



## Concept Paper

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Project Number: 52074-001  
September 2018

# Proposed Policy-Based Grant Solomon Islands: Improved Fiscal Sustainability Reform Program

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Asian Development Bank

## CURRENCY EQUIVALENTS

(as of 26 August 2018)

Currency unit – Solomon Islands dollar (SI)

SI\$1.00 = \$0.1280

\$1.00 = SI\$7.8125

## ABBREVIATIONS

ADB	–	Asian Development Bank
CEWG	–	Core Economic Working Group
IMF	–	International Monetary Fund
MOFT	–	Ministry of Finance and Treasury
NDS	–	National Development Strategy
PFM	–	public financial management
PRM	–	policy reform matrix
TA	–	technical assistance

## NOTE

In this report, "\$" refers to United States dollars

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## PROGRAM AT A GLANCE

<b>1. Basic Data</b>		<b>Project Number: 52074-001</b>	
<b>Project Name</b>	Improved Fiscal Sustainability Reform Program	<b>Department/Division</b>	PARD/PLCO
<b>Country Borrower</b>	Solomon Islands Government of Solomon Islands	<b>Executing Agency</b>	Ministry of Finance
<b>2. Sector</b>	<b>Subsector(s)</b>	<b>ADB Financing (\$ million)</b>	
✓ <b>Public sector management</b>	Economic affairs management		2.50
	Public expenditure and fiscal management		2.50
		<b>Total</b>	<b>5.00</b>
<b>3. Strategic Agenda</b>	<b>Subcomponents</b>	<b>Climate Change Information</b>	
Inclusive economic growth (IEG)	Pillar 2: Access to economic opportunities, including jobs, made more inclusive	Climate Change impact on the Project	Low
Environmentally sustainable growth (ESG)	Natural resources conservation		
Regional integration (RCI)	Pillar 3: Money and finance		
<b>4. Drivers of Change</b>	<b>Components</b>	<b>Gender Equity and Mainstreaming</b>	
Governance and capacity development (GCD)	Public financial governance	Effective gender mainstreaming (EGM)	✓
Knowledge solutions (KNS)	Knowledge sharing activities		
Partnerships (PAR)	Implementation		
Private sector development (PSD)	Private Sector Conducive policy and institutional environment		
<b>5. Poverty and SDG Targeting</b>		<b>Location Impact</b>	
Geographic Targeting	Yes	Nation-wide	High
Household Targeting	No		
SDG Targeting	Yes		
SDG Goals	SDG8		
<b>6. Risk Categorization:</b>	Low		
<b>7. Safeguard Categorization</b>	<b>Environment: C Involuntary Resettlement: C Indigenous Peoples: C</b>		
<b>8. Financing</b>			
<b>Modality and Sources</b>		<b>Amount (\$ million)</b>	
<b>ADB</b>		<b>5.00</b>	
Sovereign Stand-Alone Policy-Based Lending (Grant): Asian Development Fund		5.00	
<b>Cofinancing</b>		<b>16.40</b>	
European Union - Stand-Alone Policy-Based Lending (Grant) (Not ADB Administered)		2.90	
Government of Australia - Stand-Alone Policy-Based Lending (Grant) (Not ADB Administered)		1.50	
New Zealand Grant - Stand-Alone Policy-Based Lending (Grant) (Not ADB Administered)		2.00	
World Bank - Stand-Alone Policy-Based Lending (Grant) (Not ADB Administered)		10.00	
<b>Counterpart</b>		<b>0.00</b>	
None		0.00	
<b>Total</b>		<b>21.40</b>	

## I. THE PROPOSAL

1. The proposed Improved Fiscal Sustainability Reform Program will help the Government of Solomon Islands implement policy and institutional reforms that improve public finances and investments, strengthen fiscal management and sustainability, and contribute to private sector development.<sup>1</sup>

2. Policy actions supported under the stand-alone policy-based grant are part of a government-led multipartner reform effort which started in 2009 through the Core Economic Working Group (CEWG), of which the Asian Development Bank (ADB) is a founding member.<sup>2</sup> The program builds on previous ADB policy-based grant programs during 2010–2016, is closely aligned with the CEWG process, and provides flexibility to respond to changes in a fragile and conflict-affected country.<sup>3</sup> A stand-alone modality is considered appropriate given the risk to reform momentum posed by the national elections, which are scheduled for early 2019, and it meets the government's financing needs in 2018. Potential weakening of the government reform commitment beyond 2018 is mitigated through the demonstrated success of previous stand-alone programs that were negotiated with multiple governments, and a post-program partnership framework that contains long-standing reform priorities drawn from the National Development Strategy (NDS) 2016–2035 and which has broad-based political support.<sup>4</sup>

## II. PROGRAM AND RATIONALE

### A. Background and Development Constraints

3. **Macroeconomic challenge.** Solomon Islands is confronted with a narrow production base, remoteness and geographic dispersion, thin administrative capacity, vulnerability to natural disasters and climate change, a large infrastructure gap, and high dependence on aid and imports. Despite these constraints, its economy has continued to grow in recent years. Growth averaged 2.9% per annum during 2013–2017, which is higher than the regional average of 2.4% over the same period. But population growth of about 2.3% means there is limited per capita income growth. The government's challenges in managing and accounting for its scarce resources, combined with weak internal coordination, poor utilization of capital expenditure, and outdated business and taxation laws and regulations, has often resulted in poor public sector management and service delivery.

4. Although economic growth has been broadly steady, it has relied on expansionary fiscal policy, unsustainable logging, and post-flooding reconstruction. While export performance is currently strong, the longer-term prospects for sustaining growth are uncertain.<sup>5</sup> The government is well aware that recent trends are not sustainable, especially as logging (which accounted for around 20% of domestic revenue and two-thirds of exports in 2017) is expected to gradually

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<sup>1</sup> The program is included in ADB. 2017. *Country Operations Business Plan: 11 Small Pacific Island Countries 2018–2020*. Manila. It is aligned with ADB. 2016. *Pacific Approach, 2016–2020*. Manila.

<sup>2</sup> The CEWG is chaired by the Ministry of Finance and Treasury (MOFT) and includes senior representation from government and development partners.

<sup>3</sup> ADB. 2010. *Report and Recommendation of the President to the Board of Directors: Proposed Economic Recovery Support Program, Subprogram 1*. Manila; ADB. 2011. *Report and Recommendation of the President to the Board of Directors: Proposed Economic Recovery Support Program, Subprogram 2*. Manila; ADB. 2013. *Report and Recommendation of the President to the Board of Directors: Proposed Economic and Financial Reform Program*. Manila; and ADB. 2016. *Report and Recommendation of the President to the Board of Directors: Proposed Economic Growth and Fiscal Reform Program*. Manila.

<sup>4</sup> Government of Solomon Islands. 2016. *National Development Strategy 2016–2035*. Honiara.

<sup>5</sup> ADB. 2017. *Asian Development Outlook*. Manila.

decline over the medium term.<sup>6</sup> When the government was formed in late 2017, one of the first steps it took to accelerate its reform program was reactivating the CEWG and adopting a policy reform matrix (PRM) that would unlock budget support from development partners. In the past the CEWG has proven effective in utilizing policy financing to sustain reform momentum and efforts to strengthen fiscal sustainability.<sup>7</sup>

5. **Reform performance.** During 2010–2014, the government streamlined the process for foreign investment, modernized company and business legislation, and liberalized the telecommunications industry in order to improve the business and investment climate. Following the global financial crisis in 2009–2010, the government implemented several important financial reforms, including adopting fiscal management targets for the budget and public debt, launching a debt management strategy, establishing a multiagency public financial management (PFM) working group, and strengthening internal auditing across government. From 2011, and working closely with the International Monetary Fund (IMF), the government also maintained a cash buffer of at least 2 months of recurrent expenditure to improve its ability to respond to shocks (footnote 6). However, the fiscal position deteriorated during 2015–2017, reversing earlier surpluses, because of poor fiscal management, in particular rising discretionary expenditure and changes in government priorities that resulted in limited policy dialogue and reform slippage.<sup>8</sup> The government’s cash buffer declined to less than 1 month of cash reserves in September 2017, well below the target of 2 months of total spending. Action is needed to restore a sustainable budget and improve PFM processes to strengthen budget credibility.

6. **Budget performance in 2018.** Key leadership changes in late 2017 have enabled the resumption of reform momentum.<sup>9</sup> In 2018 the government made a concerted effort to reestablish macroeconomic and fiscal stability through a balanced budget and a targeted fiscal adjustment program that included budget support and rebuilding of cash buffers.<sup>10</sup> This approach is closely aligned to the NDS; ADB’s Pacific Approach, 2016–2020; and its three-pronged strategy to reduce costs, manage risks, and enable value creation. It is also consistent with the IMF’s policy advice to the government (footnote 6). Achieving a fully funded budget, however, has come at the expense of substantial reductions in development expenditure. The government adopted the same prudent approach to the July 2018 supplementary budget, which was around \$28.9 million. Line ministries were advised that new or additional expenditure pressures would only be accommodated if there was a commensurate increase in revenues and/or funds could be reallocated from the 2018 recurrent budget. No new or additional discretionary expenditures have been included. Consequently, the government’s fiscal framework maintains a near-balanced budget.<sup>11</sup>

## B. Policy Reform and ADB’s Value Addition

7. **Policy reforms.** The program will leverage critical reforms from the PRM, which reflects the government’s desire to strengthen public sector management and service delivery. The PRM

<sup>6</sup> International Monetary Fund (IMF). 2018. *Solomon Islands: Staff Report for the 2017 Article IV Consultation*. IMF Staff Country Report. No. 18/57. Washington, DC.

<sup>7</sup> ADB. 2011. ADB. 2012. *Completion Report: Solomon Islands: Economic Recovery Support Program—Subprograms 1 and 2*. Manila; and Independent Evaluation Department. 2015. *Solomon Islands: Economic and Financial Reform Program*. Manila. The reestablishment of the CEWG in late 2017 and a request for general budget support has reopened the policy dialogue on macroeconomic and fiscal management.

<sup>8</sup> Discretionary expenditures such as tertiary scholarships and shipping grants, for example, increased as a share of the development budget from 1.7% to 5.1% during 2014–2017. Overall, discretionary expenditures now account for about one-third of the development budget and nearly 10% of total expenditure.

<sup>9</sup> In November 2017, the Prime Minister was replaced following a vote of no confidence. The current coalition, the Solomon Islands Democratic Coalition for Change, faces elections in early 2019.

<sup>10</sup> Government of Solomon Islands. 2018. *2018 Budget Strategy and Operational Rules*. Honiara.

<sup>11</sup> Government of Solomon Islands. 2018. *2018 Supplementary Appropriation Bill*. Honiara.

is based on three strategic themes: strengthening PFM, improving fiscal management and sustainability, and enabling drivers of economic growth and promoting investment. These are all areas of long-standing policy engagement for ADB (footnote 3). In line with international good practice, the program will focus policy attention and reform capacity on a small number of important and challenging actions under each strategic theme, as well as demonstrate strong ADB value addition.<sup>12</sup>

8. **Reform Area 1: Public financial and investment management.** A key policy priority for the Ministry of Finance and Treasury (MOFT) is to improve budget outcomes and increase transparency by strengthening PFM and public investment management. Both are vital to macroeconomic stability and private sector development.<sup>13</sup> The potential policy actions achieve this by reducing key discretionary expenditures and improving the policy guidance governing tertiary scholarships expenditure, raising additional revenue, and rebuilding confidence in government payments by eliminating arrears. Potential policy actions include

- (i) establishing a core ministerial Cabinet committee to oversee the implementation of high-priority policies and the 2018 national budget;
- (ii) Cabinet approving a public investment management diagnostic report that will guide future reforms that improve the quality, effectiveness, and sustainability of public investments; and
- (iii) Parliament approving the Anticorruption Bill 2018 and Whistleblower Bill 2018.

9. **Reform Area 2: Fiscal management and sustainability.** In line with the IMF's policy advice (footnote 6), the MOFT is committed to rebuilding fiscal buffers and maintaining fiscal discipline. The potential policy actions achieve this by reducing discretionary expenditure, raising additional revenue, keeping confidence in government payments by eliminating arrears, and providing greater policy guidance in expending budget funds. Potential policy actions include

- (i) clearing outstanding expenditure arrears from 2017, amounting to \$17.8 million, in 2018;
- (ii) Cabinet approving the Scholarship Management Instructions to align the awards process with the existing scholarships policy;
- (iii) Cabinet approving the following expenditure restraint measures in the 2018 budget:
  - (a) new government-funded tertiary scholarships do not exceed 700 in the 2018 budget (a reduction of 86% compared to 2017), and
  - (b) government shipping grants reduced by 50% compared to 2017;
- (iv) Cabinet approving the following domestic revenue mobilization measures in the 2018 budget:
  - (a) withholding tax increase to 7.60%,
  - (b) goods tax increase of 4.18%, and
  - (c) excise on tobacco products and alcoholic drinks increase of 7.50%.

10. **Reform Area 3: Private sector investment climate.** As highlighted in ADB's 2017 private sector assessment, increased private investment that will diversify the economy is needed to address employment and income challenges in Solomon Islands.<sup>14</sup> The government has an important role to play in establishing an attractive investment climate where entrepreneurs and businesses can thrive, and which broadens the economic base away from unsustainable extractive industries. The potential policy actions achieve this by working towards a tax system

<sup>12</sup> 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.

<sup>13</sup> Government of Solomon Islands. 2014. *Public Finance Management Reform Roadmap 2014–2017*. Honiara.

<sup>14</sup> ADB. 2017. *Private Sector Assessment – Solomon Islands*. Manila.

that supports private sector development, starting a policy development process to more sustainable forestry practices, and providing the policy basis for a more competitive economy. Potential policy actions include the following:

- (i) Cabinet approval of a policy framework and work plan to review and implement taxation reforms. This will bring the tax system more into line with good international practices and ensure a fair, simple, and broad-based system that encourages local businesses and is attractive to foreign investors.
- (ii) Establishment of a sustainable forestry taskforce to oversee the formulation of a policy that promotes sustainable logging practices and broadens the base for economic growth.
- (iii) Cabinet approval of a competition policy to promote competition in Solomon Islands' markets and to support sustainable and inclusive economic growth.

11. **Program modality and ADB value addition.** The government has requested a standalone policy-based program based on the PRM to support the implementation of the 2018 national budget and the medium- to long-term objectives of the NDS. ADB has been a major reform partner and technical assistance (TA) provider in PFM, fiscal management, and private sector development reforms since 2009 (footnote 7). ADB TA is supporting efforts across each of the reform areas.<sup>15</sup> Grant release conditions of earlier programs have proven effective in encouraging the government to implement several complex and politically sensitive reforms without the incentives created by the grant conditions (footnote 7). The ongoing policy dialogue and TA support has also helped to sustain the policy engagement with government despite significant political changes during 2009–2016.

12. **Development partner coordination.** The program is fully integrated with the CEWG and Technical Economic Working Group process. In addition, the program and the policy operations of the Governments of Australia and New Zealand, the European Union, and the World Bank are aligned with the PRM. The program incorporates past lessons and good practice from ADB's engagement in Solomon Islands and other countries in the region (footnotes 7 and 12). ADB, the World Bank, and the IMF also share a common view on the macroeconomic and structural reform priorities for Solomon Islands.

### C. Impacts of the Reform

13. The program will help the government achieve the NDS objective of sustained and inclusive economic growth. The outcome will be improved public sector management and service delivery through enhanced public financial and investment management, improved fiscal management and sustainability, and fostering of a more supportive private investment climate.<sup>16</sup>

### D. Development Financing Needs and Budget Support

14. The program amount is a \$5 million grant financed from ADB's Asian Development Fund resources. The World Bank, the Governments of Australia and New Zealand, and the European Union will provide \$16.4 million in parallel cofinancing. The program will help the Government of Solomon Islands meet its total financing requirements in 2018 (the revised budget estimates project a funding gap of \$47.4 million without budget support), maintain development expenditure, and rebuild fiscal buffers.

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<sup>15</sup> ADB. 2010. *Pacific Economic Management—Enhanced Economic Management* (Subproject 2). Manila; ADB. 2013. *Pacific Private Sector Development Initiative Phase III*. Manila; and ADB. 2014. *Technical Assistance for Sector and Thematic Analyses in Policy Development*. Manila.

<sup>16</sup> A program impact assessment will be prepared as part of the program documents.



## E. Implementation Arrangements

15. The MOFT will be the executing agency and an implementing agency. The MOFT; Office of the Prime Minister; Ministry of Forestry and Research; Ministry of Mines, Energy and Rural Electrification; and Ministry of Commerce, Industry, Labor and Immigration will also be implementing agencies. Implementation of the program at the technical level will be overseen by the Technical Economic Working Group while higher-level political ownership and leadership of the reforms is provided by the CEWG.

### III. DUE DILIGENCE REQUIRED

16. Due diligence for the program, to be prepared in cooperation with development partners, will include a sector assessment focusing on public sector management, a risk assessment and risk management plan covering the country's PFM systems, and a program impact assessment. The program is expected to be rated category C for environment, involuntary resettlement, and indigenous peoples and is classified as having no gender elements. An IMF assessment letter will be provided. The initial poverty and social analysis is in Appendix 3.

### IV. PROCESSING PLAN

#### A. Risk Categorization

17. The program is assessed *low risk* as per ADB's risk categorization criteria.

#### B. Resource Requirements

18. ADB staff will prepare the program utilizing an estimated 10 person-months of international staff time and 6 person-months of national staff time. Country and regional TA will be available to support PFM and fiscal reform implementation. Other development partners are providing ongoing TA support.

#### C. Processing Schedule

**Table 1: Proposed Processing Schedule**

<b>Milestones</b>	<b>Expected Completion Date</b>
Fact-finding mission	Completed
Management review meeting	28 September 2018
Grant negotiation	5 October 2018
Board consideration	29 November 2018
Grant effectiveness	7 December 2018

Source: ADB Staff.

### V. KEY ISSUES

19. Attention during processing and implementation will be paid to (i) maintaining reform commitment and managing the political economy, especially between election cycles; (ii) ensuring timely TA to provide technical expertise or supplement government capacity; and (iii) ensuring close collaboration with development partners.

**DESIGN AND MONITORING FRAMEWORK**  
(Initial Draft)

<b>Country's Overarching Development Objectives</b>			
<p>The rate of inclusive economic growth reinvigorated and increased The environment for private sector development improved and investment opportunities for all Solomon Islanders increased</p> <p>(National Development Strategy 2016–2035)<sup>a</sup></p>			
<b>Results Chain</b>	<b>Performance Indicators with Targets and Baselines</b>	<b>Data Sources and Reporting</b>	<b>Risks</b>
<p><b>Effect of the Reform</b></p> <p>Strengthened public sector management and service delivery</p>	<p>By 2019:</p> <p>a. Total revenue receipts exceed the 2019 budget target (2018 baseline: \$3.7 billion)</p> <p>b. Fiscal deficit maintained below 1.5% of gross domestic product in 2019 (2018 baseline: 0.5% of gross domestic product)<sup>b</sup></p>	<p>a. 2018 budget out-turn documents</p> <p>b. 2018 budget out-turn documents</p>	<p>Change in government policy or commitment shifts resources away from implementing the program.</p>
<p><b>Reform Areas</b></p> <p>1. Public financial and investment management</p>	<p><b>Indicative Policy Actions</b></p> <p>1.1 By 2019, a public investment management (PIM) diagnostic report that will guide future reforms to improve the quality, effectiveness, and sustainability of public investments approved by Cabinet (2018 baseline: no PIM)</p> <p>1.2 By 2018, a core ministerial cabinet committee to oversee the implementation of high-priority policies and the 2018 national budget established (2018 Baseline: No core ministerial cabinet committee)</p>	<p>1.1 Ministry of Finance and Treasury (MOFT) annual report</p> <p>1.2 Cabinet decision</p>	<p>Leadership and political will to complete the reforms is lacking because of vested interests.</p>

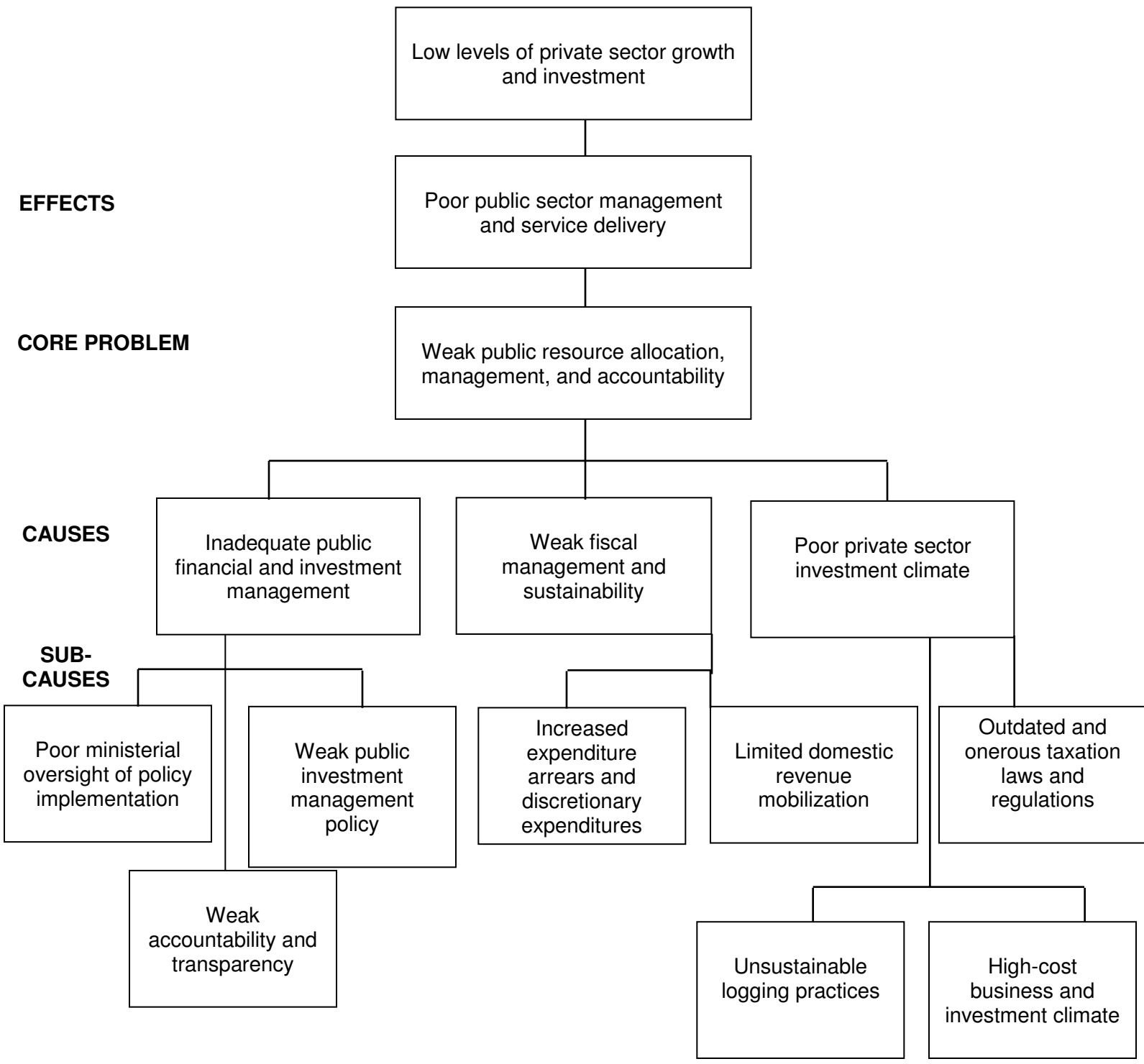
Results Chain	Performance Indicators with Targets and Baselines	Data Sources and Reporting	Risks
2. Fiscal management and sustainability	2.1 By 2018, all outstanding expenditure arrears from 2017, amounting to \$17.8 million in 2018, cleared (2017 baseline: \$17.8 million in expenditure arrears)	2.1 MOFT annual report	
	2.2 By 2019, scholarship management instructions to align the awards process with the existing scholarships policy approved by Cabinet (2018 baseline: No scholarship management instructions)	2.2 Cabinet decision	
3. Private sector investment climate	3.1 By 2019, a policy framework and work plan to review and implement taxation reforms approved by Cabinet (2017 baseline: No policy framework and work plan)	3.1 Cabinet decision	
	3.2 By 2019, a competition policy approved by Cabinet (2017 baseline: No competition policy)	3.2 Cabinet decision	
<b>Budget Support</b>			
ADB: \$5.0 million World Bank: \$10.0 million Government of Australia: \$1.5 million Government of New Zealand: \$2.0 million European Union: \$2.9 million			

<sup>a</sup> Government of Solomon Islands. 2016. *National Development Strategy 2016–2035*. Honiara.

<sup>b</sup> The target was developed in conjunction with the International Monetary Fund and allows for fiscal sustainability while helping to finance significant infrastructure needs.

Source: Asian Development Bank.

**PROBLEM TREE<sup>a</sup>**



<sup>a</sup> Problem tree based on National Development Strategy 2016–2035 and Pacific Approach 2016–2020.

**LIST OF LINKED DOCUMENTS**

<http://www.adb.org/Documents/LinkedDocs/?id=52074-001-ConceptPaper>

1. Initial Poverty and Social Analysis