



Report and Recommendation of the President to the Board of Directors

Project Number: 48479-001
April 2016

Proposed Policy-Based Grant Solomon Islands: Economic Growth and Fiscal Reform Program

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Asian Development Bank

CURRENCY EQUIVALENTS

(as of 7 April 2016)

Currency unit – Solomon Islands dollar (SI\$)

SI\$1.00 = \$0.1266
\$1.00 = SI\$7.8989

ABBREVIATIONS

ADB	–	Asian Development Bank
CEWG	–	core economic working group
CPS	–	country partnership strategy
GDP	–	gross domestic product
JRM	–	joint review mission
MOFT	–	Ministry of Finance and Treasury
NDS	–	national development strategy
PEFA	–	public expenditure and financial accountability
PFM	–	public financial management
SOE	–	state-owned enterprise

NOTE

In this report, “\$” refers to US dollars.

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PROGRAM AT A GLANCE

1. Basic Data		Project Number: 48479-001	
Project Name	Economic Growth and Fiscal Reform Program (formerly Economic and Financial Reform Program)	Department /Division	PARD/PLCO
Country Borrower	Solomon Islands Government of Solomon Islands	Executing Agency	Ministry of Finance and Treasury
2. Sector	Subsector(s)	ADB Financing (\$ million)	
✓ Public sector management	Economic affairs management		2.50
	Public expenditure and fiscal management		2.50
		Total	5.00
3. Strategic Agenda	Subcomponents	Climate Change Information	
Inclusive economic growth (IEG)	Pillar 1: Economic opportunities, including jobs, created and expanded	Climate Change impact on the Project	Low
4. Drivers of Change	Components	Gender Equity and Mainstreaming	
Governance and capacity development (GCD)	Public financial governance	Some gender elements (SGE)	✓
Partnerships (PAR)	Bilateral institutions (not client government) Implementation Official cofinancing		
Private sector development (PSD)	Conducive policy and institutional environment		
5. Poverty Targeting		Location Impact	
Project directly targets poverty	No	Nation-wide	High
6. Risk Categorization:	Low		
7. Safeguard Categorization	No Safeguards Categorization available.		
8. Financing			
Modality and Sources		Amount (\$ million)	
ADB		5.00	
Sovereign Program grant: Asian Development Fund		5.00	
Cofinancing		0.00	
None		0.00	
Counterpart		0.00	
None		0.00	
Total		5.00	
9. Effective Development Cooperation			
Use of country procurement systems		Yes	
Use of country public financial management systems		Yes	

I. THE PROPOSAL

1. I submit for your approval the following report and recommendation on a proposed policy-based grant to Solomon Islands for the Economic Growth and Fiscal Reform Program.¹

2. The proposed program is a single-tranche policy-based grant of \$5 million. The program continues efforts of the Asian Development Bank (ADB) to support the Government of Solomon Islands in implementing an ongoing reform program in coordination with other development partners. The proposed program will support continued policy attention to reform, which has become increasingly essential following recent natural disasters, the closure of a large gold mine (an important source of government revenue), and the decline of logging output over the medium term.

II. THE PROGRAM

A. Rationale

3. Solomon Islands is one of the largest countries in Melanesia, with a land area of about 28,000 square kilometers, comprising six large islands, dozens of smaller islands, and hundreds of islets and atolls. About 85% of the population of 600,000 is rural, living in widely dispersed villages comprising a few hundred persons each. The economy is based on primary commodities from agriculture, forestry, and fishing; alternative income-generating opportunities are scarce, especially in rural areas. The nation has been steadily recovering from the 1999–2003 civil conflict. While the security situation is now stable, recent events—such as the May 2014 riots and looting in the capital, Honiara, and other parts of Guadalcanal—have demonstrated the stability’s fragile nature.

4. Creating an environment in Solomon Islands that fosters sustainable economic growth remains a challenge. The country continues to exhibit characteristics of a fragile state. State structures lack the capacity to provide many of the basic functions for poverty reduction, the legitimacy of the government has at times been weak, and public service delivery and economic management needs strengthening. Remoteness is a particular challenge. Most people live far from major markets, internal dispersion is high, transport infrastructure is weak (although steadily improving), transport costs are high, and transport services irregular. Creating an enabling environment for private sector-led growth, as well as enabling alternative drivers of economic growth, are critical for expanding the current narrow economic base. ADB assistance in transport infrastructure and related capacity building is essential in revitalizing the economy and providing access to basic services. Support for selected projects in the energy sector, complementing the efforts of other development partners, is also essential to sustainable economic growth.

5. Solomon Islands was adversely affected by major natural disasters in 2014 and 2015. The April 2014 floods caused per capita gross domestic product (GDP) to fall by 2.4%. Gold production ceased, and damage to businesses, houses, and public infrastructure was widespread. Private enterprises and public services were heavily affected. Damage was centered in and around Honiara, where dozens of people were killed, more than 10,000 were displaced, and 52,000 were otherwise affected. The government estimated flooding damage and losses at \$108 million, or 9% of GDP. In March 2015, Cyclone Pam hit Solomon Islands, heavily damaging the easternmost province, Temotu.

¹ The design and monitoring framework is in Appendix 1.

6. Gold output fell by more than 70% in 2014 because flooding halted production at the country's only mine, where operations are likely to remain suspended for some time. Flooding also damaged transport links and disrupted log exports. Logging output has essentially been flat since 2012, with production sustained by secondary harvests in previously logged areas. Logging output is expected to begin to decline over the next few years as forest area dwindles.

7. In November 2015, the government made a small downward revision in its forecast GDP growth rate for fiscal year 2015 from 3.50% to 3.25% (ADB's projected growth rate for 2015 is 3.22%). The revised growth rate is due to weaker than expected output in the formal fishing and agriculture sectors, and slightly weaker than expected activity in the retail and wholesale trade sector. Weak global economic activity has contributed to lower commodity prices, resulting in lower copra and cocoa production.

8. Macroeconomic policy is expected to remain expansionary through to 2017. After coming to power late in 2014, the government used its first budget to signal a shift toward expansionary fiscal policy after years of budget surpluses. Despite its late approval, the 2015 budget resulted in a deficit estimated to equal 2.2% of GDP, financed by drawing down on government cash reserves. In 2016, the government is targeting a fiscal deficit equal to 5.8% of GDP. Similar to 2015, weak execution means the actual deficit is likely to be smaller, estimated by ADB at 3.6% of GDP. Selected economic indicators are in Table 1.

Table 1: Economic Indicators, 2014–2017

Item	2014	2015 (e)	2016 (p)	2017 (p)
GDP growth (% constant prices)	2.0	3.2	3.0	2.8
Inflation (annual % change)	5.2	(0.3)	4.4	5.7
Overall budget surplus (deficit) (% of GDP)	2.0	(2.2)	(3.6)	(3.9)
External debt (% of GDP)	10.4	9.8	8.4	9.4
Nominal GDP (\$ million, current prices)	1,038.6	1,016.2	1,066.4	1,141.0

... = data not available, () = negative, (e) = estimate, GDP = gross domestic product, (p) = projection.

Sources: *Asian Development Outlook* database, Central Bank of Solomon Islands; International Monetary Fund Article IV Consultation Staff Reports (various years), and Solomon Islands National Statistics Office.

9. In March 2009, the government established a core economic working group (CEWG) to provide a forum to discuss economic and financial reform priorities, monitor their implementation, coordinate government and development partner support around these priorities, and undertake program monitoring to evaluate reform and assess impact.² Since the establishment of the CEWG, development partners have provided technical and financial support that has contributed effectively to steady reform progress, particularly in strengthening budget preparation and planning systems, improving the quality of financial management systems, and improving the environment for private sector investment.

10. The program is included in ADB's country operations business plan and country partnership strategy (CPS) for Solomon Islands.³ The Solomon Islands CPS focuses assistance on creating a more diversified and productive economy. In line with this strategy, ADB supports the government's national development strategy (NDS) for 2011–2020 through assistance in four sectors: energy, information and communication technology, public sector management,

² The CEWG comprises officials from the Central Bank of Solomon Islands, the Ministry of Development Planning and Aid Coordination, the Ministry of Finance and Treasury, the Office of the Prime Minister, and development partner representatives from ADB, Australia, the European Union, New Zealand, the Regional Assistance Mission to Solomon Islands, and the World Bank.

³ ADB. 2015. *Country Operations Business Plan: Solomon Islands, 2016–2018*. Manila; and ADB. 2012. *Country Partnership Strategy: Solomon Islands, 2012–2016*. Manila.

and transport.⁴ ADB assistance in public sector management aims to promote an environment that enables growth and development that is inclusive and led by the private sector. The CPS calls for ADB support via the CEWG mechanism, in coordination with development partners, for government-led public sector management reforms through policy-based program grants every other year. This program follows earlier ADB programs approved in 2010, 2011, and 2013.⁵

11. ADB's 2013 program focused on (i) better public finance management, (ii) greater economic efficiency for a business enabling environment, and (iii) broader access to social services. The program was rated *successful* overall.⁶ Together with contributions from other development partners, the program grant of \$5 million helped close the \$9 million recurrent financing gap in the 2013 budget. The final budget outcome reported a fiscal surplus of SI\$181.6 million (\$22.99 million), against a revised deficit of SI\$259.2 million (\$32.81 million).⁷

12. General elections were held in Solomon Islands on 19 November 2014. Subsequently, the Democratic Coalition for Change government was formed. Progress on moving forward a program of economic and financial reform initially slowed because of the elections and change of government. This program is being used as a basis to reengage with the new government as its policy agenda continues to evolve. The first CEWG meeting, following the formation of the new government, was held on 17 March 2015. In September 2015, technical working group meetings resumed, and a CEWG meeting was held on 30 September 2015.

13. Including the proposed budget support from ADB, the government is anticipating SI\$709.1 million in budget support in 2016, primarily comprising sector budget support from the governments of Australia and New Zealand. The European Union is the other main provider of sector budget support. For 2014–2020, under the 11th European Development Fund, it will focus on the water and sanitation sector and on rural development. The World Bank's most recent budget support program was processed in 2014 and is equivalent to \$5 million.⁸

14. ADB proposes a stand-alone, policy-based operation that will require all policy actions to be accomplished in advance of grant effectiveness. Post program policy actions are identified for ongoing monitoring subsequent to grant effectiveness. The program supports implementation of policies agreed with the government. Policy dialogue with the government on the program includes (i) discussions on the design and implementation of the program policy matrix, (ii) CEWG meetings, and (iii) joint review missions (JRMs) with government and development partner representatives assessing program performance and identifying lessons from program implementation.⁹ Earlier budget support programs by ADB—and other development partners—focused primarily on monetary and fiscal stability and strengthening the institutional framework for public expenditure and financial management. This program builds on those earlier reforms, but broadens the policy actions to address the key challenges of ensuring

⁴ Government of Solomon Islands, Ministry of Development Planning and Aid Coordination. 2011. *National Development Strategy 2011 to 2020*. Honiara.

⁵ ADB. 2010. *Report and Recommendation of the President to the Board of Directors: Proposed Program Cluster and Grant to Solomon Islands for Subprogram 1 of the Economic Recovery Support Program*. Manila; ADB. 2011. *Report and Recommendation of the President to the Board of Directors: Proposed Grant to Solomon Islands for Subprogram 2 of the Economic Recovery Support Program*. Manila; and ADB. 2013. *Report and Recommendation of the President to the Board of Directors: Proposed Policy-Based Grant to Solomon Islands for the Economic and Financial Reform Program*. Manila.

⁶ ADB. 2015. *Completion Report: Economic and Financial Reform Program in Solomon Islands*. Manila.

⁷ Government of Solomon Islands, Ministry of Finance and Treasury. 2014. *2013 Final Budget Outcome*. Honiara.

⁸ Development Coordination (accessible from the list of linked documents in Appendix 2).

⁹ CEWG Joint Review Mission. 2013. *Report of the Fourth Annual Joint Review Mission*. Honiara; and CEWG Joint Review Mission. 2014. *Report of the Fifth Annual Joint Review Mission*. Honiara.

that improved financial management systems translate into improved public service delivery, creating an enabling environment for private sector-led growth, as well as enabling alternative drivers of economic growth.

15. The program incorporates lessons from ADB's policy-based operations in Solomon Islands and the Pacific: (i) limiting reform to a few major actions; (ii) using a single tranche within a programmatic, multiyear approach supported by several partners; (iii) combining technical assistance with policy-based operations to undertake complex, politically sensitive reforms; and (iv) adopting a medium-term perspective, recognizing that thorough institutional and structural change requires time to implement.¹⁰ ADB's program in Solomon Islands combines policy reform support with investment financing to support inclusive, environmentally sustainable economic growth. This program complements operations under implementation, or being processed, in education, energy, and transport.

B. Impacts and Outcome

16. The impacts will be (i) to provide an enabling environment to stimulate economic growth, especially in rural areas, and (ii) to pursue public sector reforms and commit resources to enable private sector-led growth.¹¹ The outcome will be a strengthened economic and fiscal position to deliver improved opportunities and living standards.

C. Outputs

17. The outcome will be achieved through three outputs: (i) improving public service delivery and economic management, (ii) creating an enabling environment for private sector-led growth, and (iii) enabling the drivers of economic growth (paras. 19–31). The policy matrix, with policy actions all completed, is in Appendix 4.¹²

18. The policy reform actions in outputs 1 and 2 build on progress achieved since CEWG establishment in 2009. Reform actions in output 3 follow from the recommendations of the 2014 JRM and reflect the CEWG's refocus on the drivers of economic growth. More broadly, these three outputs support the wider objectives articulated in the government's policy documents (footnote 11) and the NDS (footnote 4).

1. Output 1: Improving Public Service Delivery and Economic Management

19. Public sector expenditure amounts to about half the formal economic activity in Solomon Islands. Improving public spending quality has been a primary focus of the CEWG since its inception, and a feature of prior budget support programs. Improving public service effectiveness and efficiency will likely have a positive impact on Solomon Islanders' economic inclusion and well-being. In response to downward pressure on revenue mobilization from decreasing mining and logging activity and to spending needs for post-disaster reconstruction, the program will support new customs and excise legislation, and improvements in public

¹⁰ ADB, Australian Department of Foreign Affairs and Trade, New Zealand Ministry of Foreign Affairs and Trade, Pacific Financial Technical Assistance Centre, and the World Bank. Good Practice Principles for Multi-Donor Budget Support. Unpublished.

¹¹ Government of Solomon Islands, Office of the Prime Minister and Cabinet. 2015. *Democratic Coalition for Change Government: Policy Statement*. Honiara; and Government of Solomon Islands, Office of the Prime Minister and Cabinet. 2015. *Democratic Coalition for Change Government: Policy Strategy and Translation*. Honiara.

¹² The program's policy actions were selected based on the (i) impact of the proposed reforms; (ii) linkage with ADB's Solomon Islands operations; and (iii) alignment with ADB's previous Solomon Islands programs.

financial management (PFM), through implementation of the PFM road map. Along with a revised NDS that prioritizes public spending for 2016–2036, this is expected to make the fiscal framework more sustainable.

20. **Strengthening customs administration and revenue collection.** Customs and excise comprise about one-third of total government revenue. A comprehensive review of the customs regulatory regime undertaken in 2012 concluded that the Customs and Excise Act, 1960 was unsuited to modern international trade. The review identified a number of improvements, including duty and excise assessment and collection, advanced reporting of arrivals, customs powers, and customs decisions. A draft Customs and Excise Bill to address these and other issues is in its final version. Under the program, Cabinet approved the draft legislation for sending to the Attorney General’s Chambers for review, with the legislation now moving through the review and approval stages, prior to consideration by Parliament.

21. **Supporting improvements in public financial management.** An assessment of public expenditure and financial accountability (PEFA) in Solomon Islands in 2012 showed that most areas of PFM had improved since the first assessment in 2008.¹³ The Public Financial Management Act, 2013 and the PEFA assessments have provided the government with a platform and the authority to introduce incremental reforms to build a credible and robust PFM system. Under the program, Cabinet approved the PFM road map, with implementation of selected actions now underway. The priorities in the roadmap focus on (i) implementation of the Public Financial Management Act; (ii) development of PFM systems; (iii) compliance with controls on budget, expenditure, and debt; and (iv) strengthening revenue collection.¹⁴

22. **Strengthening national development planning.** The new government has begun a revision of the existing NDS to cover 2016–2036 to provide a longer-term framework that will allow greater stability and continuity in planning. The proposed NDS establishes a vision and broad strategic framework centered around five long-term objectives, with specific targets for years 10, 15, and 20. The revision will also enable the government to incorporate a linkage to the Sustainable Development Goals, and strengthen performance targets and monitoring indicators. Under the program, Cabinet approved the new framework for the NDS, and is working toward final approval of the new NDS later in 2016.

2. Output 2: Creating an Enabling Environment for Private Sector-Led Growth

23. The government has introduced a number of important structural reforms to improve the enabling environment for private sector-led growth. These include reforms that have made it easier to start a business, improve the performance of state-owned enterprises (SOEs), and increase the access to and affordability of telecommunications services. However, much more needs to be done to improve the quality of the country’s investment climate. Regulatory inefficiencies can be a major constraint to economic growth and development. Reforms that increase the security of land tenure, improve access to finance, and strengthen the business environment could significantly enhance inclusive economic growth. The program addresses this by (i) improving the governance of alienated land through a new land board; (ii) initiating

¹³ ECORYS Nederland BV. 2008. *Solomon Islands: Public Financial Management—Performance Report (Final Report)*. Rotterdam; and European Commission. 2012. *Public Expenditure and Financial Accountability (PEFA) Assessment: Final Report*. Brussels.

¹⁴ ADB support for implementation of the road map under ADB. 2014. *Technical Assistance to Solomon Islands for Strengthening the Implementation of the National Development Strategy*. Manila, will focus on strengthening the preparation of the development budget and supporting multiyear budget projections, including the preparation of a medium-term fiscal framework.

reforms to strengthen the competition policy, credit unions, and the capital structure of SOEs; and (iii) introducing legislation to facilitate new business registration.

24. Improving the governance of alienated land. The main objective of the Lands and Titles (Amendment) Act, 2014 was to increase transparency and openness in the land allocation process and to provide and improve an administrative system to strengthen customer service and set the platforms for a justifiable and equitable land allocation system. To achieve this, the act established a land board composed of 13 members who will take on the powers (previously undertaken by the Commissioner of Lands) to deal with interests in land and deliberate on applications for land allocation and related issues. This allows staff in the Ministry of Lands, Housing and Survey to focus on administrative matters. The transfer of responsibilities to a land board is also expected to provide greater certainty to the private sector. Under the program, the land board was established, and transparency of land transactions is being improved.

25. Strengthening of credit unions policy. Credit unions play an important role in the financial services sector in Solomon Islands.¹⁵ The legislation—the Credit Unions Act, 1986—its regulations, and the standard credit union bylaws are outdated and no longer encompass best practice for the regulation and supervision of credit unions. Certain legislative provisions limit the growth of credit unions and do not provide sufficiently for the protection of member deposits. A credit unions policy taskforce was established to finalize a credit unions policy seeking to address these issues. The program supported the approval by Cabinet of this policy, and will now support the drafting of a new Credit Union Bill and regulations, which will provide the legal underpinning for the central bank to register, license, regulate, and supervise credit unions. An updated regulatory framework would help put the industry on a sound footing from where it can grow sustainably. A growing credit union industry would contribute to the government’s agenda of increasing access to financial services and promoting financial sector development.

26. Developing competition policy. The country lacks a formal competition policy or generally applicable competition law. Competition policy has an important role to play in private sector growth in Solomon Islands. Legislation in place enables the government to set price controls, protect industries, and restrict foreign investment into the country—all of which are inconsistent with competition and might impose significant costs. Careful scrutiny is required to determine whether such measures are economically and socially justified and provide effective solutions to the problems they are intended to address. Under the program, Cabinet approved the initial competition policy work, and the program will now support the government to move ahead with a competition policy that will examine (i) pro-competitive regulation of public utilities, (ii) possible new laws against anticompetitive conduct in business, (iii) possible updates to existing consumer protection laws, (iv) effective enforcement of consumer protection laws, and (v) the promotion of competitive neutrality and a “level playing field” for public and private sector enterprises in Solomon Islands.

27. Improving the capital structure of state-owned enterprises. The Solomon Islands SOE portfolio has undergone a dramatic turnaround since 2008 and is now the most profitable portfolio in the Pacific in the benchmarking sample in ADB’s assessment. The average return on equity of the portfolio increased from –12% in 2002–2008 to 6% for 2009–2012 and 15% in 2012.¹⁶ Cabinet endorsement was given to the development of an SOE capital structure policy

¹⁵ Credit unions are financial cooperative organizations, owned and controlled by their members. Their central purpose is to provide savings, credit, and other financial services to their members. As of December 2013, the 10 credit unions in Solomon Islands had a total membership of about 5,700 and total assets of SI\$50.6 million.

¹⁶ ADB. 2014. *Finding Balance 2014: Benchmarking the Performance of State-Owned Enterprises in Island Countries*. Manila (latest data available).

under the program that intends to improve the performance, governance, and oversight of SOEs by minimizing costs and promoting good investment and/or financing decisions. The policy, now under preparation, will include (i) a clear mechanism for the provision of additional equity by the government and, conversely, the return of equity to the government by SOEs; (ii) the minimum required return on the shareholder equity or assets and dividend distribution arrangements; (iii) guidance on the level and mix of capital used to fund the projected capital expenditure requirements of SOEs; and (iv) flexibility for SOEs to be able to find appropriated value-adding investment opportunities and flexibility for SOE capital requirements to be considered in the context of broader government budgetary and policy requirements.

28. Improving business formalization. The Government of Solomon Islands has undertaken extensive business law reform activity, including the passing of the Companies Act, 2010, and the launch of an online company registry, Company Haus. Building on earlier programs, this program continued to support business law reform activity in relation to business names, including enacting legislation and now preparation of associated regulations. Company Haus will also upgrade its paper-based business names registry to an electronic registry. The ability to register a business name provides opportunities for sole traders, partnerships, and companies to operate a business under a name other than their actual name. This has a range of benefits, including an encouraging environment for businesses to enter the formal economy, improved fraud detection, protection of a business's goodwill, and greater tax compliance.

3. Output 3: Enabling the Drivers of Economic Growth

29. Although Solomon Islands' geographical isolation limits medium-term growth prospects, opportunities exist for increasing the revenue base. As logging activity starts to taper when stocks are exhausted, the development and management of alternative natural resources has become a strategic government priority. Mining, fisheries, and tourism offer potential opportunities, but significant institutional reforms and technical assistance are needed to strengthen the sectors' regulation and management.¹⁷ The program contributes to these critical reforms by strengthening fisheries' governance and management through new legislation and by developing a new tourism strategy to attract overseas visits, including from cruise ships. This will help to harness the growth potential in these sectors.

30. Strengthening fisheries management. Solomon Islands has a significant tuna resource, which could deliver significantly greater economic benefits to the country if it were more effectively utilized. Under the program, new fisheries legislation was enacted, with implementation of the legislation now being supported, including the development of accompanying regulations. The new act makes a provision for the conservation, management, development, and sustainable use of fisheries and marine resources in Solomon Islands, as well as strengthening the monitoring and control of fishing vessels. The act provides for the establishment of a Fisheries Licensing Committee, Fisheries Appeals Committee, and Fisheries Advisory Council; as well as the establishment of fisheries management plans at national, provincial, and community levels. The act will mean that Solomon Islands fisheries resources will be used more sustainably, balancing economic growth with sound ecological principles.

31. Developing tourism potential. Solomon Islands' tourism is widely viewed as having significant potential, but remains largely untapped. In 2014, about 6,000 tourists visited the country, compared with 110,000 in Vanuatu that year. Few visitors venture outside of Honiara

¹⁷ ADB. 2016. *Continuing Reforms to Stimulate Private Sector Investment: A Private Sector Assessment for Solomon Islands*. Manila.

and Guadalcanal. The Solomon Islands National Tourism Development Strategy, 2015–2019, now approved under program, is designed to identify and address sector-related impediments to facilitate faster economic growth and increased benefits from tourism, including in rural areas. The focus of the strategy is on small-scale tourism, based on niche markets. Cruise ships also provide a key development opportunity for the sector; the Solomon Islands receives a small but growing number of visitors from this market and the strategy highlights key constraints and recommended actions to increase the level of tourists. With support from development partners, implementation on the strategy is now underway.

D. Development Financing Needs

32. The government has requested a grant not exceeding \$5 million from ADB's Special Funds resources to help finance the program.¹⁸ The proposed grant size is within the established country allocation and was determined after considering (i) the relative importance of economic and financial reform to promote sustained economic growth, (ii) the country's development financing needs, (iii) the availability of financing from other development partners, (iv) the significance and complexity of the program's policy actions, and (v) the conformity of the program with ADB's CPS for Solomon Islands. Program grant proceeds will help finance the projected fiscal deficit for 2016 of SI\$568.5 million (\$71.97 million), and support key investment projects identified in the 2016 budget, as outlined in the development policy letter (Appendix 3).

E. Implementation Arrangements

33. The program period is from 1 March 2015 to 31 March 2017. Program funding will be provided as a single-tranche grant of \$5 million and will be withdrawn when the government meets the conditions for effectiveness, including completing the agreed prior policy actions as set forth in the policy matrix. Grant proceeds will be disbursed using ADB's simplified disbursement procedures and related requirements for program loans.¹⁹ The government and ADB will continuously review program implementation using the design and monitoring framework and the policy matrix. Proceeds will be used to finance items produced and procured in ADB member countries, excluding items in the list of ineligible items and imports financed by other bilateral and multilateral sources.²⁰

34. The Ministry of Finance and Treasury (MOFT) will be the executing and implementing agency and will be responsible for overall implementation, including implementing all policy actions, administering the program, disbursing funds, and maintaining all program records. MOFT will monitor and report to ADB on the implementation of policy actions and their impact on budget outcomes in line with the design and monitoring framework. Monitoring outcomes and impacts will maximize the use of the government's own processes and the CEWG mechanism.

35. In cooperation with the government and CEWG development partners, ADB will continue to carry out periodic JRMs. The reviews will evaluate the implementation of the policy reform and assess impact, describe lessons identified during the program period, and outline policy actions and any assistance needed to accomplish the agreed reform targets. The government will continue to keep ADB informed of the outcome of policy discussions with other multilateral

¹⁸ A country's eligibility for Asian Development Fund grants under the revised grant framework is determined by its risk of debt distress. The latest debt sustainability analysis determined that Solomon Islands had a moderate risk of debt distress and was therefore eligible to receive 50% of its Asian Development Fund allocation as grants.

¹⁹ ADB. 1998. *Simplification of Disbursement Procedures and Related Requirements for Program Loans*. Manila.

²⁰ List of Ineligible Items (accessible from the list of linked documents in Appendix 2).

and bilateral agencies that have implications for program implementation, as well as provide ADB with the opportunity to comment on any resulting policy proposals.

III. DUE DILIGENCE

A. Economic and Financial

36. The program is focused on improving the quality of public spending, improving the environment for doing business, and enabling the drivers of economic growth. Having stabilized its immediate macroeconomic and fiscal position, and made progress on improving PFM systems, the government's priorities have shifted to a medium-term program to consolidate and advance its economic and financial reform program, while putting in place the necessary supporting reforms to improve development outcomes and strengthen economic growth.

B. Governance

37. The government and its development partners continue to support various aspects of PFM, procurement, anticorruption, and other governance reforms. A PEFA assessment was first undertaken in 2008, with a follow-up assessment in 2012 (footnote 13). While some components of the PFM system involve risks, the PFM road map draws all relevant actions to strengthen the PFM system into a single document over a 3-year period.²¹ Procurement reviews were undertaken in 2012 and 2014.²² More generally, ADB participates along with government and CEWG partners in the annual review of the government's progress in implementing its reform agenda, with the most recent review endorsed by the CEWG in March 2015.²³

38. ADB's Anticorruption Policy (1998, as amended to date) was explained to and discussed with the government and MOFT. The specific policy requirements and supplementary measures are described in the legal documents.²⁴

C. Poverty and Social

39. While Solomon Islands does not have a national poverty reduction strategy, poverty alleviation is one of eight objectives of the current NDS. The Democratic Coalition for Change government policy statement also focuses on the prevention and alleviation of poverty.

40. The program is classified as some gender elements. ADB supported the completion of a country gender assessment in 2015.²⁵ This assessment examines the progress toward gender equality across social, economic, and political spheres in Solomon Islands, such as health, education, work, political participation, and gender-based violence. The Ministry of Women, Youth, Children and Family Affairs will be taking the assessment report to the cabinet for endorsement and subsequent launch. The report's recommendations will then be taken to the gender focal points in each ministry to see how they can be integrated into sector plans and programs where appropriate. This work will feed into the government's national planning work and is included under action 1.3 of the policy matrix.

²¹ Risk Assessment and Risk Management Plan (accessible from the list of linked documents in Appendix 2).

²² World Bank. 2012. *Solomon Islands Operational Procurement Review*. Washington DC; and Government of Solomon Islands, ADB, and Government of Australia, Department of Foreign Affairs and Trade. 2014. *Joint Review of the Solomon Islands National Transport Fund*. Honiara.

²³ CEWG Joint Review Mission. 2014. *Report of the Fifth Annual Joint Review Mission*. Honiara.

²⁴ Grant Agreement (accessible from the list of linked documents in Appendix 2).

²⁵ ADB, Ministry of Women, Youth, Children & Family Affairs, and Secretariat of the Pacific Community. 2015. *Solomon Islands Country Gender Assessment*. Manila.

D. Safeguards

41. The program is safeguard category C for environment, involuntary resettlement, and indigenous peoples. No adverse environmental impacts were identified. No involuntary resettlement or impacts on indigenous people are expected.

E. Risks and Mitigating Measures

42. Major risks and mitigating measures are summarized in Table 2 and described in detail in the risk assessment and risk management plan (footnote 21).

Table 2: Summary of Risks and Mitigating Measures

Risks	Mitigating Measures
The government's capacity to implement reforms effectively may prove insufficient.	Ongoing TA activities have been supporting the government in meeting the policy actions. ^a
Political instability may weaken fiscal discipline and policy commitment.	ADB will continue policy engagement with the government and its development partners. Policy engagement with the government on its reform program consists of three main elements: (i) discussions on the design and implementation of the program policy matrix, (ii) CEWG meetings, and (iii) joint review missions assessing program performance.
The government may limit its engagement or withdraw completely from engaging with development partners on a program of economic and financial reform.	The government, particularly MOFT, has provided a firm commitment to the program, including achievement of the policy actions under the program.

ADB = Asian Development Bank, CEWG = core economic working group, MOFT = Ministry of Finance and Treasury, TA = technical assistance.

^a ADB. 2013. *Technical Assistance for the Pacific Private Sector Development Initiative, Phase III*. Manila; and ADB. 2014. *Technical Assistance to Solomon Islands for Strengthening the Implementation of the National Development Strategy*. Manila.

Source: Asian Development Bank.

IV. ASSURANCES AND CONDITIONS

43. The government has assured ADB that implementation of the program shall conform to all applicable ADB policies, including those concerning anticorruption measures, safeguards, gender, procurement, consulting services, and disbursement as described in detail in the grant documents.

44. The government has agreed with ADB on certain covenants for the program, which are set forth in the grant agreement. The government has also agreed with ADB that, as conditions for grant effectiveness, a deposit account will be opened and policy actions for the program have been completed in a manner satisfactory to ADB.

V. RECOMMENDATION

45. I am satisfied that the proposed policy-based grant would comply with the Articles of Agreement of the Asian Development Bank (ADB) and recommend that the Board approve the grant not exceeding \$5,000,000 to Solomon Islands from ADB's Special Funds resources for the Economic Growth and Fiscal Reform Program, on terms and conditions that are substantially in accordance with those set forth in the draft grant agreement presented to the Board.

Takehiko Nakao
President

28 April 2016

DESIGN AND MONITORING FRAMEWORK

Impacts the Program is aligned with			
Provide an enabling environment to stimulate economic growth, especially in rural areas ^a Pursue public sector reforms and commit resources to enable private sector-led growth ^a			
Results Chain	Performance Indicators with Targets and Baselines	Data Sources and Reporting	Risks
Outcome A strengthened economic and fiscal position to deliver improved opportunities and living standards	1. By 2017, total revenue (excluding grants) is maintained above 30% in line with government forecast (2014 baseline: 33.2% of GDP) 2. Number of new companies registered increases by at least 300 in 2015–2017 (2014 baseline: 354)	1. MOFT-supplied data (medium-term fiscal strategy); IMF Article IV staff report 2. Data supplied from the companies registry	Broad reform consensus weakens because of political pressure. External shocks undermine fiscal and economic performance.
Outputs 1. Improving public service delivery and economic management 2. Creating an enabling environment for private sector-led growth	1a. Customs and excise bill submitted to Parliament by 2016 1b. Public financial management road map actions are being implemented by 2016 1c. NDS that effectively mainstreams gender approved by the cabinet by 2016 2a. List of all alienated land transaction decisions for financial year 2015 published by 2016 2b. Credit unions bill drafted by 2016 2c. Discussion paper on competition policy released for public consultation by 2016 2d. SOE capital structure policy approved by 2016 2e. Business Names Act, 2014 regulations in place by 2016	1a. Approved cabinet paper 1b. MOFT confirmation 1c. Approved cabinet paper 2a. Publicly available list 2b. Draft bill 2c. Discussion paper 2d. Approved cabinet paper 2e. Official government gazette	Capacity constraints and staff turnover reduce continuity and quality of reform implementation. Lack of coordination for policy formulation among key government agencies delays reform. Limited stakeholder consultations with the executive and legislative branches of government put the passing of legislative reforms at risk. Lack of or delay in technical assistance to support reform design and implementation undermines the pace of reform.

Results Chain	Performance Indicators with Targets and Baselines	Data Sources and Reporting	Risks
3. Enabling drivers of economic growth	3a. Fisheries Act adopted by Parliament by 2016 3b. Cabinet approval of new tourism strategy and cruise ship action plan issued by 2016	3a. Official government gazette 3b. Approved cabinet paper	
Inputs ADB: \$5,000,000 grant			
Assumptions for Partner Financing Development partners that are CEWG members provide budget support as programmed. ^b			

ADB = Asian Development Bank, CEWG = core economic working group, GDP = gross domestic product, IMF = International Monetary Fund, MOFT = Ministry of Finance and Treasury, NDS = national development strategy, SOE = state-owned enterprise.

^a Government of Solomon Islands, Office of the Prime Minister and Cabinet. 2015. *Democratic Coalition for Change Government. Policy Statement*. Honiara.

^b Development Coordination (accessible from the list of linked documents in Appendix 2).

Source: Asian Development Bank.

LIST OF LINKED DOCUMENTS

<http://adb.org/Documents/RRPs/?id=48479-001-2>

1. Grant Agreement
2. Sector Assessment (Summary): Public Sector Management
3. Contribution to the ADB Results Framework
4. Development Coordination
5. Country Economic Indicators
6. International Monetary Fund Assessment Letter
7. Summary Poverty Reduction and Social Strategy
8. Risk Assessment and Risk Management Plan
9. List of Ineligible Items

Supplementary Document

10. Macroeconomic Analysis



SOLOMON ISLANDS GOVERNMENT

DEVELOPMENT POLICY LETTER

23rd December 2015

Mr. Takehiko Nakao
President
Asian Development Bank
6 ADB Avenue
Mandaluyong, Metro Manila
Philippines

Dear Mr. Nakao,

THE SOLOMON ISLANDS ECONOMIC AND FINANCIAL REFORM

The Solomon Islands Government, first of all, wish to acknowledge and thank the Asian Development Bank (ADB) for its continuous engagement and support to its economic and financial reform efforts to bring about positive changes for its citizens and people.

Secondly, the Government wishes to inform the ADB that under the new political governing body, the Democratic Coalition for Change, that assumed political leadership in Solomon Islands on the 9th of December 2014, is bringing about positive changes through effective reform programs to ensure that Solomon Islanders are governed and empowered to achieve a meaningful quality of life.

The Government is proud to note that shortly after assuming office, the government released a *Policy Statement* and a *Policy Strategy and Translation*. The *Policy Statement* sets out the broad political direction of this government and its long-term strategy. The *Policy Strategy and Translation* document expands on the *Policy Statement* with a comprehensive list of reform actions, including funding and expected outcomes.

The implementation of the *Policy Strategy and Translation* is requiring a 'whole of government approach'. The Government is aware that our policies, strategies, and translations can only lead to maximum change in the lives of all persons in the

country only with efficient and effective implementation of whole of government activities. These policy documents are driving two parallel reform programs; namely, fundamental reform and sectoral reform. On fundamental reform, the government is working to redefine the norms and values of Solomon Islands society to become more inclusive to enhance sustainable unity. On sectoral reform, the government is focusing on the productive, resource, and social sectors. Equally important are the judiciary and national security sector and the development sector in the sectoral reform program.

The *Policy Strategy and Translation* is a living document that is being monitored on a regular basis by the Policy Implementation, Monitoring and Evaluation Unit (PIMEU), based in the Office of the Prime Minister and Cabinet. The PIMEU is providing support to cluster groups that are leading the reforms. These clusters are providing the fuel for the engine of service delivery, and reporting directly to the Cabinet Ministers of Solomon Islands.

In addition to these policy documents, the Government has requested that the existing National Development Strategy be reviewed and revised. The Strategy will be extended to cover a twenty year period (2016–2035) to provide a longer term framework for planning that lays the foundations for recovery and long term sustainable development. It will also provide a strategic vision through to 2035, that will provide greater stability and continuity.

Mr. President, having provided an overview of our current development strategies, let me update you on the macroeconomic situation. The Government has recently revised down slightly the 2015 GDP growth rate to 3 ¼ percent from previous forecast of around 3 ½ percent. The revision to growth primarily reflects weaker than expected output in the formal fishing and agriculture sectors, and slightly weaker than expected activity in the retail and wholesale trade sector. The economy has recovered well from the 2014 flash flood, with the lower petrol and diesel price providing valuable support for consumption and business investment. As expected, commodity prices have fallen in line with weak global economic activity, resulting in lower copra and cocoa production.

The 2015 budget deficit is not expected to be as significant as originally forecast; indeed there is a possibility of a small surplus in 2015. This is largely due to the late approval of the 2015 budget, which was necessary to allow the Government to formalize its plans following the November 2014 election. The recurrent budget is expected to be fully spent, as it was partially spent under an interim budget in the first quarter of 2015. At this time, revenue is expected to be at around the forecasted levels.

The Parliament approved the 2016 Budget on 15th December 2015. The 2016 budget, which forecasts a deficit of \$568.5 million to be fully funded from reserves, is themed around ‘focusing on economic growth through delivery’. To achieve this the Government is budgeting to deliver key economic investment through 2016, including: (a) Guadalcanal Plain road infrastructure and bridges to help the growth in the palm oil sector, (b) Suave Bay and Bina Harbor land investments, (c) climate proofing the north and south Malaita roads, (d) sealing of Auki roads to build the “credibility” of Auki as an economic hub, (e) sealing of Gizo roads to encourage business investment in industry and tourism and to enhance economic prospects in Western Province, (f) sealing airport runways in Taro, Sege, and Lata to promote tourism opportunities, and (g) proceeding with the Tina River Hydro Project.

Development partner budget support in the Solomon Islands is now linked to a firmly established set of processes, consisting of (a) discussions on the design and implementation of a policy matrix of reform conditions, (b) Core Economic Working Group (CEWG) meetings, and (c) joint review missions – undertaken by both government and development partner representatives – assessing economic and financial reform progress. The government remains committed to these processes, and in late-September I chaired the most recent meeting of the CEWG. These processes have stood the “test of time”, having been first put in place in 2009 and having continued to operate regularly since.

Mr. President, budget support from our development partners, including from the ADB, is critical to our continued progress, and implementing an ongoing program of economic and financial reform is very much a key part of this government’s reform efforts. Indeed, two key objectives of this government – as outlined in the *Policy Statement* – are: (i) to provide an enabling environment to stimulate economic growth, especially in the rural areas, and (ii) to pursue public sector reforms and commit resources to enable private sector-led growth in the country.

The program with ADB includes actions consistent with these objectives and is aimed at (a) improving public service delivery and economic management, (b) creating an enabling environment for private sector-led growth, and (c) enabling the drivers of economic growth.

Improving public service delivery and economic management. The government is aware that public sector expenditure amounts to about half of formal economic activity in Solomon Islands, and therefore improving public service effectiveness and efficiency will have a positive impact on Solomon Islanders’ economic inclusion and well-being. Under the program, we are supporting new customs and excise legislation, and supporting ongoing improvements in public financial management

through implementation of the public financial management roadmap. This work – along with the revision to the National Development Strategy that I referred to earlier – will assist our efforts in improving public service delivery and economic management.

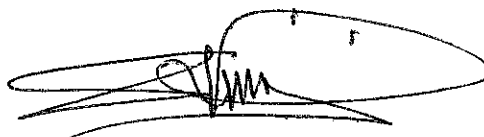
Creating an enabling environment for private sector-led growth. Significant improvements have been made to the environment for doing business in Solomon Islands, including reforms in business laws, upgrading and modernization of the company registry, and improving transparency in the resources sector. The government is continuing efforts to improve this area, and under the program (a) is improving the governance of alienated land through a new land board; (b) is initiating reforms to strengthen the competition policy, credit unions, and the capital structure of state-owned enterprises; and (c) has introduced legislation to facilitate new business registration.

Enabling the drivers of economic growth. Agriculture, mining, fisheries, and tourism all offer potential opportunities for the economic growth of Solomon Islands, however institutional reforms and technical assistance is needed to strengthen the sectors' regulation and management. Reforms are underway in all of these sectors, including the two that are the focus of this program – improving fisheries' governance and management through new legislation, and development of a new tourism strategy to attract overseas visits.

In light of the progress made and the need to maintain the momentum required to sustain its desired outcomes, the Government remains committed to the reform agenda, as outlined in the ADB's program, realizing that its long-term commitment to the process is critical. To this end, Government will continue to ensure achievement of the policy actions that are proposed for accomplishment by December 2016.

The Government is pleased with its performance since assuming Office; however much more remains to be done and our reform program is ambitious. We are confident that our strong ownership, supported by financial and technical assistance from ADB and other development partners, will help us achieve our goals.

Yours sincerely

A handwritten signature in black ink, appearing to read 'Snyder Rini', written over a horizontal line.

Hon. Snyder Rini, MP
Minister of Finance and Treasury

Attachment: Policy Matrix

POLICY MATRIX

Policy Reform Area [Reference to DCC Policy Statement] ^a	Policy Actions – to be completed by December 2015 (Tranche release conditions)	Means of Verification and/or Supporting Documents	Status	Program partnership monitoring framework Policy Actions – to be completed by December 2016 (Non tranche release conditions)
1. Improving public service delivery and economic management				
1.1 Strengthen Solomon Islands' revenue systems. [DCC 4.2.1.a]	Cabinet approves the draft Customs and Excise Bill for sending to the Attorney General's Chambers for review.	Copy of approved Cabinet paper and letter from Ministry of Finance and Treasury certifying Cabinet approval.	Completed	Submit to Parliament the Customs and Excise Bill to repeal and replace the current Act.
1.2 Strengthen expenditure control and cash management. [DCC 4.2.1.a]	Cabinet approves the public financial management roadmap.	Copy of approved Cabinet paper and letter from Ministry of Finance and Treasury certifying Cabinet approval.	Completed	Support ongoing improvements in public financial management through implementation of the public financial management roadmap.
1.3 Strengthen resource allocation processes to improve the government's ability to deliver essential public services. [DCC 4.2.5.2]	Cabinet approves the framework for the National Development Strategy, 2016–2036.	Copy of approved Cabinet paper and letter from Ministry of Development Planning and Aid Coordination certifying Cabinet approval.	Completed	The National Development Strategy, 2016-2036, and the Medium Term Development Plan 2017-2021, incorporate recommendations from the Country Gender Assessment. Cabinet approves the National Development Strategy, 2016–2036.
2. Creating an enabling environment for private sector led growth				
2.1 Improving the management of land. [DCC 4.2.2.4]	Ministry of Lands, Housing and Survey establishes a Land Board under Land and Titles (Amendment) Act 2014, to improve the governance of alienated land.	Letter from Ministry of Lands, Housing and Survey certifying establishment of Land Board.	Completed	The Land Board publishes at end-2015 a list of all alienated land transaction decisions for financial year 2015.

Policy Reform Area [Reference to DCC Policy Statement] ^a	Policy Actions – to be completed by December 2015 (Tranche release conditions)	Means of Verification and/or Supporting Documents	Status	Program partnership monitoring framework Policy Actions – to be completed by December 2016 (Non tranche release conditions)
2.2 Reforming the financial sector and improving access to credit. [DCC 4.2.1.b]	Cabinet approves a policy recommendation paper for credit unions.	Copy of approved Cabinet paper and letter from Ministry of Finance and Treasury certifying Cabinet approval.	Completed	Draft a new credit unions bill based on the policy recommendation paper.
2.3 Competition policy reform. [DCC 4.2.1.b]	Cabinet approves work undertaken on the competition policy project and agrees to development of a policy recommendation paper.	Copy of approved Cabinet paper and letter from Ministry of Finance and Treasury certifying Cabinet approval.	Completed	Release discussion paper on competition policy for public consultation.
2.4 Improving the performance of public assets. [DCC 4.2.1.b]	Cabinet approves a policy recommendation paper outlining the broad parameters, process, and timeline for the development of an SOE capital structure policy.	Copy of approved Cabinet paper and letter from Ministry of Finance and Treasury certifying Cabinet approval.	Completed	Cabinet approves a capital structure policy paper for SOEs to ensure optimal, commercial-equivalent levels of funding for SOE activities, from appropriate sources (public/private, debt/equity).
2.5 Reforming business registration process to encourage faster, more efficient micro, small and medium enterprise business start-up. [DCC 4.2.1.b]	Parliament enacts the Business Names Act.	Certified copy of the enacted law.	Completed	Implement Business Names Act, including development of accompanying regulations and electronic registry.

Policy Reform Area [Reference to DCC Policy Statement] ^a	Policy Actions – to be completed by December 2015 (Tranche release conditions)	Means of Verification and/or Supporting Documents	Status	Program partnership monitoring framework Policy Actions – to be completed by December 2016 (Non tranche release conditions)
3. Enabling the drivers of economic growth				
3.1 Establish and strengthen national and provincial fisheries governance and institutional arrangements. [DCC 4.2.2.7]	Parliament enacts the Fisheries Act to strengthen fisheries' governance and management.	Certified copy of the enacted law.	Completed	Implement the Fisheries Act including development of accompanying regulations.
3.2 Growing the economy through creating investment opportunities in tourism. [DCC 4.2.2.2]	Cabinet approves a new National Tourism Strategy which includes a cruise ship action plan.	Copy of approved tourism strategy and letter from Ministry of Culture and Tourism certifying Cabinet approval.	Completed	Implement the National Tourism Strategy.

DCC = Democratic Coalition for Change Government, SOE = state-owned enterprise.

^a Office of the Prime Minister and Cabinet. 2015. Democratic Coalition for Change Government. *Policy Statement*. Honiara.

Source: Asian Development Bank and Government of Solomon Islands.