely manner. A key signal that the KPPRP is being implemented in a timely manner would be the establishment of an operational CPU. Once the CPU is able to operate, it will be possible for the Secretary to Cabinet to delegate procurement powers to the CPO. That delegation could thus therefore serve as an indicator that Cabinet's approval of the KPPRP has been effective in spurring the timely implementation of the KPPRP.

Pillar 2: Improving the environment for inclusive growth.

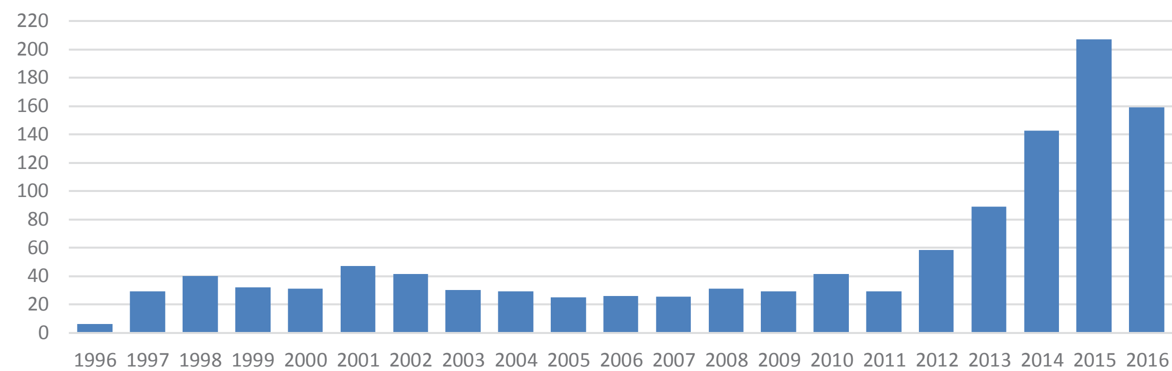
Prior Action 4: The Recipient, through its Cabinet, has: (i) approved a fisheries joint ventures policy outlining the criteria for evaluating existing and new fisheries joint ventures; and (ii) approved a plan to annually review the performance of fisheries joint ventures against this policy.

44. **Fisheries are one of Kiribati's most important assets, and – particularly through the public sector activity that fisheries license revenue supports – are the main driver of the economy.** They also provide direct economic benefits, in the form of jobs in fishing, processing and transshipment operations. Increasing the returns from fisheries – whether revenue to fund public sector activity or direct economic benefits – is critical to inclusive growth in Kiribati. Historically, fisheries revenues were low and volatile, but a turning point came with the implementation of the Vessel Day Scheme (VDS) in 2012 (Figure 5). The VDS was the result of an accord reached by the Parties to the Nauru Agreement (PNA) to establish limits on the number of fishing days they would sell to purse seine vessels. Effectively, this supply constraint enables PNA members to retain a greater proportion of the tuna catch value in license fees. Kiribati's progress in negotiating access arrangements consistent with the VDS and within the overall catch limits was slow, however, as a result of lack of whole-of-government commitment to the VDS and, in particular, lack of coordination between MFED and MFMRD. In the previous DPO series, the Bank supported the GoK to reform the management of fisheries resources and fisheries revenue. This included adoption of a National Fisheries Policy, which incorporated a commitment to comply with the VDS, and the production of a joint annual report on fisheries revenue by MFED and MFMRD. Previously, MFMRD did not share disaggregated data on the sources of fisheries revenue with MFED, so the information sharing and cooperation inherent in producing this report – which has been produced on an annual basis since – was a critical step forward for transparency and macroeconomic management. Alongside the RERF reforms, fisheries reforms represented one of the most significant achievements of the previous DPO series.

45. **Increasing the returns that Kiribati obtains from its fisheries assets is an overriding priority for the GoK.** Having made considerable progress in the area of fisheries revenue management under the previous DPO series, this series has focused on the reform of fisheries joint ventures. To increase domestic value-added from fisheries assets and provide employment opportunities for I-Kiribati workers, the government has forged a number of joint ventures with overseas partners. The GoK has provided concessions and incentives to attract potential investors, to offset the high costs of business operations in Kiribati and the paucity of essential infrastructure. While some of these joint ventures –

like Kiribati Fish Limited – have resulted in operational processing plants that provide domestic jobs and produce export-grade products – the benefits of others have been less clear. The details of the joint venture agreements – including the concessions provided – were not readily shared by MFMRD to facilitate an assessment of their costs and benefits for Kiribati. The previous operation supported the GoK's review of its six existing joint ventures, to examine their financial performance, contribution to the economy (including government revenue and domestic employment), and compliance with regional agreements, to ensure the joint ventures were not being formed merely to take advantage of the local vessel status and thus subvert fishing effort limits imposed on international vessels. Cabinet considered the findings and recommendations of the review, endorsing the recommendation to dissolve one joint venture and substantially restructure another.[7]

Figure 5: Fishing license fee revenues, 1996-2016 (A$m)



Source: MFED and MFMRD.

46. **The prior action for this operation is that the government institutionalize the formal review process by adopting a fisheries joint ventures policy, which has been completed.** Cabinet considered and endorsed a set of criteria against which all existing and proposed joint ventures will be assessed, and agreed that the assessment should take place on an annual basis. The criteria include: the impact of the joint venture on government revenue and revenue-expenditure; its contribution to domestic employment; its potential for future expansion; its impact on the sustainability of local fisheries and fishing operations; its financial viability, risk exposure and risk mitigation; its compatibility with sub-regional, regional and international fisheries instruments; and the degree of cooperation of joint venture partners with agreements, policies, management and operations. The adoption of this policy, including annual evaluation of all joint ventures against the specified criteria, signals the GoK's commitment to actively ensure that Kiribati derives an appropriate level of benefits from its fisheries assets.

47. **There are a number of other aspects of the GoK's strategy for increasing the returns Kiribati accrues from its fisheries, which could be supported in the future.** One possible area is transshipment, which appears to have the potential to generate substantial domestic economic activity, through backward linkages to private sector supply firms.

48. **For the current series, the expected outcome of this area of reforms is that – through the annual review process – Kiribati obtains value-for-money from its fisheries joint ventures.** The value-for-money assessment will be made annually, based on the criteria approved by Cabinet. The target will be that all joint ventures are assessed as providing value-for-money for Kiribati (or for those that

[7] Whereas in the first DPO series the fisheries reforms focused on the management of fisheries revenues, in the current DPO series the reforms focus on the broader returns (including the contribution to the economy and domestic employment) Kiribati obtains from its fisheries assets. It thus seems more appropriate to include this reform area under the second pillar (on the environment for inclusive growth) than under the first pillar (on public financial management), which explains the proposed new location of this reform area.

are not, associated remedial actions have been agreed). The baseline, based on the findings of the initial review, is that two-thirds of joint ventures provided value-for-money.

Prior Action 5: The Recipient, through its Cabinet, has approved ownership and management plans for telecommunications assets in the outer islands, in order to facilitate the roll out of telecommunications services to outer islands that do not currently have access to them.

49. **Achieving universal access to reliable and affordable telecommunications services is important to facilitate inclusive growth across the country, including through strengthening disaster risk management.** Telecommunications connectivity is critical to the quality of life of I-Kiribati, to the business enabling environment in Kiribati, and to Kiribati's capacity to mitigate the impact of natural disasters through effective early warning systems and effective disaster responsive efforts. In recent years, Kiribati has made substantial reforms to the telecommunications sector, supported by technical assistance from the World Bank. In 2013, the GoK enacted new telecommunications legislation, providing for the liberalization of the telecommunications sector, including the commercialization of the incumbent SOE and the introduction of competition. In 2014, the GoK tendered for the sale of the assets of the incumbent SOE. These reforms were supported by the operations in the first DPO series. The new privately-owned telecommunications provider moved quickly to improve the quality of services on offer and expand the market, with mobile penetration now at about 45 percent and mobile broadband penetration at about 40 percent.

50. **While the costs of mobile telecommunications services have declined under the new provider, they remain very high.** The main reasons for this include the lack of scale and high costs of maintaining service on remote and sparsely populated islands, the difficult operating environment – particularly the high cost of satellite bandwidth since Kiribati does not yet have access to a submarine fiber optical cable, and the absence of competition in the market. In 2015, the GoK issued a second mobile operator license to introduce competition in mobile telecommunications services, with technical assistance for the introduction of competition provided by the World Bank. This reform was supported by the first operation in the current DPO series. Though progress with the establishment of the second operator has been very slow, in recent months the GoK has worked to tackle the obstacles to its establishment that are within the GoK's control. The interconnection agreement remains outstanding, however. With respect to access to a submarine fiber optical cable, the World Bank is supporting the GoK to establish an international submarine cable connection, while the ADB is supporting a cable connection to Kiritimati (Christmas) Island.

51. **Even with the reforms to date, access to telecommunications is far from universal.** While most households in South Tarawa now have at least one mobile subscriber, only about 70 percent of the population is within mobile network range – with the populations of most outer islands outside the range. In 2017, Cabinet approved ownership and management plans for telecommunications assets in the outer islands, detailing the costs, options, and timeline to roll out mobile and internet services to the outer islands. Cabinet adopted a two-phase approach to the roll-out, aligning priority areas with the availability of financial resources and implementation capacity, to support the success of the plan. The Bank's telecommunications team is of the view that the ownership and management plans adopted by Cabinet meet the requirements of a universal access program in the Kiribati context, thus their approval does not represent a substantial change to the original trigger, which was framed in terms of a universal access plan. Following consultations with the Bank's telecommunications team, the GoK has opted for a public-private partnership approach to outer island telecommunications assets, and has now moved to prepare the necessary documentation to proceed with this approach, in the four outer islands that will be covered in the first phase of the roll-out.

52. **The roll-out of telecommunications services to the outer islands is expected to improve the environment for inclusive growth across the country, including for women who will potentially be**

able to utilize these services for small enterprise development, market linkages, and mobile banking. Broadband internet would also help outer island populations get better access to weather data, facilitate early warnings via alerts, and facilitate disaster response efforts. Potentially also, telecommunications infrastructure would facilitate the establishment of sensor networks to monitor specific climate change impacts and risks. The Bank will continue to provide technical assistance for the implementation of reforms in the telecommunications sector, including support for the regulator and for the first phase of the implementation of the outer island roll-out.

53. **There are two expected results indicators for this reform area.** The first, relating to the prior action for the previous operation, is that the Tarawa market is served by at least two mobile operators, with increased mobile penetration and lower prices. Specifically, the penetration rate in the Tarawa market is expected to reach at least 50 percent by the end of 2018, and the price of mobile calls within Tarawa is expected to fall by at least 17 percent.[8] The second, relating to the prior action for this operation, is that the penetration rate for mobile phones in the outer islands increases to 20 percent by the end of 2018.

Prior Action 6: The Recipient, through its Cabinet, has approved: (i) a new electricity tariff that makes electricity more affordable for the poor while aligning the average tariff with cost recovery; and (ii) a reduced household electricity connection fee, to expand access to electricity.

54. **Access to quality, affordable electricity, water and sanitation services is critical to both the quality of life of I-Kiribati and the business enabling environment in Kiribati, thereby supporting inclusive growth.** In South Tarawa and Betio, where there is an electricity grid, a reticulated water system and a sewage system, but where population growth is most pronounced, use of grid electricity for lighting is quite low by regional standards for capitals (73 percent of households), access to piped water is also relatively low (37 percent), and only 13 percent of households are connected to the sewage system. Low levels of access to improved water and sanitation, in combination with extreme population density, contribute to very significant health problems – including one of the highest rates of infant mortality in the region and the rise of leprosy in the most densely populated atoll Betio. Stakeholder consultations at the time of the first DPO series suggested that problems with the provision of basic services – including water and electricity – have a large impact on the lives of the poor and especially households headed by women. Women typically bear a disproportionate burden of household work, which lack of ready access to electricity, water or sanitation increases significantly. Electricity, water and sewage disposal are the responsibility of PUB, which until recently has been a very poorly performing SOE. Following on from the broad SOE governance reforms supported by the first DPO series, and with assistance from a group of development partners including the World Bank, ADB, MFAT and DFAT, the Ministry of Public Works and Utilities prepared a performance improvement plan for PUB, identifying short-term measures to improve the operational performance of PUB. These included the competitive international selection and recruitment of a new CEO, to spearhead the implementation of the plan. These reforms were supported by the first operation in this DPO series.

55. **The original trigger for the second operation in the series was Cabinet adoption of a medium-term reform plan for PUB, and the implementation of key aspects of the first six months of the plan.** As it turned out, the medium-term reform plan did not ever go to Cabinet, but was substantially implemented in a short timeframe anyway. The maintenance of electricity generators was improved, contributing to improved reliability and availability of electricity and a 7 percent

[8] 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 telecommunications sectors in 2010 and 2008, respectively.

increase in electricity sales in 2016. 1.5 MW of solar PV was brought into service, offsetting a significant volume of diesel consumption. A dedicated effort was made to create a culture of payment, with record recovery of electricity revenues – 104 percent for 2016. Losses and wastage across PUB operations were reduced and the GoK provided a modest community service obligation (CSO) for water and sewage for the first time in 2016. Overall, and in a very short space of time, PUB went from making persistent, significant losses to making a very small net profit in 2016.

56. **It is proposed that the original trigger for the second operation be revised to capture key aspects of the medium-term reform plan, since its substantial implementation now makes Cabinet approval of the plan itself a moot point.** The key policy aspects of the reform plan that have required Cabinet approval pertain to the electricity tariff. In January 2017, Cabinet approved a new tariff structure that significantly lowers the burden of electricity costs for the poorest households. The first 100 kWh (enough for lighting, a fridge and perhaps a fan for a very small home) is now charged at 10c per kWh for domestic consumers (down from 40c). From 100 kWh to 300 kWh is charged at 40c per kWh, and over 300 kWh is charged at 55c per kWh (up from 40c), the same charge as commercial users and approximately the cost recovery level. At present, industrial users (charged at 70c per kWh) effectively cross-subsidize the tiered tariff structure that benefits small domestic consumers. PUB has complemented the new tariff with an education campaign to help households manage their electricity use better. Cabinet has also approved a reduction in the household electricity connection fee from A$380 to A$50, prompting over 1,000 households to request electricity connections. Female-headed households are over-represented among households below the basic needs positive line, so these measures are expected to have a disproportionate benefit to female-headed households.

57. **In the future, PUB will increasingly focus its reform efforts on water, reforms which the Bank support.** Electricity-related reforms will be ongoing at the operational level, but the next critical area for PUB that requires policy change is in the area of water. At present, PUB is preparing to pilot the concept of being able to deliver piped water that is available 24 hours a day, 7 days a week through a pressurized system. PUB’s research suggests that even poor households would be prepared to pay a usage fee to have water available in this way, in preference to the current situation for many poor households where water is free but only available from communal standpipes for two hours a day every second day. At present, however, PUB is prevented by government policy from charging for water. With a modest CSO and series of misaligned incentives, technical and commercial losses of water are unlikely to be significantly reduced and household access to piped water is unlikely to be significantly expanded unless there is a shift in policy, which the current pilot could contribute towards. Once PUB has proved the concept of this level of service delivery, deliberations over how to fund the cost of providing it universally and on a sustainable basis can begin.

58. **There are two expected results indicators for this reform area.** The first, relating to the prior action for the previous operation, is an improvement in the operational and financial performance of PUB, including improved electricity service quality. Specifically, the billing collection rate is expected to rise from 85 percent in 2015 to over 90 percent by the end of 2018, total power losses are expected to fall from 18 percent in 2015 to less than 15 percent in 2018, the frequency of electricity outages is expected to fall from 7.8 in 2016 to the regional average of 6 in 2018, and the duration of electricity outages is expected to fall from 956 minutes in 2016 to 880 minutes in 2018. The second, relating to the prior action for this operation, is that 70 percent of poor households (defined as households consuming less than 100kWh) benefit from the new tariff structure.

Table 3: DPO prior actions and analytical underpinnings

Indicative Trigger	Proposed Prior Action	Explanation for Change	Analytical Underpinnings
Pillar I: Strengthening public financial management			
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.	1. (i) The Recipient, through its Ministry of Finance and Economic Development, has completed a review of RERF custodial arrangements to ensure that the services of the provider remain competitive with current market practice and benchmarks; (ii) the Recipient's Cabinet has endorsed the recommendations of the review; and (iii) the Recipient has issued a request for proposal for custodial services. *Status: Completed*	The current government has focused on continuing the implementation of earlier recommendations to strengthen the management of the RERF. At the same time, it has taken time to articulate objectives for the RERF that seek to strike a balance between benefits to current and future generations, and is now in the process of determining an appropriate strategy to achieve those objectives. An approach to transfers and withdrawals consistent with this strategy could be supported in a subsequent DPO series.	IMF Country Report No. 9/196 (Selected Issues Paper I); IMF Monetary and Capital Markets Department technical assistance report, 2011; IMF Country Report No. 15/207 (Box 3); World Bank Treasury RAMP technical assistance reports: especially recommendations concerning the need to renegotiate the contract with the custodian and strengthen oversight of the asset managers.
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.	2. The Recipient has improved monitoring of contingent liabilities, through: (i) quantifying the government's guarantees; (ii) bringing up to date the financial statements of the five largest SOEs; and (iii) submitting the financial statements of the Kiribati Provident Fund to the external auditor. *Status: Completed*	The change to component (ii) corrects it to refer to completion of financial statements rather than completion of external audits, since only the former has a timeframe specified in legislation. Learning from the ICR of the first DPO series, it also narrows the focus to the five largest SOEs (which include DBK), to appropriate reflect scarce capacity.	IMF Establishing a Structure for Public Debt Management technical assistance report, September 2013; Kiribati Debt Management Policy, 2013; 2016 World Bank–IMF Debt Sustainability Analysis: especially the analysis and recommendations concerning the monitoring and management of contingent liabilities.
–	3. The Recipient: (i) through its Cabinet, has approved the Kiribati Public Procurement Reform Plan; and (ii) has made the Kiribati Public Procurement Reform Plan publicly available. *Status: Completed*	This is a new prior action, reflecting the initiation of reform measures in this critical area of PFM.	Kiribati Public Financial Management Performance Report, 2010; Kiribati Procurement System Review Report, 2016: recommending a comprehensive reform of procurement legislation, regulations, processes and institutions.

Indicative Trigger	Proposed Prior Action	Explanation for Change	Analytical Underpinnings
Pillar II: Improving the environment for inclusive growth			
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.	4. The Recipient, through its Cabinet, has: (i) approved a fisheries joint ventures policy outlining the criteria for evaluating the existing and any new fisheries joint ventures; and (ii) approved a plan to annually review the performance of fisheries joint ventures against this policy. *Status: Completed*	Minor wording changes only.	Kiribati Public Financial Management Performance Report, 2010; Kiribati National Fisheries Policy 2013-25: particularly the recommendations pertaining to the need for closer fiscal oversight of the joint ventures.
4. The Recipient's Cabinet has adopted the revised Universal Access Plan, detailing costs, options, and the timeline to roll out the telecommunications services to the outer islands.	5. The Recipient, through its Cabinet, has approved ownership and management plans for telecommunications assets in the outer islands, in order to facilitate the roll out of telecommunications services to outer islands that do not currently have access to them. *Status: Completed*	The World Bank's telecommunications team is of the view that the approved ownership and management plans for outer islands telecommunications assets meet the requirements of a universal access program in the Kiribati context, thus this change does not represent a substantial change to the original trigger.	World Bank Kiribati ICT Development Project Appraisal Document, 2012: analysis on improving outer island connectivity.
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.	6. The Recipient, through its Cabinet, has approved: (i) a new electricity tariff that makes electricity more affordable for the poor while aligning the average tariff with cost recovery; and (ii) a reduced household electricity connection fee, to expand access to electricity. *Status: Completed*	This revision removes the first part of the indicative trigger which has been superseded (the medium-term reform plan was substantially implemented, without ever having gone to Cabinet), and specifies the key policy aspects of the reform plan (as was needed, in accordance with the wording of the indicative trigger).	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: recommendations concerning cost recovery tariffs.

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

59. **The proposed operation is aligned with the priorities identified in the Regional Partnership Framework (RPF).** The first component of the PDO on strengthening public financial management is aligned with focus area 4 of the RPF (strengthening the enablers of growth opportunities – specifically the development and maintenance of frameworks to improve fiscal management). The second component of the PDO on improving the environment for inclusive growth is aligned with focus area 1 (fully exploiting the available economic opportunities – specifically improved management of oceanic and coastal fisheries) and focus area 4 (specifically increased access to basic services and improved connective infrastructure). Both components of the PDO are aligned with the twin goals of ending extreme poverty and promoting shared prosperity in a sustainable manner, through the way fiscal management, exploiting available economic opportunities and access to basic services and connective infrastructure contribute to poverty reduction and share prosperity.

60. **The proposed operation is complemented by a number of other Bank engagements in contributing to achieve the objectives of the RPF.** These include: (i) the World Bank Treasury RAMP, which is helping the government improve the governance, management and strategy relating to the RERF; (ii) the Telecommunications and ICT Development Project and the Pacific Regional Connectivity Program Phase 4: KI: Connectivity Project, led by the Transport and ICT Global Practice, which is helping the country achieve the transition to a market-driven telecommunications sector, expand services to the outer islands and establish international cable connectivity; and (iii) the Utility Service Reform Project, led by the Energy and Extractives Global Practice, which is helping government develop and implement comprehensive reforms of PUB to ensure the sustainable provision of essential public utilities.

4.4 CONSULTATIONS, COLLABORATION WITH DEVELOPMENT PARTNERS

Consultations

The GoK formulates its national development plans through a consultative process among government stakeholders, civil society and the private sector. As well as being consulted in its formulation, civil society and the private sector are invited to provide feedback on drafts of the plan. It also involves widespread consultation with all government ministries and agencies. The consultation process for DPOs in Kiribati occurs through the Economic Reform Taskforce (ERT). The ERT was established prior to the first DPO series, to serve as a forum for consultation, coordination and management of key economic reforms. It is a joint government-donor working group, chaired by the Secretary to Cabinet and including the Permanent Secretaries for Finance and Economic Development, Fisheries and Marine Resources Development, Communications, Transport and Tourism Development, and Commerce, Industry and Cooperatives, as well as representatives of the World Bank, ADB, DFAT and MFAT. ERT provides a forum for dialogue, progress monitoring, results monitoring, and coordination of technical assistance for budget support-related reforms.

Collaboration with other Development Partners

61. **The World Bank has collaborated closely with the ADB, DFAT and MFAT in the preparation of this operation.** In keeping with the established practice in the region, this operation is based on a joint policy matrix agreed between the GoK and this group of development partners. This approach improves the feasibility of reforms by having the GoK and key development partners focusing on a small set of reforms, and coordinating the provision of their technical assistance in support of these reforms. This approach also reduces the transaction costs on the GoK, by harmonizing a number of the engagement and procedural aspects of budget support operations. With respect to the actions in the joint matrix, the World Bank provides technical assistance on the RERF and telecommunications

reform areas, the ADB provides assistance on the contingent liabilities and procurement reform areas as well as on broader SOE monitoring and reform, and MFAT provides assistance on the fisheries reform areas. The Bank, ADB MFAT and DFAT also work together to provide assistance to PUB. In addition, the Bank collaborates closely with the IMF and with the Pacific Financial Technical Assistance Centre (PFTAC) on macro-fiscal policy and PFM issues.

5.1 POVERTY AND SOCIAL IMPACT

62. **Policies supported by the proposed operation are expected to have a positive impact on poor people and vulnerable groups.** Strengthening public financial management and safeguarding fiscal sustainability should help ensure that the government can maintain public services and public investment in human and physical capital, which are of disproportionate importance to the poor. Improving the financial and operational performance of the RERF is vital to fiscal sustainability in Kiribati. Improving public debt management, including the management of contingent liabilities, should help avoid unsustainable borrowing, the realization of contingent liabilities, and, ultimately, a debt crisis that would disproportionately hurt the poor who are less able to accumulate buffers or insure against risk. Improving the efficiency of public procurement should contribute to higher quality public spending, again of disproportionate benefit to the poor.

63. **Improving the returns Kiribati obtains from its fisheries assets is expected to benefit the poor, primarily through the public services and public investment that sustained higher revenues enable.** The current DPO series focuses on the returns to Kiribati from its fisheries joint ventures. Through the supported reforms, the GoK is ensuring that the concessions it grants through joint ventures (tax concessions or concessional access to its fisheries – both of which take away from the revenues otherwise available for public services and public investment) are worth the benefits (in terms of domestic economic activity and employment generation). The criteria approved for the evaluation of joint ventures also include their impact on local fisheries and fishing operations. Although the impact of these joint ventures on local fisheries is typically minimal, because the joint ventures are concerned with access to oceanic – not coastal – fisheries, the inclusion of this criteria should help to mitigate any potential negative poverty and social impact.

64. **Facilitating competition in the telecommunications market and expanding access to telecommunications services in the outer islands are expected to be pro-poor.** Competition is expected to improve services and lower prices for the population of South Tarawa, where the largest numbers of poor people live. Rolling out telecommunications services to the outer islands is expected to help reduce isolation and potentially also improve the quality of public services, like health and education, in the outer islands. In so doing, it may reduce the intensity of some of the push factors in internal migration to South Tarawa – access to health and education – which, in turn, could help to moderate population pressures, health and sanitation challenges, and environmental degradation in the capital. More broadly, the reforms in the telecommunications sector are expected to improve the business environment in Kiribati, enabling the private sector to take advantage of the economic opportunities that do exist, with consequential benefits for job creation.

65. **Improving access to and quality of essential services is also expected to disproportionately benefit poor people and vulnerable groups.** Consultations with women's groups at the time of the first DPO series confirmed the significance of basic services – including water and electricity – to wellbeing, especially to the welfare of households headed by women. The reforms at PUB are improving the reach and quality of services, which should improve rates of electrification, access to an improved water source and access to improve sanitation in South Tarawa, where the largest numbers of poor people live. Over time, this should improve the health of residents in the capital. The specific measures supported by this series include a substantial reduction of the electricity tariff for the first portion of household electricity consumption, of particular benefit to smaller electricity users

who are typically poorer, and a major reduction of the household connection fee, of disproportionate benefit to those who have, until now, been unable to afford an electricity connection. Approximately 150 households fall into the highest bracket of domestic electricity consumers (over 300kWh), so will be adversely affected by the increase in the tariff for units of electricity over 300kWh (to match the commercial tariff, which is approximately the cost recovery level). If a future DPO series supports reforms to water tariffs that introduce usage fees to improve access and quality of water services in a sustainable manner, any such reforms would be preceded by distributional analysis and examination of options for mitigating the impact on the poor, with technical assistance provided by the World Bank and the other donor partners supporting the PUB reforms. More broadly, the reforms in the utilities sector are expected to improve the business environment in Kiribati.

5.2 ENVIRONMENTAL ASPECTS

66. **Policies supported by the proposed operation are not expected to have any significant direct adverse effects on the environment, forests and natural resources.** In the team's judgment, improving the performance of the RERF, improving public debt management, and improving the efficiency of public procurement, are not expected to have any environmental impact. Improving the returns Kiribati obtains from its fisheries assets is not expected to have a direct environmental impact. It may have a small positive indirect impact, because one of the criteria established for the evaluation of joint ventures is their compatibility with regional and international fisheries instruments. The regional VDS sets limits on the level of fishing effort based on a regional determination of sustainable effort levels. Thus, including this criteria brings sustainability into the considerations applying to the evaluation of joint ventures. In addition, the degree of cooperation by joint venture partners with agreed policies allows for the evaluation of joint ventures to take account of their adherence to environmental and social policies and regulations. The reforms supported in relation to PUB are not expected to have direct environmental impacts.

67. **The reforms in the telecommunications sector supported by the proposed operation are likely to have direct effects on the environment, because the ownership and management plans for telecommunications assets in the outer islands approved by Cabinet represent a strategy for rolling out telecommunications services to the outer islands, which will necessarily involve infrastructure development.** For the first phase of the roll out of telecommunications services, covering four outer islands, the infrastructure development that will occur as a consequence of Cabinet's approval of the ownership and management plans will be supported through the Bank's Telecommunications and ICT Development Project. The Project itself will finance the delivery of telecommunications services, with bidders for the provision of these services constructing towers for the mobile networks. The Project is subject to an Environmental Code of Practice, which was approved during Project preparation and remains current. Bidders for the provision of telecommunications services will need to comply with this Environmental Code of Practice.

68. **Kiribati's institutional capacity for environmental assessment and climate risk management is rated 3.0 according to the latest 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. Its capacity remains weak due to staff turnover, inadequate budget allocations to monitoring and enforcement, and a lack of capacity to carry out technical reviews of complex applications. Technical assistance is being provided through a number of sector-specific Bank projects, to help mitigate these institutional capacity weaknesses. This capacity building assistance has included support in the areas of social safeguards, community engagement and social inclusion,

and the implementation of environmental management plans. Further support is also likely to be provided in the future in the areas of sustainable use and management of oceanic fisheries and coastal fisheries and wider ecosystems. With respect to mainstreaming climate change management in national policy, Kiribati is committed to integrating climate risk awareness and responsiveness into its economic and operational planning frameworks. In vulnerable areas, such as fresh water management and coastal protection, climate risks are integrated into projects and plans. Overall, while administrative capacity for environmental protection in Kiribati is weak, a combination of the existing environmental regulatory framework, the capacity building assistance being provided by the Bank, the nature of the reforms supported in the proposed operation, and the risk mitigation measures relating to the telecommunications reforms, support the conclusion that the proposed operation is unlikely to lead to significant adverse environmental impacts.

5.3 PFM, DISBURSEMENT AND AUDITING ASPECTS

69. **Overall, the fiduciary risk to this operation arising from Kiribati's public financial management framework is assessed as substantial.**

70. **The 2010 Public Financial Management Performance Report identified relative strengths in Kiribati's public financial management in several areas.** These included: (i) credibility of the aggregate expenditure program; (ii) credibility of the expenditure composition; (iii) transparency of inter-government fiscal relations; (iv) orderliness of and participation in the annual budget process; (v) predictability of taxpayer obligations and liabilities; (vi) predictability in the availability of funds for commitment of expenditures; (vii) scope, nature and follow-up of external audit; and (viii) legislative scrutiny of external audit reports (all scoring better than a C).

71. **At the same time, the report highlighted a number of weaknesses.** These included: (i) revenue estimates in the budget; (ii) classification of the budget; (iii) oversight of aggregate fiscal risk from other public sector entities; (iv) multi-year perspective in fiscal planning, expenditure policy and budgeting; (v) recording and management of cash balances, debt and guarantees; (vi) competition, value for money and controls in procurement; (vii) quality and timeliness of in-year budget reports; (viii) effectiveness of internal controls; and (ix) timeliness and regularity of accounts reconciliation (all scoring below a C).

72. **Following the 2010 Public Financial Management Performance Report, the government has worked to strengthen public financial management, with technical assistance from donors.** Information sharing between MFMRD and MFED on the sources of fisheries revenues has improved significantly, strengthening the ability of the GoK to project fisheries revenues in the budget (a measure supported by the previous DPO series). There has been some progress in strengthening expenditure controls, through improved accounting systems and the move toward a more standard budget classification. However, issues remain in relation to the effectiveness of the controls and in reconciling the central accounting system with the separate systems in line ministries. There has been some incorporation of a multi-year perspective in budgeting. The backlog of annual financial statements of the government has been eliminated, and progress has been made in eliminating the backlog for the large SOEs (a measure supported by the current operation). The government has strengthened the transparency of SOE-related financial activities, breaking down transfers to SOE between CSOs and other transfers). Procurement reforms have also now been initiated (a measure also supported by the current operation). Kiribati's annual budget is publicly available on the GoK's website.

73. **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 eight months of their receipt, there have in the past been delays in the submission of the financial statements to the Audit Office. These delays have now been eliminated. The government's 2015 annual accounts were subject to a qualified opinion with the Auditor-General unable to satisfy herself as to the accuracy of the financial statements. 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, issues relating to the coverage of the budget – including limited information on public debt and guarantees, and 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 fiscal operations.

74. **Kiribati does not have a central bank or its own national currency.** It has not, therefore, been subject to an IMF Safeguards Assessment. The disbursement measures proposed are that the grant funds disbursed by the World Bank be deposited into a dedicated Local Currency Deposit Account and from it into the budget account of the government and thus 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$5 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 Bank. ANZ is a large Australian Bank and owns 75 percent of the ANZ Banking Company operating in Kiribati. The government owns the other 25 percent. This is the only commercial bank operating in Kiribati. All investment lending funds to Kiribati which require a Designated Account have used the ANZ.

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

76. **As an additional risk 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 the accuracy of any 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 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 end of the Recipient's financial year in which the grant is disbursed, and will be made publicly available in a timely fashion.

77. **The closing date for the proposed operation would be 31 December, 2018.** The Bank's experience with DPOs in Pacific Islands suggests the utility of a closing date approximately 12 months after the expected disbursement of the proceeds of the operation.

5.4 MONITORING, EVALUATION AND ACCOUNTABILITY

78. **The ERT provides the structure supporting the monitoring and evaluation of the proposed operation.** Progress against actions and outcomes will be collaboratively tracked, and any necessary remedial actions identified and executed jointly by the members of the ERT. Monitoring and evaluation will be supported by the data provided by relevant government ministries and agencies, donors, and those available from publicly available sources. As far as possible, results indicators rely on data that would be produced anyway or, where it does not, technical assistance has been committed to support the GoK to measure the required indicator. The paucity of data is a significant constraint in some areas, particularly with respect to the telecom and PUB reforms which can be expected to have significant positive impacts on women, but where the data will not exist to measure these effects by the time the ICR is undertaken. In addition, the Bank's approach to DPOs in Kiribati (which is essentially to undertake annual DPOs, where each indicates triggers for the next operation – whether it is in the same series or the next series) means that some continuous sequences of reforms are split across different series, so the relevant baseline is not the beginning of the current series but before the final operation in the previous series (as for the RERF and telecom reforms in the first operation of this series). That continuity across series needs to be understood in order to explain the choice of baseline year.

79. **Grievance Redress.** Communities and individuals who believe that they are adversely affected by specific country policies supported as prior actions or tranche release conditions under a World Bank DPO may submit complaints to the responsible country authorities, appropriate local/national grievance redress mechanisms, or the World Bank's Grievance Redress Service (GRS). The GRS ensures that complaints received are promptly reviewed in order to address pertinent concerns. Affected communities and individuals may submit their complaint to the World Bank's independent Inspection Panel which determines whether harm occurred, or could occur, as a result of World Bank non-compliance with its policies and procedures. Complaints may be submitted at any time after concerns have been brought directly to the World Bank's attention, and Bank Management has been given an opportunity to respond. For information on how to submit complaints to the World Bank's corporate GRS, please visit http://www.worldbank.org/GRS. For information on how to submit complaints to the World Bank Inspection Panel, please visit www.inspectionpanel.org.

6. SUMMARY OF RISKS AND MITIGATION

Risk Categories	**Rating (H, S, M or 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	H
6. Fiduciary	S
7. Environment and social	S
8. Stakeholders	M
9. Other	-
Overall	**S**

80. **The overall risk rating for the proposed operation is substantial.**

81. **Institutional capacity risks are rated as high, because of the extremely thin capacity of the public sector to implement the reform program and sustain it over time.** Kiribati struggles with thin capacity – with a small number of public servants and external consultants responsible for carrying out a large number of tasks and implementing a large number of reforms. Those with well-developed technical skills and experience are often difficult for the public service to retain, due to the relatively compressed salary structure of the public sector in Kiribati and the attractive opportunities offered by development partners with local offices or employment overseas. Program implementation and especially sustainability is constrained by thin capacity, and can be significantly affected whenever public servants or external consultants leave their positions. This risk is mitigated somewhat by: having a relatively strong engagement with government that has been maintained over a number of years and has thus become somewhat institutionalized; selecting a limited number of policy actions; ensuring an alignment between those policy actions and government priorities; having dedicated technical assistance from various development partners to support the implementation of the policy actions; and having regular missions to help maintain the momentum of the reform program. That said, some of the reforms supported in the current operation are more demanding of implementation capacity than those supported in the previous operation (outer island telecommunications versus the issuance of a second license, for instance) posing a particularly high risk to the operation.

82. **The political and governance risk is rated as substantial because the reform program supported by the DPO series includes areas that have tended to be politically sensitive.** These include the management of the RERF, the governance and reform of SOEs, and the management of fisheries joint ventures. To mitigate these risks, the dialogue accompanying the proposed operation has focused on reaching shared understandings, building common platforms, and taking a step-by-step approach to reforms. Still, there is a large degree to which these political risks cannot be mitigated, because the reforms pertain to Kiribati's key assets and major established interests – this makes the reforms potentially very important, but it means they are inherently risky.

83. **The macroeconomic risk is rated as substantial because Kiribati's economic and fiscal situation is inherently volatile and any economic or fiscal shock will inevitably detract from the policy focus on the reform program.** A major downturn in fisheries revenues, a major shock to global financial markets that affects the value of the RERF, or an extreme weather event that provides a large negative shock to the economy, would each intensify fiscal pressures and likely divert scarce administrative effort away from the reform program and towards addressing the shock. These are not the kind of risks that should be mitigated, because in any of those events, addressing the impact of the shock would likely be a higher priority than pursuing the broader reform program. To the extent that it is appropriate to maintain the reform momentum, the strong policy dialogue and technical and financial assistance provided by the group of development partners should serve as mitigating factors.

84. **A further risk to the operation is posed by Kiribati's high degree of vulnerability to natural disasters and the effects of climate change.** If Kiribati experiences a natural disaster over the medium term, its macroeconomic stability may be threatened and significant parts of the bureaucracy may have to shift their attention to disaster recovery efforts. This poses a risk to the operation through the adequacy of the macroeconomic framework, and also through the potential diversion of scarce reform effort away from the reforms in the policy matrix. This risk is mitigated somewhat by the selection of a limited number of high priority reforms, but in the event of a major natural disaster it may well be that the reforms in the policy matrix rightly considered lower priorities relative to disaster response and recovery efforts.

85. **As noted in Section 5.3, the fiduciary risk is rated as substantial.** The last Public Financial Management Performance Report identified a number of significant weaknesses. Considerable

reform work has been undertaken since, but a subsequent assessment is yet to be carried out, so the impact of these reforms has not been validated. As a risk mitigation measure, within 30 days of receipt of the IDA funds the Recipient will provide, by way of a letter, confirmation to the World Bank that the grant amount has been credited to an account used to finance budgeted expenditures. As an additional risk 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 be provided to the World 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.

ANNEX 1: POLICY AND RESULTS MATRIX

DPO3 Prior Actions	DPO4 Prior Actions	Results
Pillar I: Strengthening public financial management		
1. 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.	1. (i) The Recipient, through its Ministry of Finance and Economic Development, has completed a review of RERF custodial arrangements to ensure that the services of the provider remain competitive with current market practice and benchmarks; (ii) the Recipient's Cabinet has endorsed the recommendations of the review; and (iii) the Recipient has issued a request for proposal for custodial services	1. The return on the RERF portfolio is aligned with the relevant market benchmark. Baseline: a return 8.29 percent below the benchmark (year to March 31, 2014); Target: a return 0.25 percent below the benchmark or better (2018). 2. The RERF is managed according to prevailing market standards, with reduced costs. Baseline: Costs of 0.2 percent of market value (2015); Target: Costs of no more than 0.1 percent of market value (2018).
2. 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.	2. The Recipient has improved monitoring of contingent liabilities, through: (i) quantifying the Recipient's guarantees; (ii) accepting the financial statements of the five largest state-owned enterprises for the Recipient's financial year commencing January 1, 2016; and (iii) submitting the financial statement of the Kiribati Provident Fund for the Recipient's financial year commencing January 1, 2016 to the external auditor.	3. Public sector debt, including contingent liabilities, is monitored effectively through a comprehensive and up-to-date public sector debt database. Baseline: The debt database covers only central government external debt (Dec 31, 2015); Target: The debt database covers public sector external and domestic debt, including contingent liabilities, and all debt and debt-related transactions (including repayments and disbursements) are recorded within a three-month lag (Dec 31, 2018).
	3. The Recipient: (i) through its Cabinet, has approved the Kiribati Public Procurement Reform Plan; and (ii) has made the Kiribati Public Procurement Reform Plan publicly available.	4. Through the implementation of the KPPRP, the CPU has become operational, as indicated by the delegation of the relevant procurement powers to the CPO. Baseline: No CPU (Dec 31, 2016); Target: The CPO holds delegated procurement powers (Dec 31, 2018).

ANNEX 1: POLICY AND RESULTS MATRIX

DPO3 Prior Actions	DPO4 Prior Actions	Results
Pillar II: Improving the environment for inclusive growth		
3. (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.	4. The Recipient, through its Cabinet, has: (i) approved a fisheries joint ventures policy outlining the criteria for evaluating existing and new fisheries joint ventures; and (ii) has approved a plan to annually review the performance of fisheries joint ventures against this policy.	5. All fisheries joint ventures are reviewed annually based on the approved criteria and, for joint ventures that the review finds do not offer value-for-money to Kiribati, remedial actions are agreed. Baseline: Two-thirds of joint ventures were assessed as providing value-for-money to Kiribati (Dec 31, 2015); Target: All remaining joint ventures were assessed as providing value-for-money to Kiribati in the latest annual review, or had associated remedial actions agreed (Dec 31, 2018).
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.	5. The Recipient, through its Cabinet, has approved ownership and management plans for telecommunications assets in the outer islands, in order to facilitate the roll out of telecommunications services to outer islands that do not currently have access to them.	6. The telecommunications market in Tarawa is served by at least two mobile service operators competing on access and price. Baseline: The Tarawa market is served by one mobile service operator, with the mobile phone penetration rate at 12 percent (Dec 31, 2014) and the cost of a three-minute peak-hour mobile-to-mobile call in Tarawa at A$0.90 (Dec 31, 2013); Target: The Tarawa market is served by at least two mobile service operators, with the mobile phone penetration rate at least 50 percent and the cost of a three-minute peak-hour mobile-to-mobile call in Tarawa no more than A$0.75 (Dec 31, 2018). 7. There is increased penetration of mobile telephones in the outer islands. Baseline: 12 percent penetration rate (Aug 13, 2015); Target: 20 percent penetration rate (Dec 31, 2018).
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.	6. The Recipient, through its Cabinet, has approved: (i) a new electricity tariff that makes electricity more affordable for the poor while aligning the average tariff with cost recovery; and (ii) a reduced household electricity connection fee, to expand access to electricity.	8. The financial and operational performance of the Public Utilities Board and the quality of electricity services have improved, as measured by the billing collection rate, total power losses from the distribution network, and the frequency and duration of electricity outages. Baseline: Billing collection rate of 85 percent (2015), total power losses of 18 percent (2015), SAIFI of 7.9 interruptions (2016) and SAIDI of 946 minutes (2016);

ANNEX 1: POLICY AND RESULTS MATRIX

DPO3 Prior Actions	DPO4 Prior Actions	Results
		Target: Billing collection rate of at least 90 percent, total power losses of less than 15 percent, SAIFI of 6 interruptions and SAIDI of 880 minutes (2018). 9. The is an increase in the proportion of poor households in Tarawa benefiting from the new electricity tariff structure. Baseline: 0 percent of poor households (households consuming less than 100kWh) benefit from the new tariff (Dec 31, 2016); Target: 70 percent of poor households (households consuming less than 100kWh) benefit from the new tariff (Dec 31, 2018).

GOVERNMENT OF KIRIBATI
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File ref: 2/13 Date: 1 September 2017

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

Dear President Kim

Re: Letter of Development Policy

In Kiribati, we face important challenges to achieving a higher quality of life for our population. In recent years, through a combination of good management and favourable weather conditions, we have enjoyed record fishing license fee revenue, which has enabled this government to increase expenditure on education and health, and provide greater levels of assistance to the people living in the outer islands through the copra subsidy scheme. At the same time, there is a pressing need to generate more employment opportunities for the growing population, particularly in the areas of fisheries and tourism. Equally, there is a need to continue to strengthen fiscal resilience, to enable the country to cope with the range of shocks that Kiribati is vulnerable to, from volatility in fishing license fee revenue, to imported food and fuel price shocks, to natural disasters and the effects of climate change.

This government is committed to both expanding economic opportunities in Kiribati and building fiscal resilience. After coming to power in March 2016, this government launched the 2016-19 Kiribati Development Plan (KDP) identifying key development priorities in the medium term in the areas of human resource development, economic growth and poverty reduction, health, the environment, governance, and infrastructure. As well as investing additional resources in education, health and assistance to the outer islands in successive budgets, this government is firmly committed to a program of infrastructure development targeting the outer islands, to improve connectivity and economic opportunities for all under the auspices of the Kiribati Vision 20 (a 20 year development path for Kiribati). The government plans to fund the bulk of this infrastructure from the cash reserves that we have accumulated through the exercise of fiscal discipline in the face of high levels of fishing license fee revenue. We also look forward to the assistance of the World Bank, and other development partners, in support of our outer island infrastructure priorities.

This government places a high priority on maintaining prudent macroeconomic policy and strengthening public financial management. In particular, the government is committed to the good management of the RERF, an asset of vital importance to both current and future generations. Since taking office, this government has appointed two new asset managers through a transparent and competitive selection process, restructured the RERF portfolio to better align it with the RERF's long-term investment objectives, issued a request for proposal for custodial services, and made a $70 million replenishment of the RERF – the largest single transfer in more than a decade. The government has also been working to formulate clear objectives for the RERF, seeking both to achieve a target value of $1 billion by 2020, and to strike an appropriate balance between the benefits that current and future generations derive from the RERF. With technical assistance from the World Bank, we are now examining alternative strategies to achieving these twin objectives, which will inform a subsequent decision by government on the most appropriate strategy to adopt. Other priorities in our efforts to strengthen public financial management include improving the monitoring of contingent liabilities – particularly those arising from state-owned enterprises, which play an important role in service delivery in Kiribati, and undertaking a comprehensive reform of public procurement. This has commenced with the adoption of the Kiribati Public Procurement Reform Plan, which the government plans to move quickly to begin implementing with technical assistance from the Asian Development Bank.

This government also places a high priority on improving the environment for inclusive growth, including expanding employment opportunities and service delivery for the growing population. A key area of this agenda is maximizing the returns to Kiribati from its fisheries assets. Building on already critical steps to strengthen fisheries management and enhance the revenue Kiribati obtains from fisheries license fees, this government has focused on reviewing joint fisheries in the fisheries sector with a view to increasing the returns to Kiribati from these arrangements. We are also taking steps to develop the transshipment industry, which is a priority for government over the medium term.

Another key area of the government's agenda for inclusive growth is improving the delivery of key infrastructure services, to support business development and to improve the wellbeing of households, particularly the poor and vulnerable. To this end, this government has worked to facilitate the establishment of a second telecom service provider, to promote competition in the sector, and has adopted a plan for the rollout of improved telecom services in the outer islands, to improve the connectivity of these underserved populations. The government has also made important policy changes to the electricity tariff structure and to the level of household connection fees, to significantly improve access to electricity for the poor. These measures complement other programs, supported by government and development partners, focused on addressing the huge backlog that exists in basic infrastructure, particularly for transport.

This government welcomes the World Bank's continued engagement and assistance in support of the government's reform priorities. The previous three budget support operations have helped the government build a strong partnership with the World Bank and other development partners, and to develop a shared vision 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 reform agenda.

Yours sincerely

Hon. Dr Teuea Toatu
Minister for Finance and Economic Development

Kiribati—Assessment Letter for the World Bank
August 29, 2017

1. **Kiribati's growth has remained strong in recent years thanks to high fishing revenue and donor-financed infrastructure investment.** Record high fishing revenue in 2014–16, averaging nearly 80 percent of GDP (A$170 million) per year compared to the historical average of 25 percent of GDP, has boosted growth, improved the fiscal position and strengthened the current account. Real GDP growth is estimated to be around 4 percent in 2016, more than double the historical average, driven by construction and wholesale and retail trade. Growth is projected to decline somewhat to around 2¾ percent in 2017 as several large infrastructure projects come to completion, and moderate further to 2¼ percent over the medium term. The overall fiscal balance including grants remained in surplus in 2016, despite declining fishing revenue and recurrent expenditure pressures, but fiscal deficits are projected under current policies from 2017 onwards as a result of further fishing revenue declines. Inflation has remained contained, in line with trading partner inflation and international food and fuel prices.

2. **Risks to the near term economic outlook are largely related to external factors.** Besides fishing revenue and given its high reliance on imported goods, Kiribati is vulnerable to commodity price shocks and volatility in the Australian dollar. Global financial market turmoil can feed into the domestic economy through the exposure to foreign assets of the Revenue Equalization Reserve Fund (RERF) and the Kiribati Provident Fund (KPF), the country's two main savings vehicles. Climate change is also increasing uncertainty for fishing revenue over the medium term. Continued engagement and financial support from development partners remain essential to mitigate these downside risks.

3. **Prudent management of public resources remains the key policy challenge, especially against the projected decline in fishing revenue and the country's considerable spending needs.** The authorities have made remarkable progress in economic reforms including restructuring the RERF, strengthening its role as an intergenerational savings vehicle. To support the government's long run development agenda, budget decisions need to be taken in the context of a strengthened policy framework with prudent assessment of the country's spending goals, revenue projections and wealth management targets. This should entail achieving a balanced structural budget in the medium term, based on the assumed path of fishing revenue with a view to insulating spending from potential revenue volatility and complemented by an appropriately-sized cash reserve buffer to deal with external shocks. As Kiribati is one of the countries most affected by climate change, the budget should also include an explicit provision for climate change adaption, up to 2 percent of GDP annually to cover the recurrent cost. Over the long run, after the RERF balance achieves the government's wealth management target, a rule-based mechanism for RERF withdrawal could be adopted to support development spending, with the aim to preserving the RERF as an endowment fund that can provide the population with a permanent and stable stream of income, thus serving as an anchor for long run fiscal sustainability.

4. **Kiribati remains at high risk of debt distress.** Despite its large balance, the RERF serves as a vehicle for intergenerational saving and therefore is not viewed as a buffer against debt distress risks. Containing the risk of debt distress will require continued fiscal sustainability through further progress in structural and fiscal reforms, as well as securing grants to finance the country's large development needs. Government borrowing through concessional loans should be closely monitored to safeguard long run debt sustainability.

5. **Further strengthening macroeconomic management capacity and institutions is critical for the effective implementation of the government's development plan.** To this end, the authorities should push forward structural fiscal reforms to address the institutional weakness in tax administration and public financial management. To catalyzing donor support, the authorities could also consider technical assistance on improving the institutional framework for managing public investment, as well as access to donor financing for climate change adaptation and marine resource preservation.

6. **Achieving sustained and inclusive growth in Kiribati depends on creating better conditions for private sector growth, as there is limited scope in the public sector to absorb the strong population growth**. The authorities should maintain the momentum of state-owned enterprise (SOE) reforms to create an environment for private sector led growth, by further strengthening the commercial mandate of the SOEs and developing a medium-term reform plan for operationally and financially sustainable delivery of electricity, water and sanitation services. Continued divestment and outsourcing of SOE activities to the private sector will help improve efficiency and strengthen public finances.

7. **Further improvement in infrastructure, business climate and human capital remains critical for private sector development and employment.** This includes promoting air transportation and shipping services, streamlining business licensing process and improving land registration. 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 could also offer more employment possibilities.

8. **Financial deepening needs to be implemented in a more 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, including by developing a comprehensive banking regulation framework. The KPF's investment strategy should be more conservative and its crediting rates for member balances more closely linked to its investment returns to ensure its ability to meet its contractual obligations.

9. **The IMF's 2016 Article IV Consultation was concluded on September 9, 2016.** Kiribati continues to benefit from a comprehensive IMF technical assistance program in statistics, tax administration and policy, budget management and financial sector reform and supervision. The 2017 Article IV Consultation mission is scheduled for September.

Table 1. Kiribati: Selected Economic Indicators, 2014–19

Nominal GDP (2015): US$173.8 million — GDP per capita (2015): US$1,578
Nominal GNI (2015): US$453.1 million — Population (2015): 110,136
Main export products: fish and copra — Quota: SDR 5.6 million

	2014	2015	2016	2017	2018	2019
			Est.		Proj.	
Real GDP (percent change)	0.4	7.5	4.2	2.8	2.3	2.3
Real GNI (percent change)	12.4	15.9	-8.5	-8.7	0.7	1.6
Consumer prices (percent change, average)	2.1	0.6	1.9	2.2	2.5	2.5
Central government finance (percent of GDP)						
Revenue and grants	143.4	153.4	121.7	125.2	120.8	116.2
Total domestic revenue	89.9	111.7	87.5	65.9	61.5	60.0
Of which: Fishing revenue	72.3	93.1	68.1	43.6	42.4	41.5
Grants	53.6	41.7	34.2	59.3	59.3	56.2
Expenditure and net lending	118.8	114.6	117.9	128.8	127.7	127.5
Current	60.9	61.0	75.1	66.4	65.2	65.0
Of which: wages and salaries	27.2	24.7	24.4	26.4	25.6	24.9
Development	57.9	53.5	42.8	62.4	62.4	62.4
Current balance 1/	29.0	50.7	12.5	-0.5	-3.7	-5.0
Overall balance	24.6	38.9	3.9	-3.6	-6.8	-11.2
Financing	-24.6	-38.9	-3.9	3.6	6.8	11.2
Of which: Revenue Equalization and Reserve Fund (RERF)	4.2	-22.5	-49.8	-3.7	-0.5	2.1
RERF						
Closing balance (in millions of Australian dollars) 2/	679	756	894	929	957	978
Per capita value (in 2006 Australian dollars)	5,062	5,482	6,273	6,258	6,182	6,050
Balance of payments						
Current account including official transfers (in millions of US dollars)	44.8	59.0	26.8	-8.5	-11.6	-14.2
(In percent of GDP)	25.1	35.2	15.4	-4.6	-5.9	-6.9
External debt (in millions of US dollars)	14.3	35.7	44.2	51.0	56.8	69.2
(In percent of GDP)	8.8	22.1	25.8	27.2	28.9	33.6
External debt service (in millions of US dollars)	8.3	0.6	0.7	1.2	0.6	2.2
(In percent of exports of goods and services)	39.4	3.1	3.8	6.2	3.1	10.5
Exchange rate (A$/US$ period average)	1.1	1.3	1.3	...	...	...
Memorandum item:						
Nominal GDP (In millions of US dollars)	178.2	173.8	186.2	196.1	206.1	214.4

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.

ANNEX 4: ENVIRONMENT AND POVERTY/SOCIAL ANALYSIS TABLE

Prior actions	Significant positive or negative environment effects (yes/no/to be determined)	Significant poverty, social or distributional effects – positive or negative (yes/no/to be determined)
Pillar I: Strengthening public financial management		
1. (i) The Recipient, through its Ministry of Finance and Economic Development, has completed a review of RERF custodial arrangements to ensure that the services of the provider remain competitive with current market practice and benchmarks; (ii) the Recipient, through its Cabinet, has endorsed the recommendations of the review; and (iii) the Recipient has issued a request for proposal for custodial services.	No	Yes – positive
2. The Recipient has improved monitoring of contingent liabilities, through: (i) quantifying the Recipient's guarantees; (ii) accepting the financial statements of the five largest state-owned enterprises for the Recipient's financial year commencing January 1, 2016; and (iii) submitting the financial statement of the Kiribati Provident Fund for the Recipient's financial year commencing January 1, 2016 to the external auditor.	No	No
3. The Recipient: (i) through its Cabinet, has approved the Kiribati Public Procurement Reform Plan; and (ii) has made the Kiribati Public Procurement Reform Plan publicly available.	No	No
Pillar II: Improving the environment for inclusive growth		
4. The Recipient, through its Cabinet, has: (i) approved a fisheries joint ventures policy outlining the criteria for evaluating existing and new fisheries joint ventures; and (ii) approved a plan to annually review the performance of fisheries joint ventures against this policy.	No	Yes – positive
5. The Recipient, through its Cabinet, has approved ownership and management plans for telecommunications assets in the outer islands, in order to facilitate the roll out of telecommunications services to outer islands that do not currently have access to them.	Yes – potentially negative, risk to be mitigated	Yes – positive
6. The Recipient, through its Cabinet, has approved: (i) a new electricity tariff that makes electricity more affordable for the poor while aligning the average tariff with cost recovery; and (ii) a reduced household electricity connection fee, to expand access to electricity.	No	Yes – positive