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Operation Name	Kiribati Fourth Economic Reform Development Policy Operation
Region	East Asia and Pacific
Country	Kiribati
Operation ID	P161794
Lending Instrument	Development Policy Operation
Borrower	Republic of Kiribati
Implementing Agency	Ministry of Finance and Economic Development
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Concept Review Decision	Following the corporate review, the decision was taken to proceed with the preparation of the operation.

I. Country and Sector Background

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 3.5 million square kilometers of ocean (an area larger than India). The population of about 114,000 people lives on 20 of the coral atolls and a 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 each of Australia, New Zealand and Hawai'i. 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. According to a recent survey of experts, if the sea level continues to rise at its current rate, Kiribati is expected to disappear by 2100.

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 and transport 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 (formal sector employment accounts for only 20 percent of the labor force, however). 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 industry. Open unemployment is estimated to exceed 30 percent, and youth unemployment, 50 percent.

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 and transport 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.

II. Operation Objectives

The program development objective is to: (i) strengthen public financial management; and (ii) improve the environment for inclusive growth. With the support of the Government of Kiribati (GoK), the World Bank's development policy engagement is taking place jointly with other major development partners. The Asian Development Bank, Australian Department of Foreign Affairs and Trade and New Zealand Ministry of Foreign Affairs and Trade are each providing budget support against a joint policy matrix agreed between the GoK and this group of development partners.

The two pillars of the operation correspond with the two components of the program development objective. 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.

The two pillars of the proposed operation are aligned with key priority areas of the Kiribati Development Plan 2016–19 (KDP). KDP's overarching vision is, "Towards a better educated, healthier, more prosperous nation with a higher quality of life," and its priority areas include economic growth and poverty reduction, governance, and infrastructure. The first pillar of the proposed operation, on strengthening public financial management, is closely aligned with the KDP priority areas of economic growth and poverty reduction, and governance – in particular, the strategies on enhancing management of the sovereign wealth fund, the Revenue Equalization Reserve Fund (RERF), ensuring effective public financial management and debt management, timely audits of government ministries and SOEs, and greater transparency and accountability in public service delivery. The second pillar, on improving the environment for inclusive growth, is closely aligned with the KDP priority areas of economic growth and poverty reduction, and infrastructure – in particular, the strategies on providing for the sustainable development of the fishing industry and maximizing economic returns from marine resources, placing SOEs on a more commercial footing, improving telecommunications connectivity for the outer islands, reforming the Public Utilities Board (PUB) to achieve operationally and financially sustainable electricity, water and sanitation services, and ensuring that that the most vulnerable groups in the population are cared for.

Under the first pillar of the proposed operation, the policy actions focus on: (i) strengthening management of the RERF through the competitive tendering of custodial services; (ii) improving the monitoring of contingent liabilities, including those arising from SOEs; and (iii) approving a reform plan for public procurement. 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 specific results indicators targeted under this pillar are: (i) the performance of the RERF portfolio is aligned with the relevant market benchmark and the RERF is managed according to prevailing market standards with substantially reduced costs; (ii) public debt management is based on a comprehensive and up-to-date public sector debt database for effective monitoring of the debt, including contingent liabilities; and (iii) the new Central Procurement Unit is operational.

Under the second pillar of the proposed operation, the policy actions focus on (i) strengthening Cabinet oversight of fisheries joint ventures; (ii) facilitating the roll out of telecommunications services to the outer islands; and (iii) reforming the electricity tariff to make electricity more affordable to the poor. 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). The specific results indicators targeted under this pillar are: (i) all fisheries joint ventures are annually reviewed based on the approved criteria; (ii) the telecommunications market in Tarawa is served by at least two mobile service operators competing on access and price, and there is increased penetration of mobile telephones in the outer islands; and (iii) the operational efficiency of PUB has improved, as measured by the billing collection rate, total power losses from the distribution network, and the frequency and duration of outages, and an increased proportion of poor households in Tarawa are benefiting from the new electricity tariff structure.

III. Rationale for Bank Involvement

Despite major capacity constraints, Kiribati has made solid progress on key macro-fiscal reforms in recent years. The three most critical reform areas have been the management of the RERF, the management of fisheries revenues, and the management of public debt. With respect to the RERF, Kiribati has reviewed the historical management of this asset and reallocated it to two new asset managers on the basis of a competitive tender, resulting in significant improvements in portfolio performance relative to the relevant market benchmark. This is vital to Kiribati, because the RERF serves as the main mechanism to save wealth for future generations and provide a buffer against current shocks. With respect to fisheries revenues, Kiribati has introduced a national fisheries policy that includes a commitment to comply with regional fisheries agreements, which has contributed to the very substantial increase in fisheries license fee revenues Kiribati has seen in recent years – revenues that are critical to public service delivery because they provide about half of total public revenues and grants. With respect to the management of public debt, Kiribati has introduced a new debt policy and has been adhering to its provisions by avoiding all non-concessional borrowing. Kiribati has also made progress with key structural reforms, particularly through introducing a new legislative framework to strengthen the corporate governance of state-owned enterprises (SOEs) – an important reform because ad hoc subsidies to SOEs previously represented a substantial drain on public finances. The proposed operation supports further reform measures in each of these areas.

Kiribati's recent economic and fiscal performance has been strong. The GoK is committed to the maintenance of sound macroeconomic and poverty reduction policies. After an earlier period of volatility, Kiribati had its sixth consecutive year of economic growth in 2016. The fiscal position has also improved markedly in recent years, due primarily to high fishing license fee revenue. There is no recent data on poverty, however, which prevents analysis of poverty and inequality dynamics. The World Bank, in conjunction with the Secretariat for the Pacific Community, is supporting the government to undertake a Household Income and Expenditure Survey in 2017.

IV. Tentative financing

Source:		($m.)
Borrower/Recipient		–
IDA		5
	Total	5

V. Institutional and Implementation Arrangements

Kiribati's Economic Reform Taskforce (ERT), for which the Ministry of Finance and Economic Development is the Secretariat, 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 existing 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 Implementation Completion and Results (ICR) report is undertaken. In addition, the Bank's approach to development policy operations in Kiribati (which is essentially to undertake annual operations, 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.

VI. Risks and Risk Mitigation

The overall risk rating for the proposed operation is substantial. On balance, the risks are offset by the expected benefits of the proposed operation.

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.

The political and governance risk is rated as substantial because the reform program supported by the 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.

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.

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.

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 Borrower 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.

VII. Poverty and Social Impacts and Environment Aspects

Poverty and Social Impacts

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.

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.

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.

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.

Environment Aspects

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.

The reforms in the telecommunications sector supported by the proposed operation are likely to have direct effects on the environment, because the OIN Policy outlines a strategy for rolling out telecommunications services to the outer islands that will necessarily involve infrastructure development. For the first phase of the roll out of telecommunications services, covering four outer islands, the infrastructure development consequent to the approval of the OIN Policy 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 Code.

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 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.

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