PROGRAM INFORMATION DOCUMENT (PID)
APPRAISAL STAGE

February 15, 2018
Report No.: 123891

Operation Name	Fiji Fiscal Sustainability and Climate Resilience Development Policy Operation
Region	EAST ASIA AND PACIFIC
Country	Fiji
Operation ID	P165276
Lending Instrument	Development Policy Loan
Borrower(s)	Republic of Fiji
Implementing Agency	Ministry of Economy
Date PID Prepared	15 February 2018
Estimated Date of Appraisal	16 February 2018
Estimated Date of Board Approval	2 April 2018
Corporate Review Decision	Following the corporate review, the decision was taken to proceed with the preparation of the operation.

I. Country and Sector Background

Fiji is a small island economy that faces similar challenges to other small islands, but has succeeded in developing a relatively sophisticated and diversified economy. The country has a population of 870,000 and an area of 18,000 square kilometers spread over 330 islands. It is remote, with New Zealand 2,000 km away, Australia 3,000 km, and the United States, 5,000 km. It has, however, developed a relatively sophisticated economy with substantial services and manufacturing sectors. It has a well-developed transport sector, which serves as a hub for re-exports to the rest of the Pacific, and a large tourism sector, which now attracts over 750,000 visitors a year.

The economy has rebounded strongly following Cyclone Winston—the most powerful storm on record in the Southern Hemisphere, which killed 44 people and caused a loss of nearly a third of GDP. The resurgent growth is supported by reconstruction work, buoyant visitor arrivals, and strong consumer demand from higher incomes and lower unemployment. Annual inflation has moderated to around 2.0 percent as cyclone-related supply shortages have eased and the effect of higher duties on alcohol and tobacco have tailed off. The Fijian dollar has remained broadly stable against a basket of currencies of its main trading partners. In the year to January, it has strengthened against the US and the New Zealand dollars, but weakened against the euro, the Australian dollar, and the yen. The real effective exchange rate appreciated over the same period by 1.6 percent. The current account deficit remains elevated, reflecting the structural deficit in the merchandise trade account and strong import demand for raw materials and capital equipment as reconstruction continues. A large surplus in the services account (relating to tourism and transport) is providing needed offsets. Foreign reserves continue to remain at comfortable levels, at about $2,160 million at end-February, which is sufficient to cover 4.9 months of retained imports.

II. Operation Objectives

The Program Development Objective of the proposed DPO series is to support the government's effort to: (i) strengthen medium-term fiscal sustainability; (ii) improve the investment climate; and (iii) build climate resilience. Under the first pillar, the government is simplifying the tax system to encourage compliance and private-sector-led growth and strengthening the monitoring framework of fiscal risks associated with the country's sizeable state-owned enterprise sector. Under the second pillar, the government is removing obstacles to Foreign Direct Investment (FDI) by updating the country's arbitration law to recognize and enforce overseas arbitration awards and improving the business climate by reducing costs of dealing with construction permits. Under the third pillar, the government is strengthening climate resilience of all new buildings by adopting more stringent building standards.

III. Rationale for Bank Involvement

Frequent natural disasters and rising expenditure have eroded fiscal space in the last five years. This year's budget is rightly focused on completing reconstruction, but the government needs to start rebuilding fiscal space to respond to future shocks. While continuing to pursue ambitious social and investment programs, the government has begun to tackle some difficult reforms to support medium-term fiscal sustainability. The focus has been on greater revenue mobilization, improved management of public debt, greater accountability through internal audit, and more frequent and comprehensive public financial reporting. On revenue mobilization, the government has worked to improve tax compliance, in view of the relatively large informal economy (estimated to be around 30 percent of GDP). The main strategy has been to simplify the tax system and lower tax rates to encourage compliance and promote investment and job creation to expand the base. Expenditure measures, such as rationalizing capital expenditure from post-Winston peaks while protecting essential public investment and not increasing current expenditure in real terms, are needed to achieve the government's medium-term fiscal targets. Due to the scale of Cyclone Winston's damages (about 30 percent of GDP), a backloading of reconstruction spending, and limited scope for large increases in government revenues, the planned fiscal consolidation is bound to be difficult, and the World Bank's engagement is crucial to helping identify additional expenditure measures, including through an ongoing public expenditure review, to support the government's commitment to reducing the fiscal deficit and debt in the medium term.

The return to democracy in 2014 and strong economic performance have helped boost investor confidence. However, sustained increases in private investment require structural reforms to improve the business climate. In this regard, the government has begun to focus on improving the regulatory environment and reducing the costs of doing business. With the help of technical assistance from the World Bank Group, the government is reviewing the country's investment law, has established a taskforce for improving *Doing Business* indicators, and engaged with the World Bank's Doing Business Group to better understand the methodology and reforms needed to improve those indicators; it is also working with counterparts in Singapore and Malaysia to learn from their experiences in improving the business climate.

Finally, to maintain fiscal sustainability and encourage private investment, Fiji needs to continue building climate resilience. After Cyclone Winston, immediate rehabilitation of nearly 500 schools became a government priority. Of the F$208 million reconstruction budget, about 70 percent was allocated to the rebuilding of schools. The government has committed to start building climate resilience by "building back better" from Winston, and has begun implementing the necessary reforms, including adopting higher building standards, putting in place new safeguards to control the quality of construction, and working with the private sector in this effort.

The proposed operation supports the government's medium-term reform programs in the key areas of strengthening medium-term fiscal sustainability, improving the business environment, and building climate resilience. The operation is consistent with the priorities identified in the recently completed report Fiji Systematic Country Diagnostics, which identified strengthening fiscal sustainability, improving the business environment, and investing in climate resilience as among the top five priorities for Fiji's continued progress toward the twin goals. The reforms supported by the proposed operation also enjoy coordinated technical assistance from the World Bank, the ADB, the IMF and its Pacific Financial Technical Assistance Centre, and other development partners.

IV. **Tentative financing**

Source:	($m)
Borrower/Recipient	0
IBRD	15
Others	0
Total	15

V. **Institutional and Implementation Arrangements**

The Ministry of Economy is responsible for coordinating the monitoring and evaluation of the results indicators for the proposed operation. The Ministry of Economy will cover the results indicator relating to the first pillar of the operation, including through collaboration with the relevant agencies involved in this area of work. The Ministry of Economy will collaborate with the Ministry of Public Enterprises and the Ministry of Industry and Trade on the results indicators relating to the second pillar of the operation. Finally, the Ministry of Economy will cover the result indicator relating to the third pillar of the operation, collecting information from its Climate Change Strategic Planning Office. The Ministry of Economy has strong convening power, which was been demonstrated in the previous Post-Winston Emergency DPO.

VI. **Risks and Risk Mitigation**

The overall risk of the operation is substantial on account of substantial macroeconomic, political and governance, and social and environmental risks. The macroeconomic risk primarily relates to the possibility of another natural disaster or additional economic shocks that could undermine Fiji's ability to complete the post-cyclone reconstruction program this year and delay the planned fiscal consolidation from next year. The risk is being mitigated by the proposed budget support to strengthen Fiji's fiscal position to complete the reconstruction program and support the implementation of structural reforms to help promote growth. Strengthening the fiscal position and promoting growth are expected, in turn, to help rebuild fiscal space and reduce macroeconomic risk. The political and governance risk primarily relates to the country's approaching general election, which can take place anytime in the second half of 2018. There is a risk that the election could detract from the government's focus on implementing the planned fiscal and structural reforms; there is also a risk that, if there is a change of government, the planned reforms may not be implemented. To mitigate the risks, the proposed operation focuses on the reform areas where the government has strong commitment to take action before the election, and selects policy triggers that would help maintain the reform momentum but still allows some flexibility if there was a change of government. Close coordination and consultation with other development partners in formulating the policy matrix—including the ADB, the European Union, IMF and the Pacific Technical Assistance Center (PFTAC), and bilateral partners—should also mitigate the risk. The environmental and social risk relates partly to Fiji's exposure to natural disaster that could delay reforms and hamper achievement of results, and to potential adverse unintended environmental costs of promoting private investment, including attracting more FDI. Private investment is likely to be concentrated in sectors with sensitive ecosystems, such as tourism, agriculture or mining. Investment in these sectors also tends to be more vulnerable to extreme weather events. The risks are mitigated by several of the supported reforms such as strengthening building standards and raising environmental levies to help reduce environmental externalities and raise revenue to finance climate adaptation and mitigation investment. Improving coordination across agencies involved in the approval of construction permits and business licensing should also help the enforcement of existing regulations. Additional environmental and social assessments could be encouraged as part of the ongoing dialogue of the government and development partners.

VII. Poverty and Social Impacts and Environment Aspects

Poverty and Social Impacts

The policy actions supported by the proposed operation are expected to have a positive impact on poverty and vulnerability. Under the first pillar, increasing the personal income tax threshold is expected to benefit the lowest-income households by reducing their tax burden. It is also expected to benefit more women wage earners, who tend to work in lower-paying jobs and whose average estimated earned income is less than 40 percent of men's. Raising duties on alcohol and tobacco could have a mixed impact on poverty: on the one hand, taxes on cigarettes and alcohol are regressive and likely to hit the poor hardest. On the other hand, because people on lower incomes are more sensitive to price increases, they are more likely to alter their consumption behavior by either quitting or reducing their consumption and, therefore, more likely to improve their health. Moreover, the increased tax on alcohol holds promise for reducing the prevalence of gender-based violence in Fiji, where the proportion of women experiencing physical or sexual abuse by their husband or partner remains among the highest in the world. International evidence shows that drinking, especially binge drinking by men, increases both the frequency and severity of partner abuse, and that policy interventions to reduce alcohol consumption, including taxation of alcohol, contributes to reducing intimate partner violence. An increased tax on alcohol and tobacco also supports Fiji's National Gender Policy (2014), in particular its commitment to the reduction of domestic violence, child abuse, and road deaths. Raising environmental levies is expected to raise revenue to finance projects to enhance climate resilience, which would disproportionately benefit the poor who tend to be more exposed to climate-related shocks, have less financial assets to respond, and take longer to recover. Under the second pillar, reducing the cost of starting a business and dealing with construction permits is expected to have an indirect positive impact on the poor through an improved investment climate, stronger private sector growth, and a greater availability of more and productive jobs. Cross-country evidence suggests that there is a positive association between employment growth and the distance to frontier score as measured by Doing Business, although the results cannot be interpreted as causal. Cross-country evidence also suggests that reforms in the areas of starting a business, among others, can be particularly beneficial to employment creation. A more efficient building permits process can also encourage employment creation by stimulating construction activities, which tend to benefit lower-skilled workers.

Under the third pillar, strengthening the building standards is expected to help poor communities access disaster-resilient shelters (for example, hospitals, critical infrastructure services in high-risk areas, and schools that also serve as community evacuation centers) in the event of natural disasters. The poor tend to benefit more from such shelters, because they tend to live in less secure housing in more hazard-prone areas.

Environment Aspects

The policy actions supported under the proposed operation are not expected to create significant negative impacts on Fiji's environment, natural resources or forests. The policy actions relating to the simplification of the tax system, lowering of the tax burden on low-income households, improving the management of contingent liabilities, and revising Fiji's arbitration law in line with international conventions are expected to have little direct environmental impact. The policy actions relating to increasing environmental levies and introducing a 10 cents charge on plastic bags, on the other hand, are expected to have direct positive environmental impacts, both by raising revenue to finance Fiji's large investment needs for climate adaptation and by mitigating the environmental externalities from increasing consumption of plastic bags. The policy actions relating to strengthening the building standards are also expected to have a positive impact on the environment by improving the sustainability of buildings, reducing the demand for timber and forest products, and providing communities with access to more disaster-resilient shelters in the event of natural disasters. To achieve the level of resilience required, it is likely that more modern building materials such as concrete, bricks and steel will be more widely used. Fiji has a long record of constructing buildings with these materials and has established systems to manage any environmental impacts and maintenance issues associated with these materials. The policy action relating to reducing the time required to obtain a building permit for non-residential properties will focus solely on administrative processes to increase effectiveness of the necessary bureaucratic steps to improve interagency coordination and reduce duplication and will not involve any reduction in environmental assessment benchmarks or thresholds.

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