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INTERNATIONAL DEVELOPMENT ASSOCIATION

PROGRAM DOCUMENT FOR A PROPOSED DEVELOPMENT POLICY GRANT

IN THE AMOUNT OF SDR 3.3 MILLION
(US$5 MILLION EQUIVALENT)

INCLUDING SDR 1.3 MILLION
(US$2 MILLION EQUIVALENT)

IN CRISIS RESPONSE WINDOW RESOURCES

TO
SOLOMON ISLANDS

FOR THE

ECONOMIC REFORM AND RECOVERY DEVELOPMENT POLICY OPERATION

October 27, 2014

Macroeconomic and Fiscal Management Global Practice
Country Management Unit for Timor Leste, Papua New Guinea and Pacific Islands
East Asia and Pacific Region

Solomon Islands
GOVERNMENT FISCAL YEAR
January 1 – December 31

CURRENCY EQUIVALENTS
(Exchange Rate Effective as of October, 2014)

Currency Unit = Solomon Island Dollar
US$1.00 = SBD 7.14

ABBREVIATIONS AND ACRONYMS

ADB	Asian Development Bank	MMERE	Ministry of Mines, Energy and Rural Electrification
AusAID	Australian Agency for International Development	MoFT	Ministry of Finance and Treasury
CBSI	Central Bank of Solomon Islands	MPS	Ministry of Public Service
CED	Customs and Excise Division	MTDS	Medium-term Development Strategy
CEWG	Core Economic Working Group	NDS	National Development Strategy
CoA	Chart of Accounts	NGO	Non-Governmental Organization
CPS	Country Partnership Strategy	NZAP	New Zealand Aid Programme
CSO	Community Service Obligation	OAG	Office of the Auditor General
DMS	Debt Management Strategy	PEFA	Public Expenditure and Financial Accountability
DPO	Development Policy Operation	PER	Public Expenditure Review
DSA	Debt Sustainability Analysis	PFM	Public Financial Management
EC	European Commission	PMO	Prime Minister's Office
EFRP	Economic and Financial Reform Program	PPG	Public and Publicly Guaranteed
EITI	Extractive Industries Transparency Initiative	PSDI	Pacific Private Sector Development Initiative
FEDU	Financial and Economic Development Unit	RAMSI	Regional Assistance Mission to Solomon Islands
FEMSP	Financial and Economic Management Strengthening Program	RDP	Rural Development Program
GDP	Gross Domestic Product	ROSC	Report on the Observance of Standards and Codes for Accounting and Auditing
GEC	Global Economic Crisis	SBD	Solomon Islands Dollar
HCA	Honiara Club Agreement	SCF	Standby Credit Facility
HIES	Household Income and Expenditure Survey	SDR	Special Drawing Rights
HSSP-TA	Health Sector Support Program Technical Assistance	SIEA	Solomon Islands Electricity Authority
IDA	International Development Association	SIG	Solomon Islands Government
IMF	International Monetary Fund	SISEP	Solomon Islands Sustainable Energy Project
IRD	Inland Revenue Division	SISO	Solomon Islands Statistical Office
ISN	Interim Strategy Note	SIWA	Solomon Islands Water Authority
JRM	Joint Review Mission	SOE	State Owned Enterprise
LDP	Letter of Development Policy	UN	United Nations
MDPAC	Ministry of Development, Planning, and Aid Coordination	UNDP	United Nations Development Programme
MEHRD	Ministry of Education and Human Resource Development	UNICEF	United Nations Children's Fund
MHMS	Ministry of Health and Medical Services		

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Sector Manager: Jim Brumby (through June 30, 2014)
Practice Manager: Mathew Verghis
Programme Leader: Robert Utz
Task Team Leader: Tobias Haque

SOLOMON ISLANDS
ECONOMIC REFORM AND RECOVERY DEVELOPMENT POLICY OPERATION

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The Solomon Islands Economic Reform and Recovery Development Policy Operation was prepared by an IDA team consisting of Tobias Haque (TTL, GMFDR); Luis Alton, (GGODR); Carlos Orton Romero (GGODR); Marjorie Mpundu (LEGES); Stephen Hartung (GGODR); and Samantha Evans (EACNF). The team was supervised by Robert Utz (EACNF); and Anne Tully (EACNF). Overall guidance was provided by Mathew Verghis (GMFDR); and Franz Drees-Gross (EACNF). Peer reviewers were: Satyendra Prasad (GGODR), and Nadia Piffaretti (GFCDR).

SUMMARY OF PROPOSED DEVELOPMENT POLICY GRANT AND PROGRAM

SOLOMON ISLANDS
ECONOMIC REFORM AND RECOVERY DEVELOPMENT POLICY OPERATION

Borrower	SOLOMON ISLANDS
Implementation Agency	MINISTRY OF FINANCE AND TREASURY
Financing Data	IDA Grant; IDA terms; amount: SDR 3.3 million (US$5 equivalent) including 1.3 million SDR (US$2 million equivalent) from the Crisis Response Window.
Operation Type	The proposed operation is a stand-alone Development Policy Grant (DPG), which consists of a single tranche to be disbursed upon effectiveness.
Pillars of the Operation And Program Development Objective.	This stand-alone operation supports continued progress of the Solomon Islands Government's economic reform agenda in the context of a recent major natural disaster. The operation follows a successful programmatic series of two development policy operations, and precedes a possible further programmatic series of operations planned for 2015, following elections in November 2014 and finalization of a new Economic and Financial Reform Plan. The program development objectives of the operation are aligned with the Government's Economic and Financial Reform Program and include: i) improved management of public expenditure and debt; ii) strengthened management of extractive industries; and iii) better conditions for private sector investment.
Result Indicators	<u>Under the development objective (i):</u> i) Proportion of on-lending and guarantees to SOEs endorsed by the Debt Management Advisory Committee increases from 0 percent in 2013 to 100 percent in 2015 ii) IMF/WB Debt Distress Rating does not deteriorate from 'moderate' risk iii) Variance between budgeted and actual scholarship expenditure declines to less than 10 percent in 2015 iv) Gender-disaggregated data on scholarship awards and student performance is available from the Scholarship Management Information System <u>Under the development objective (ii):</u> v) Number of provincial consultations held using data from the EITI report increase to two during 2015 from zero during 2013. vi) Balances and transfers into and from the Mining Royalty Special Fund are reported in annual budget documentation. <u>Under the development objective (iii):</u> vii) Information on all urban land transactions as approved by the Land Board is publicly available.
Overall risk rating	Substantial
Operation ID	P149886

IDA PROGRAM DOCUMENT FOR A RECOVERY FINANCING DEVELOPMENT POLICY GRANT TO SOLOMON ISLANDS

1. INTRODUCTION AND COUNTRY CONTEXT

1. **The proposed operation supports continued progress against Government's economic reform agenda in the context of a recent major natural disaster.** Honiara experienced major flooding with substantial social and economic impacts in April, 2014. The operation will play a vital role in supporting continued policy attention to pressing fiscal management and private sector reforms while also providing fiscal resources to support recovery efforts. The funding provided through this operation complements direct disaster relief and recovery support provided by the Bank and other donors.

2. **The operation builds on a previous programmatic series of DPOs, also aligned with Government's Economic and Financial Reform Program (EFRP)**. Preparation of a subsequent series of operations may follow elections in November 2014 and a refocussing of the Government's EFRP towards fostering broad-based and inclusive economic growth. The proposed operation is a stand-alone operation to provide rapid financing support in response to the natural disaster, while allowing time and flexibility for preparation of a substantive medium-term reform program, which can be supported by a possible subsequent programmatic series of DPOs. The operation has been developed in close consultation with the Core Economic Working Group (CEWG) – a government/donor coordination mechanism supporting multi-donor budget support and economic dialogue around key reform priorities in the EFRP. The proposed amount for the operation is SDR 3.3 million (US$5 million equivalent), including SDR 1.3 million (US$2 million equivalent) in Crisis Response Window Resources.

3. **Solomon Islands is a fragile, post-conflict small island state.**[1] Solomon Islands has an ethno-linguistically diverse population of about 550,000, dispersed across 90 inhabited islands and one of the lowest population densities (18 persons/km2) and urbanization rates (17 percent) in the world. The majority of the population remains reliant on subsistence agriculture. A low-level conflict between 1998 and 2003, known as "the tensions" brought the formal economy and many state functions to a halt, causing a 40 percent decline in GDP**.** An Australian-led and financed regional peacekeeping mission, the Regional Assistance Mission to Solomon Islands (RAMSI), stopped the violence and rapidly restored law and order, and other basic state functions, particularly in finance. The country has subsequently enjoyed a fairly good security situation, interrupted only by short-lived but destructive riots in 2006, concentrated in the capital Honiara. Continued long-term efforts will be needed to address the root causes of the tensions,

[1] Comparator countries include the Federated States of Micronesia, Fiji, Kiribati, Marshall Islands, Papua New Guinea, Samoa, Timor-Leste, Tonga, Tuvalu, and Vanuatu.

which include over-centralization of decision-making in Honiara, uneven access to services and economic opportunities, conflicts over land tenure in the context of inter-island migration, and poor links between indigenous and imported political systems.

4. **The operation will utilize an existing process for coordination of economic and financial reforms.** Since the Global Economic Crisis (GEC), Government has made substantial progress against a program of economic and public financial management reforms, supported by an IMF Extended Credit Facility and multi-donor budget support. Dialogue around economic reforms has been coordinated through the CEWG, which was established during the GEC and includes the Solomon Islands Government (SIG), the Central Bank of Solomon Islands (CBSI), Australia, New Zealand, the Asian Development Bank (ADB), the European Union (EU), and the World Bank. For several years, the CEWG has provided a forum for discussion for the EFRP which identifies priority reforms. The World Bank's previous series of operations supported progress against vital reforms included in the EFRP, including those related to: i) increased budget transparency; ii) increased public participation and feedback in budget formation; iii) reforms to public financial management systems to improve budget execution; iv) legislative reforms to improve processes for the granting of tax exemptions; and v) restructuring of State-owned Enterprise (SOE) debt to facilitate improved financial management.

5. **The proposed operation will support continued reform progress in three areas under the EFRP.** The operation will ensure continued momentum with reform in a post-disaster context where policy attention and reform capacity might otherwise be distracted. Under 'improved management of public expenditure and debt' the operation will support: i) policy changes guiding the provision of guarantees and on-lending to SOEs; and ii) administrative measures to control scholarship over-expenditure and ensure a clear and transparent process for the awarding of tertiary scholarships. Under 'strengthened management of extractive industries', the operation will support: i) the submission of Solomon Islands' first EITI Report; and ii) legislative changes to ensure a predictable, certain and equitable mining tax regime. Under 'improving conditions for private sector investment' the operation will support legislative measures to establish a land board to improve governance of urban land.

6. **Extreme poverty is more widespread than in most Pacific countries and there are significant challenges to shared prosperity.** Without accurate PPP conversion factors, poverty incidence using the US$1.25 per day criteria cannot be calculated for Solomon Islands. Analysis of the 2005-2006 Household Income and Expenditure Survey (HIES) based on the derivation of food and basic needs poverty lines suggests that 10.6 percent of Solomon Islanders live in extreme poverty (below the food poverty line). This is higher than in most other Pacific island countries reflecting lower economy-wide per-capita incomes. The 'basic needs' poverty headcount rate was estimated at 22.7 percent. The poverty headcount rate was markedly higher in Honiara (32.2 percent) than in rural areas (18.8 percent). Female-headed households tended to represent a greater share of households in the poorest expenditure deciles, especially in the rural

areas. The Poverty Gap Index, measuring the depth of poverty in Solomon Islands was estimated at 7.5, which is similar to Tonga and Samoa and less than that estimated for Fiji. The Squared Poverty Gap Index, which is a measure of the severity of poverty being experienced, was 3.5 nationally, similar to Fiji, and Tonga. The profile of poverty differs by geography. Peri-urban households around the capital of Honiara suffer from disproportionate levels of poverty, with almost one in three people unable to afford a basic minimum standard of living. In contrast, 19 percent of people in rural areas are poor. Indicators suggest broad improvements in living conditions, with commensurate reductions in poverty, since 2006. Non-extractive real production (one-quarter of which is non-logging agriculture) is estimated to have grown by 17 percent between 2006 and 2013 after accounting for population growth, and urban living costs grew less rapidly than in the early 2000s. The Gini coefficient of 0.39 is lower than most countries at similar levels of income, with inequality slightly higher in rural areas (Gini of 0.32) relative to urban areas (0.30). Census and other survey data show large disparities in access to employment opportunities, justice, infrastructure, and social services between urban and rural populations and between provinces. Analysis of provincial data suggests that provinces with the highest proportion of poor households are either those which are most remote or are the most densely populated. A new HIES was carried out in 2012 and analysis is expected to be completed by the end of 2014.

7. **Gender inequality remains a serious issue in Solomon Islands.** Gains have been made in educational access, with about 95 girls now attending primary school for every 100 boys - but this drops away to about 80 girls for every 100 boys at the secondary level. Despite some modest improvement in maternal mortality, women's access to family planning services and the capacity to choose the timing and number of children they would like is limited. This is reflected in the high fertility rate (4.2) and relatively low contraceptive prevalence (35 percent). This has an impact on the work, study and other life choices women can realistically make. While women have historically played important roles within the family and community and in dispute resolution during the tensions, participation in formal institutions and employment is low. An estimated 54.3 percent of women over 15 are 'economically active,' but are concentrated in informal businesses, such as selling cooked food, handicrafts, or running micro-businesses, such as kiosks. Only 38 percent of public service positions are occupied by women, of which only 12 percent are senior positions. Women play a significant role in agriculture, but have less access than men to formal agricultural extension services. Gender based violence is endemic, with the most authoritative survey suggesting that almost two thirds of women had suffered some form of violence. Formal services to support women in such situations are limited and often difficult to access.

1.1 THE HONIARA FLOODS

8. **Recent flooding has imposed major social and economic costs.** During early April, floods in and around Honiara led to at least 23 deaths, impacting 52,000 people, and leaving

more than 10,000 people in evacuation shelters. Flooding caused widespread destruction of businesses, houses, and public infrastructure. Private sector and public service activities were heavily affected. Total damage and losses from the flooding are estimated at US$108 million or 9.2 percent of GDP, with projected growth for 2014 revised down to 0.1 percent from pre-flood baseline projections of around 4 percent.[2] Major economic impacts arose from the flood-precipitated closure of the Gold Ridge mine, which accounted for 2.5 percent of output and 6 percent of recurrent revenues in 2013.

Table 1: Summary of Damage and Loss Assessment (SBD millions)

Sector	Total Damage (SBD millions)	Total Loss (SBD millions)	Total Damage & Loss (SBD millions)	US$ Equivalent (USD millions)
Social	**$ 223.37**	**$ 16.72**	**$ 240.09**	**$ 32.88**
Housing	$ 213.22	$ 5.62	$ 218.84	$ 29.97
Health & Education	$ 10.15	$ 11.10	$ 21.25	$ 2.91
Productive	**$ 63.05**	**$ 346.18**	**$ 409.23**	**$ 56.04**
Agriculture	$ 8.80	$ 122.67	$ 131.47	$ 18.01
Commerce	$ 54.25	$ 21.05	$ 75.30	$ 10.31
Mining	$ -	$ 202.46	$ 202.46	$ 27.73
Infrastructure	**$ 95.82**	**$ 41.01**	**$ 136.84**	**$ 18.74**
Transport	$ 87.57	$ 16.11	$ 103.69	$ 14.20
Water & Sanitation	$ 8.25	$ 24.90	$ 33.15	$ 4.54
Total	**$ 382.24**	**$ 403.91**	**$ 786.15**	**$ 107.66**
As a % of GDP	4%	5%	9%	

Source: Solomon Islands Government Damage and Loss Assessment

9. **Flooding is thought to have increased poverty and pressures on social cohesion.** While not yet quantified through formal poverty impact assessment, flooding has had significant negative impacts on the poor and vulnerable through: i) disruption to subsistence and smallholder market agricultural production; ii) destruction of household assets, including housing, especially within informal urban settlements where poverty is concentrated; and iii) reduction in formal and informal employment accompanying disruption of commercial activity and mining (closure of the Gold Ridge mine is estimated to have led to the loss of direct and indirect employment for around 1000 Solomon Islanders). Loss of revenue from the mine (around 6.5 percent of total recurrent revenue) presents challenges to service delivery over the

[2] Growth projections are consistent with IMF estimates. Estimates of the total value of losses differ slightly, however, due to differences in the assessment methodologies applied by the IMF and the World Bank, with the Bank team applying the official damage and loss assessment methodology.

medium-term. Rioting broke out in Honiara in May resulting in destruction of businesses, reflecting widespread frustration among affected communities over the pace of flood response and in the context of high urban unemployment and broader fragility pressures. Pressures on social cohesion may increase if response and recovery efforts are perceived as inadequate. The withdrawal of RAMSI security forces in mid-2013 magnifies the importance of addressing fragility pressures, with local police having still limited capacity to respond to major unrest.

10. **Government has worked closely with donors, including the World Bank, in responding to the floods.** At the request of Government, the World Bank led a rapid assessment of damages and losses, feeding into ongoing detailed sectoral needs assessments. Planning for longer-term recovery is also ongoing, coordinated by a cross-sectoral Recovery Coordination Committee within the Ministry of Development Planning and Aid Coordination (MDPAC). Government has worked closely with donors in the establishment and resourcing of evacuation centers. The World Bank has contributed to the immediate response through refocussing of existing community infrastructure and urban employment-creation programs towards flood-impacted communities. The World Bank has accessed US$10 million of additional resources through the Crisis Response Window (CRW) to assist Government in meeting recovery needs through a combination of project and budget support assistance. The proposed operation will be financed from $2 million of accessed CRW resources, plus US$3 million of regular IDA, all provided as grants. Alongside the proposed operation, the Bank is supporting flood recovery efforts through additional financing to the Rapid Employment Project (labor-intensive road rehabilitation and infrastructure upgrading in urban Honiara) and the Rural Development Project (community-driven development and capacity support to the Ministry of Rural Development).

11. **Government remains committed to its broader economic reform agenda.** The operation will support continued progress with an existing program of economic reforms in a post-disaster context where reform momentum could easily be lost. Experience in other Pacific island countries has highlighted the potential for natural disasters to distract scarce capacity and policy attention from vital reforms, leading to loss of momentum and backsliding in important areas. Conscious of this risk, Government has requested that the operation focus on planned economic and financial management reforms to ensure continued momentum through the recovery process. The operation will provide much-needed financing to meet immediate recovery needs, with Government now facing a deficit (of around 1.6 percent of GDP) in 2014 and with limited scope for reprioritization within existing budget allocations to meet recovery and reconstruction needs.

2. MACROECONOMIC POLICY FRAMEWORK

2.1. RECENT ECONOMIC DEVELOPMENTS

12. **The economy of Solomon Islands is reliant on aid and natural resource extraction and heavily exposed to external shocks.** Solomon Islands is one of the poorest countries in the Pacific with per capita GNI of US$1,610. The majority of Solomon Islanders continue to live in rural areas and rely on subsistence production. Formal economic activity is centered around the Honiara service economy, which is heavily reliant on aid spending. Since the end of the tensions in 2003, aid flows have averaged around 30 percent of GDP. Logging accounts for 16 percent of GDP, but generates relatively few employment opportunities with no significant onshore processing. Gold mining at the Gold Ridge mine resumed in 2011 following closure during the tensions, with production accounting for 5 percent of output in 2013. However, the mine was abruptly closed after the floods in April. There is uncertainty as to whether and when mining will resume.

13. **Following three years of strong performance, growth slowed to 3 percent in 2013.** Timber and gold production, key drivers of growth in 2010, 2011 and 2012, were markedly lower in 2013, with annual production 3 percent and 13 percent below 2012 volumes, respectively. The decline in timber production over the year reflected a mixture of lower prices, adverse weather conditions, and possible stock depletion. The large contraction in gold production over the year was due to ongoing disputes between the mining operator at Gold Ridge mine and landowners disrupting production, the depletion of the mine's most productive pits, and illegal mining. Declines in main export sectors were partially offset by increased production in response to strong world prices for cash crops, including coconut and cocoa. Fisheries' production was another important exception to the general weakness in externally-focused sectors in 2013, with production estimated to have risen by 20 percent, resulting from a doubling of canning capacity at Soltuna. Formal sector employment growth, of 3 percent during 2013, slowed in comparison with average annual growth of 5.1 percent between 2010 and 2012.

14. **The current account balance returned to deficit in 2013.** Despite the slowdown in the domestic economy, imports increased by 3 percent. The major contributors to the increase in import values were mineral fuels (17 percent), followed by machinery and transport equipment (12 percent), and food and live animals (16 percent). Exports declined by 11 percent. The current account deficit reached 8.4 percent of GDP 2013. The deficit was financed mostly through large foreign aid inflows, with foreign exchange reserves continuing to increase to a new peak of US$530 million in December 2013, compared to US$500 million at the end of 2012. This covers more than 8 months of forward imports, a solid buffer to protect Solomon Islands from external shocks. The exchange rate was fairly stable against most major trading currencies during 2013, with the currency being pegged to a basket of currencies.

15. **Prices remained relatively stable in 2013.** Inflation moderated over the second half of 2013, leaving Honiara consumer prices at the end of the period only 3.1 percent higher than in December 2012. Food prices fell by 1 percent over this period, largely due to lower imported food prices, and many other import prices were also weaker. However, this was offset by the relative strength in domestic prices. With a new legislative mandate to focus on price stability, the Central Bank of Solomon Islands adopted a slightly contractionary monetary policy stance through its open market operations during 2013.

16. **The financial system is sound, although financial depth is limited.** Banks are adequately capitalized, highly liquid, and profitable. After declining for several years, nonperforming loans reached 7.2 percent by the end of 2013, before declining to 4.9 percent in early-2014. At the same time, the ratio of credit to GDP rose to 18 percent by end-2013, which is still only about half of the average for Pacific Island countries. Impediments to credit expansion include weak investor protection, an unclear property rights regime, and a shortage of investable projects.

17. **The government ran a fiscal surplus in 2013, reflecting significant underspending on development projects.** Inland revenue collections, more related to domestic activity, rose to SI$1.68 billion over the whole of 2013, exceeding the budget by SI$40 million, or 2.5 percent. In contrast, customs and excise collections totaled SI$0.80 billion in 2013, under budget by around SI$10 million, or 1.2 percent. This was due mainly to: i) reduced excite tax receipts from tobacco following an increase in the excise tax level; and ii) lower collections of export duties from round logs. Recurrent expenditures exceeded budgeted levels, largely due to higher payroll spending with the "relevelling" of teachers' salaries to incorporate a long-delayed pay adjustment. Notable additional shifts in spending plans throughout 2013 included a rapid growth in payments for scholarships for domestic tertiary study, and in various streams of funds directly administered by individual members of parliament (loosely termed "Constituency Development Funds"). This additional spending was partly funded by redirecting funds allocated to development projects. A supplementary budget amounting to around 2 percent of GDP was also passed in September 2013, mostly to cover commitments to tertiary education scholarships. Due to significant underspending on development projects, an overall budget surplus of 4.4 percent of GDP was ultimately recorded.

Table 2: Selected Economic Indicators

	2011	2012	2013	2014 (est)	2015	2016	2017
Real economy	Annual percentage change, unless otherwise indicated						
GDP (SI$, million)	6,637	7,281	7,946	8,530	9,281	10,209	11,060
Real GDP	10.7	3.8	3.0	0.1	3.5	3.5	3.5
Per Capita GDP	8.4	1.5	0.7	-2.2	1.2	1.2	1.2
Imports (Goods and Services)	11.4	6.7	4.3	6.2	9.3	1.5	-3.8
Exports (Goods and Services)	68.6	14.1	-9.7	-14.3	12.7	-2.0	-2.0
GDP deflator	9.1	5.7	6.0	7.3	5.1	5.5	5.5
CPI (eop)	9.4	5.1	3.1	6.0	6.0	5.5	5.5
Fiscal Accounts	Percent of GDP, unless otherwise indicated						
Expenditures	51.1	51.8	48.2	50.4	49.3	48.0	47.2
Revenues	60.3	55.9	52.6	48.8	48.5	47.6	46.9
General Government Balance	9.2	4.1	4.4	-1.6	-0.8	-0.4	-0.3
Balance of Payments	Percent of GDP, unless otherwise indicated						
Current Account Balance	-6.7	0.2	-8.4	-14.7	-15.5	-14.6	-11.9
Imports (Goods and Services)	69.3	65.2	63.2	62.5	62.8	58.0	51.5
Exports (Goods and Services)	63.3	63.7	53.4	42.7	44.2	39.4	35.6
Foreign Direct Investment	16.0	6.6	9.6	6.1	9.3	9.1	8.7
Gross Reserves (in US$, eop)	393	500	531	488	459	420	441
In months of next year's imports	7.2	8.8	8.8	7.4	6.9	6.5	6.9
External Debt	15.2	13.2	11.6	12.0	12.9	13.6	14.8
Exchange Rate (average)	7.54	7.30	7.40				
Nominal GDP (USD)	880	997	1,074	1,153	1,254	1,380	1,495

2.2. MACROECONOMIC OUTLOOK AND DEBT SUSTAINABILITY

18. **Growth is projected to slow to virtually zero in 2014.** This reflects the impacts of Guadalcanal flooding on commercial and retail activity, disruption to cash crop production, and the discontinuation of production at the Gold Ridge Mine. Flood impacts are expected to be partially offset by increased construction activities associated with privately- and publicly-financed reconstruction efforts. Formal employment is expected to remain flat.

19. **The Central Bank of Solomon Islands (CBSI) continues to closely monitor price impacts of recent flooding.** The floods have led to a spike of fresh food prices in Honiara, which are likely to drive the CPI higher in the short term. Should this price shock persist, monetary policy may be tightened. Most reconstruction work of flood damaged infrastructure is unlikely to start before 2015, which may lead to some continued inflationary pressures. Given Solomon Islands' dependence on imports, prices will be substantially driven by international developments, and particularly the prices of rice, wheat, and oil.

20. **The current account deficit is expected to widen to 14.7 percent of GDP in 2014.** This is partly due to cessation of gold production and lower cash crop exports due to the floods but also reflects the generally weaker external environment. The major medium-term risk to the current account is lower log production due to stock depletion and/or a further drop in prices should Chinese growth continue to slow. On the upside, expected lower oil and rice prices – significantly reducing the value of imports – and an expected increase in palm oil prices should soften some of the pressure on the current account. Strong donor inflows, potentially including additional allocations for reconstruction efforts, will help finance continuing trade deficits in the medium term.

Table 3: Balance of Payments and Financing Sources (USD)

	2013	2014 (est)	2015	2016	2017
BOP financing requirements and sources					
Financing requirements (US$)	-104	-191	-217	-225	-200
Current account deficit	-90	-169	-194	-201	-178
External Debt Service	-14	-22	-23	-23	-22
Financing Sources (US$)	188.3	124.7	174.4	186	198.2
FDI and portfolio investments (net)	105.1	70.1	116.7	122.8	129.4
Capital grants	82.7	32.6	25.7	27.2	28.3
Long term debt disbursements (excl. IMF)	0.5	22	32	36	40.5
IMF credit (net)	0.5	-1.1	-2.8	-4.4	-4.4
Change in reserves	84	-67	-43	-39	-2

21. **Due to the floods, a projected balanced budget (after grants) for 2014 is now forecast to turn into a deficit of 1.6 percent of GDP.** Preliminary estimates of unmet financing need arising from the recent flooding from the National Disaster Management Office (NDMO) have reached US$ 24 million.[3] This estimate is based on detailed sector assessments carried out by specialist teams, with a full reconstruction strategy expected to be finalized and presented to the donor community by the end of the year. Meanwhile, revenues are estimated to fall short of budgeted collections by US$ 21 million (primarily arising from the closure of the Gold Ridge Mine), leaving government with a flood-induced financing gap of US$ 45 million, or 4 percent of GDP. Government is expected to meet a large proportion of recovery needs from reprioritization of existing expenditure commitments, given limited fiscal space for additional expenditure due to the expected decline in revenues and an uncertain medium-term fiscal

[3] Government financing needs are less than total assessed damage because of the large proportion of total reconstruction needs accruing to the private sector, especially in commerce, agriculture, and housing.

outlook. Government cash reserves declined rapidly in the second quarter of FY 2014, prompting the Ministry of Finance to implement expenditure control measures to stabilize cash reserves, including delaying the processing of payment requests for discretionary items from line ministries. These measures remain in place. A recent supplementary budget was passed, authorizing Contingency and Advance Warrant expenditures of around US$15 million. Without additional budget support, cash reserves are projected to fall below the IMF floor of SI$ 411 million.

22. **Significant donor support has been mobilized for reconstruction needs, but often through reprioritization within existing programs**. Around US$25 million of donor support has been mobilized for recovery activities, mostly in transport infrastructure. Reprioritization of donor support towards reconstruction activities takes place against a broader context of declines in grant support – especially in security sectors – as Solomon Islands transitions from post-conflict status. Grants are expected to fall from around 30 percent of GDP in 2010 to just 16.6 percent of GDP in 2015, even with additional grant support for recovery needs.

23. **In the medium term, Solomon Islands faces the challenge of developing new sources of growth in light of a forecast decline in logging and the uncertainty around the exploitation of the country's mining potential.** Unsustainable utilization of forest stocks has proceeded at pace, with logging currently accounting for around 16 percent of GDP and 14 percent of revenues. With accessible logging resources expected to be fully depleted over coming years, the baseline macroeconomic scenario of 3.5 percent growth in the outer-years depends on foreign direct investment of above 9 percent of GDP in the next two years, resumed mining activity, significant donor infrastructure investment, the development of a new fish processing plant, and broader diversification of the economy in the context of public investment in new ICT infrastructure.

24. **This outlook is subject to considerable downside risk, especially in relation to mining.** Future mining developments depend on the development of a legal and regulatory framework conducive to mining, and clear procedures for the acquisition of land for the exploration and exploitation of natural resources. Fisheries offer some medium-term potential for growth and additional revenues if they are sustainably managed. In 2013, Solomon Islands received fisheries revenues in the order of US$23 million. These revenues could potentially be doubled with improvements made to the Vessel Day Scheme that would expand its scope and quality. Onshore processing of fish can provide benefits in terms of jobs and domestic value-addition, but investment typically relies on access to subsidized licenses. In the long-term, tourism could potentially become an important driver of growth but the sector's current marginal role is unlikely to change before significant infrastructure bottlenecks are overcome and land for development can be more readily accessed by potential investors. The proposed Tina Hydropower project may provide some short-term boost to growth through construction activities, with possible medium-term impacts from lower electricity prices. Expected

investments in ICT infrastructure have been delayed, and the impacts of improved ICT infrastructure on overall growth and employment are not well understood in small dispersed island contexts such as Solomon Islands. Overall, an outlook involving lower levels of investment and growth remains possible, with the baseline reliant on a number of assumptions regarding both policy measures and factors beyond Government control.

Table 4: Key Fiscal Indicators (% GDP)

	2010	2011	2012	2013	2014 (est)	2015
Current balance						
Overall balance	6.6	9.2	4.1	4.4	-1.60	-0.80
Total revenues and grants	62.7	60.3	55.9	52.6	48.8	48.5
Tax revenues	28.9	30.0	31.0	31.1	28.6	28.8
Taxes on goods and services	10.4	11.3	11.3	11.1	10.70	10.9
Direct taxes	11.6	10.1	10.8	11.8	10.90	11.3
Taxes on international trade	6.9	8.6	8.9	8.2	7.00	6.6
Other taxes						
Non-tax revenues	3.1	3.2	3.9	3.7	3	3.1
Grants	30.7	27.1	21	17.8	17.2	16.6
Expenditures	56.1	51.1	51.8	48.2	50.4	49.3
Current expenditures	28.2	25.6	28.7	28.3	29.3	28.1
Wages and compesation	10.7	9.4	9.5	9.2	9.4	9.4
Interest payments	0.4	0.4	0.2	0.2	0.2	0.2
Capital expenditure	27.9	25.5	23.1	19.9	21.1	21.2
General Government financing	-6.6	-9.2	-4.1	-4.4	1.6	0.8
External (net)	-1.2	-0.7	-1.2	-0.6	1.20	1.8
Domestic (net)	-5.4	-8.5	-2.9	-3.8	0.4	-1.0

25. **According to the 2013 DSA, Solomon Islands continues to face a moderate risk of debt distress, with no change in rating from the 2012 DSA.** Sensitivity analysis suggests that Solomon Islands' debt path is vulnerable to shocks to net non-debt-creating flows and financing terms. A shock to non-debt creating flows that lowers the net current transfers and net FDI 2014-15 to one standard deviation below the historical average would lead the PV-of-PPG-external-debt-to-exports ratio to breach the threshold during 2028-2033. A permanent shock to financing terms is defined as an interest rate that is 2 percentage points higher during 2013–33 than in the baseline. Such a shock would keep the PV-of-PPG-external-debt-to-GDP ratio above the threshold starting in 2032 and the PV of PPG external-debt-to-exports ratio starting 2028. The shock scenarios underscore the importance of

caution in external borrowing and of structural reform measures to broaden the export base in a country that is heavily reliant on imports, foreign aid, and foreign direct investment. In May 2014, 73 percent of total government debt was external debt. SOE loans and guarantees accounted for 6.7 percent of total debt. An informal DSA undertaken by the IMF and World Bank teams in mid-2014 showed that borrowing for the Tina River hydro project would not lead to any change in the risk of debt risk distress rating.

26. **The macroeconomic policy framework is considered adequate for the purposes of the operation.** Following recovery from the impacts of the 2009 GEC, the Government has achieved reasonable price stability, continued to reduce public debt, and accumulated significant government cash reserves and foreign exchange reserves to cushion domestic and external shocks. Government was relatively well-placed to deal with the impact of the flooding, but the sustainability of the fiscal position is reliant on the provision of donor assistance in the context of substantial reconstruction needs. Foreign exchange reserves remain at comfortable levels, while Government is taking action to protect cash reserves through the implementation of expenditure controls. Despite prudent policy responses to recent flooding, risks to the baseline outlook are substantial, including further natural disasters, a weakening of the fiscal and external position with the decline in gold production and the impending exhaustion of logging stocks, and the potential for further political instability, especially in the context of widespread dislocation following the recent floods. The macroeconomic outlook is also reliant on expected investments in mining, infrastructure, and fisheries, all of which are subject to significant policy and market risks.

2.3. IMF RELATIONS

27. **The proposed operation reflects close coordination with the IMF.** The IMF recently completed its third review of the three-year Extended Credit Facility (ECF) program for Solomon Islands, which started in December 2012. The ECF program follows the successful completion of two consecutive Standby Credit Facility programs which started in June 2010 and were completed in November 2012. IMF staff concluded that the ECF program was on track with all performance criteria met and satisfactory progress achieved against structural reforms. IMF and IDA staffs have coordinated their advice closely on economic issues and solutions for the Government. IDA relies on the IMF for advice and assistance on issues related to macroeconomic management while the IMF relies on IDA for advice and assistance on issues such as sector strategies, human development challenges, and private sector development. Both staffs collaborate on issues related to fiscal management and are also coordinating closely to provide advice to the Government in its efforts to strengthen public financial management.

3. THE GOVERNMENT'S PROGRAM

28. **Since the tensions, Solomon Islands has incrementally developed a series of**

development plans. A Medium-Term Development Strategy (MTDS) for the period 2008-2010 was adopted by the Government in 2008. A National Development Strategy (NDS) 2011-2020, was adopted in 2011. It builds on the experiences of past development strategies, and upon available analytical work done in recent years by government, donors and other agencies. It was extensively consulted with officials across the government, donors, the Solomon Islands private sector and civil society. In addition, in 2013 the Government produced its first three-year Medium-Term Development Plan (MTDP), which aims to translate the broader NDS objectives into a pipeline of development projects and lead to better planning of the development budget.

29. **The 2011-2020 NDS provides three high-level, over-arching goals.** The first is to increase social and economic opportunities for all Solomon Islanders. This goal is supported by efforts aimed at providing help for the vulnerable, and by providing an equitable distribution of public resources and economic benefits. The second goal is to secure sustainable growth. Supporting activities include facilitating private sector development, diversifying the economy, and improving the management of environmental issues and climate change in particular. The third goal is to maintain stability and peace. This goal is supported by maintaining security, law and order; and by securing regional and international partnerships. These three goals are complemented throughout by a general emphasis on improving the quality of governance. Special emphasis is placed on increasing the efficiency, effectiveness and accountability of public service delivery (notably for policing, health, education and infrastructure) and on ensuring compliance with laws and regulations. To realize these high-level objectives, over 2012 and 2013 the Government has been developing a series of sectoral strategies, which are then linked to individual ministries' corporate plans. These prioritize specific, costed activities, which are linked to a monitoring and evaluation framework. From the various policy goals of the NDS, as implemented through the sectoral strategies and ministries' corporate plans (especially MoFT and Ministry of Development Planning and Aid Coordination (MDPAC)), key policy actions are assembled into the EFRP through the consultative CEWG process. Through this process, policy actions expected to have a strong impact on improving key development outcomes, especially through more effective use of public resources, and where reform champions value links to budget support, are prioritized. From the EFRP, the World Bank identified a multi-year program of policy actions that align with its Country Partnership Strategy, and that complement the reforms supported by other CEWG development partners.

30. **The NDS benefited from stakeholder consultations conducted by MDPAC on behalf of the Government as part of the preparation process.** The consultations included cabinet ministers, parliamentarians, non-governmental organizations (NGOs), members of civil society, the private sector, cooperative associations, local authorities, religious leaders, development partners and beneficiary groups.

31. **Public consultations involving gender-specific targeting were carried out to inform several actions.** Implementation of EITI has been supported by extensive community

consultation, including with women's groups. Community consultations were also undertaken in relation to the mining tax legislation and the reforms to land legislation. The EFRP is produced through a process of extensive consultation, involving government agencies, development partners, and civil society organizations.

4. THE PROPOSED OPERATION

4.1. LINK TO GOVERNMENT PROGRAM AND OPERATION DESCRIPTION

32. **The proposed grant of SDR 3.3 million (US$5 million equivalent) builds on a previous programmatic series of DPOs and may link to a subsequent series of operations to be prepared in 2015.** The proposed DPO supports continued progress against the Government's economic reform agenda in the context of a recent major natural disaster. Financing provided under the operation will allow government to meet immediate recovery needs without cash reserves declining below a minimum limit established under the IMF program. In the long term, supporting the Government's reform program is vital in ensuring Solomon Islands' ongoing transition from post-conflict recovery to sustainable development as articulated in its NDS. The operation is fully aligned to the Government's EFRP under the CEWG and supports i) improvements in public financial management; ii) improvements in the management of extractive industries; and iii) improvements in the conditions for private sector investment.

33. **Reforms supported by the operation are part of a broader program.** Reflecting important weaknesses in central government institutions during the immediate post-conflict period, the EFRP has historically been focused on public financial management and fiscal management priorities. As Solomon Islands transitions from a post-conflict context, the focus of the EFRP is gradually broadening to include increased focus on structural reforms to support inclusive improvements in living standards and enhanced budget transparency and participatory budget processes. A stronger focus on economic growth will be reflected in the next EFRP for the period 2015-2016, currently being developed by the MoFT. The EFRP process is only one element of Government's overall reform agenda, which also includes intensive reform processes in social sectors under multi-donor Sector Wide Approaches, and an ongoing process for constitutional reform to deliver improved arrangements for the sharing of service-delivery and political representation responsibilities between central government and provinces.

34. **Reforms supported by the proposed operation are vital to ensure continued progress in fiscal management and sustainability.** Establishing on-lending and guarantee policies for State-Owned Enterprises (SOEs) will clarify the conditions under which SOEs are able to access external finance and to which extent the Government can assume contingent liabilities. This will facilitate investments in SOE infrastructure development and maintenance and reduce operating costs, which is vital for broadening access to and improving quality of services. This is especially relevant in the context of the planned Tina Hydro Project, which is

expected to greatly increase electricity generation capacity, therefore boosting growth and shared prosperity. EITI compliance and a transparent and predictable mining tax regime will facilitate poverty reduction and shared prosperity by clarifying revenue sharing obligations and increasing transparency of mining sector revenues and their distribution. These outcomes are expected to increase the resources available to the Government, and to local mining-affected communities, for poverty-reducing programs and investments in public services. Greater transparency is also expected to reduce the vulnerability to conflict associated with mining, and to increase accountability for the use of mining revenues. Improving conditions for private sector investment, through increasing transparency and efficiency in land transactions, is important for both strengthening domestic revenue collection and facilitating private sector led growth and employment creation.

35. **The proposed operation builds on lessons learned from two previous operations in Solomon Islands, as well as other DPOs completed in small Pacific Island Countries.** The proposed operation will be the third DPO for Solomon Islands and its design has benefited from lessons learned from the first two operations. The Solomon Islands experience has shown that sharply focusing on a small number of strategic reforms is the most effective approach in leveraging policy reforms. The team has emphasized Government ownership and extensive consultation in preparing the operation, selecting policy actions that are strategic and ambitious but also realistic within a difficult post-conflict political economy context. The operation builds on broader regional lessons regarding the importance of close donor coordination and shared policy matrices for budget support to minimize duplication of efforts that overstretch Government capacity. Heeding this lesson, this DPO was prepared through the CEWG mechanism, and is fully aligned with the EFRP matrix, including its annual review process.

36. **Reforms supported by the proposed operation reflect the recommendations of recent analytical work and support the WBG twin goals of eliminating extreme poverty and boosting shared prosperity.** The World Bank has undertaken significant analytical work regarding policy priorities for improved living standards in Solomon Islands, including a 2011 economic growth study, and more recent regional work examining growth prospects and priorities for small Pacific Island countries. These analytical products have consistently noted: i) the importance of effective use and management of public resources in economies where the public sector plays an unusually large role; ii) the need for effective regulation of natural resource industries, where Pacific island countries have the capacity to attract investment despite inherently higher cost structures than in larger and better-integrated economies; and iii) the importance of resolving issues around the management of urban land, given mounting pressures of urbanization and the scope for successfully managed urbanization to support realization of economies of scale in the private sector and in public service delivery. These recommendations are reflected in actions supported under the proposed operation. Debt and tertiary scholarship reforms are expected to ensure broad fiscal sustainability and facilitate pro-poor expansions in access to social services. Mining sector reforms are expected to ensure that Solomon Islands captures adequate benefits from prospective mining investments and that transparency and

revenue sharing arrangements facilitate pro-poor investment of mining proceeds. Land reforms are expected to contribute to an improved private sector environment, facilitating job creation and inclusive growth, especially in urban areas where poverty is concentrated.

4.2. PRIOR ACTIONS, RESULTS AND ANALYTICAL UNDERPINNINGS

Improving Public Financial Management

Prior Action #1: The recipient's Cabinet has adopted a policy within its Debt Management Strategy to guide on-lending and the issuance of guarantees to State-Owned Enterprises and provincial governments.

37. **There have been important recent changes in Solomon Islands' debt management framework.** The Honiara Club Agreement (HCA) was signed between the Government and its external creditors in 2005 with the aim of reducing unsustainable and unaffordable levels of public debt (the present value of external debt was equivalent to 75 percent of GDP in 2005, with Solomon Islands categorized at 'high' risk of debt distress under the joint IMF/World Bank Debt Sustainability Analysis (DSA) framework). No new debt obligations were allowed under the HCA and, as a result of both debt relief from its creditors and Government's debt repayment efforts, debt sustainability indicators improved dramatically. In 2011, a joint IMF/World Bank DSA upgraded Solomon Islands' debt distress risk rating from 'high' to 'moderate'. Subsequently, the HCA was reviewed in 2012 to enable new Government borrowing on concessional terms and for high-return investments of national importance. Reflecting revised terms of the HCA, Government has developed a new Debt Management Framework - comprising the Public Financial Management Act (2013) and the Debt Management Strategy (DMS) (2012) – which, while allowing new borrowing, imposes strict annual borrowing limits and requires prioritization of all new borrowing proposals based on expected broader economic and social returns.

38. **New policies to guide on-lending and issuance of guarantees to State-Owned Enterprises is integral to the debt management framework.** SOEs play a vital role in basic service delivery in Solomon Islands (including in the water and electricity sectors) and face large financing requirements to meet service expansion goals.[4] SIG has previously faced significant challenges with unconstrained growth and poor management of SOE debt in the absence of

[4] Only sixteen percent of Solomon Islanders have access to electricity, while 79 percent have access to an improved water source. The World Bank is providing support to improved financial and operational management in SIEA, while Australia is supporting similar institutional capacity improvements in the water authority. This technical assistance will support the utilities in accessing and making efficient use of government on-lending facilities.

explicit policy controls. For example, the Solomon Islands Water Authority (SIWA) had accumulated total debts of SBD 36.7 million by 2010, while Government was forced to provide debt forgiveness and other ad hoc transfers to SOEs totaling SBD 52 million between 2002 and 2009. Actions supported under the previous series of DPOs addressed accumulated debts of SOEs through debt swap arrangements and represented progress towards improved financial management, including through the establishment of explicit community service obligations (CSOs) subsidies to SOEs in the annual budget.

39. **The on-lending and guarantee policies represent further progress towards sound financial management of the SOE portfolio.** The policies will ensure that SOEs can access debt financing for high-value projects while managing risks to central government debt sustainability arising from unconstrained SOE borrowing. Under the new framework, all SOE borrowing will be controlled under the government's debt management framework and associated aggregate debt limits. All new SOE borrowing and issuance of guarantees will count towards overall government debt limits, explicitly reflecting the associated contingent liability to government. New SOE borrowing will be permitted within these aggregate limits, however, providing flexibility for SOE borrowing and issuance of guarantees for projects with broad economic and social benefits, providing that such benefits can be adequately demonstrated through a robust evaluation process under the auspices of the newly established Debt Management Advisory Committee (DMAC) in MoFT. This may somewhat constrain independent management decisions of SOEs but this risk is outweighed by the benefits of constraints on SOE borrowing in a weak governance environment, given a clear implicit Government guarantee for such borrowing.

40. **While ensuring debt sustainability, the on-lending policy does not unduly constrain SOE's access to finance**. While ensuring that all debt is within sustainable limits and economically justified, the policy also includes several provisions to facilitate SOE borrowing for appropriate purposes. These include: i) provision for the incorporation of an interest rate subsidy into a subsidiary loan where projects will deliver broader economic benefits, including identifiable social benefits; and ii) allowance for government to reduce or waive fees on on-lending for projects that deliver broader economic and social benefits. Subsidies to SOEs to meet community service obligations will be maintained in the annual budget, so that essential services coverage of poor and disadvantages communities will continue to increase.

41. **Results –** i) Government provides on-lending and guarantees to SOEs only within sustainable limits as measured by the IMF/WB debt distress rating; ii) Government provides on-lending and guarantees to SOEs only for high-value projects as assessed by the proportion of on-lending and guarantees to SOEs endorsed by the Debt Management Advisory Committee.

Prior Action #2: The Recipient, (a) through its Ministry of Education and Human Resource Development, has implemented revised procedures for the approval of tertiary scholarships,

and (b) through the National Education Board, has approved a new scholarships policy, establishing a clear and transparent policy governing the award of all government funded scholarships.

42. **Overspending on scholarships has negatively impacted budget execution and undermined allocative efficiency.** Spending on scholarships beyond budgeted levels – driven by highly politicized and uncoordinated allocation processes – has led to the Ministry of Education and Human Resource Development (MEHRD) substantially exceeding its overall budget allocation over recent years (by SBD 100 million in 2013, or 15 percent of total recurrent allocations). Overspending in 2013 was largely driven by a policy decision to award scholarships to all students enrolled at the newly established Solomon Islands National University (SINU). Overspending on scholarships has squeezed out ministry spending on other sub-sectors, representing a major distortion of sub-sectoral allocations within ministry baselines and undermining implementation of the National Education Action Plan (NEAP), which sets ambitious targets for early childhood and basic education. This occurs in a context where allocations to tertiary scholarships already account for an excessive share of available sectoral resources.

43. **The Government has been making important progress in improving the management of scholarships and working towards greater allocative efficiency in the education sector.** In the 2014 budget, the Government has taken a more prudent approach to granting of scholarships, reversing the policy decision for universal domestic scholarships for SINU students. Government now funds domestic scholarships only for trainee teachers. Through assistance from the Australian Government, MEHRD is also in the process of upgrading its Student Management Information System to better record new scholarship awards, as well as to validate data on existing students. While problems of overall allocative efficiency and excessive budget allocations to scholarships remain to be fully addressed, establishing systems to monitor and exert control over total tertiary scholarship spending is a vital foundation for broader reallocations of resources within the sector.

44. **Under the proposed operation, the Ministry of Education and Human Resource Development has implemented new procedures for the approval of tertiary scholarships**. In early 2014, the Ministry of Education and Human Resource Development submitted a Memorandum to Cabinet detailing budgeting and resource allocation problems caused by over-expenditure on tertiary scholarships and advising Cabinet of the implementation of new procedures to eliminate external interference in scholarship allocation. MEHRD has since successfully implemented these processes, with approvals more tightly controlled and requiring verification at more senior levels within the Ministry. As a result of this reform, expenditure on scholarships is within budgeted limits for 2014 and the total number of approved scholarships has fallen below the number of places for which budget was allocated. The proportion of total

MEHRD recurrent budget allocation used for tertiary scholarships is expected to fall from 34 percent in 2013 to 25 percent in 2014, freeing up substantial resources to support basic and secondary education.

45. **Under the proposed operation, the National Education Board has approved a new scholarships policy, establishing a clear and transparent policy governing the award of all government funded scholarships.** Building on administrative improvements and measures to curtail outside influence on scholarship awards, the new scholarships policy will replace all previous policies relevant to scholarships and will become the governing instrument for the planning, funding, management and budget accountability of all tertiary education and training scholarships funded by the Government. In particular, the policy: i) provides an overarching framework for the policy's implementation and accountabilities to the Government; ii) provides a strategic direction of the Government and MEHRD for tertiary education supporting economic and social development, including the appropriate role of scholarships in the context of tight overall education resourcing constraints; iii) describes the decision-making process and organizational structures responsible for enacting the policy, including management and administrative arrangements; and iv) provides a monitoring and evaluation framework to ensure that scholarships are provided in an affordable manner, and assess how scholarships respond to labor market needs. The new policy was approved by the National Education Board in August and will become effective following the passage of a revised Education Act, expected in early 2015, after parliament reconvenes following elections.

46. **The new policy is expected to bring important allocative efficiency benefits and contribute to shared prosperity.** New processes will essentially ensure that allocation of scholarships is merit-based and in accordance with established formal procedures, with less scope for political interference. These new processes will include explicit gender equity targets, with 50 percent of scholarships to be awarded to women subject to sufficient applications from appropriately qualified female candidates. To this extent, the reform is expected to benefit women and less advantaged groups. Further, reduction in the proportion of total education sector allocations being utilized in the provision of tertiary scholarships will support increased investment in basic education, delivering disproportionate benefits to the poor. Implementation of this policy will also benefit women by allowing the tracking of allocations, performance, and costs of scholarships by gender through the Sector Management Information System, facilitating tracking of progress against Government's goal of allocating at least 50 percent of tertiary scholarships to female candidates.

47. **Results –** i) Control is established over scholarship expenditure as measured by variance between budgeted and actual scholarship expenditure; ii) Government has sufficient information to monitor achievement of gender targets relating to tertiary scholarships as measured by availability of gender-disaggregated data on scholarship awards and student performance.

Improving Extractive Revenue Transparency

Prior Action #3: The Recipient, through its Multi Stakeholder Group, has submitted its first 'Extractive Industries Transparency Initiative' Report.

48. **Mining is likely to be a key driver of growth over the long-term.** There are opportunities to mine nickel on Choiseul and Santa Isabel islands, and copper and gold on Guadalcanal, Vella Lavella and New Georgia Islands. The seabed surrounding Solomon Islands contains mineral deposits which are rich in copper, gold and zinc, although underwater mining technologies are yet to be tested commercially. The nickel mine on Santa Isabel could export as much as 30,000 tons of nickel per year, valued at US$570 million at June 2014 market prices. Initial development applications were lodged in September 2011. In the longer-term, SIG projects that mining revenues may partially replace revenues currently earned from logging, which is widely expected to decline in the medium-term. Broad-based economic benefits, however, may be limited unless the Government is able to effectively develop and enforce tax and benefit-sharing arrangements (*see Prior Action #4*). If not properly regulated and carefully managed, there is a risk that mining could result in social, cultural and environmental harm to affected communities, with rents captured by a small elite.

49. **The implementation of Extractive Industries Transparency Initiative (EITI) will minimize risks by providing a foundation of publicly available and robust information regarding financial transactions between Government and resource firms.** EITI has proven a successful mechanism internationally for limiting opportunities for corruption and building public awareness of and involvement in decisions around the utilization of natural resource rents. Such transparency measures can play a vital role in ensuring broad, society-wide benefits from resource extraction activities and adequate scrutiny regarding the capture of resource rents and their use. This, in turn, can mitigate the conflict and social cohesion pressures that have been shown to often accompany natural resource extraction activities in fragile, post-conflict states. The previous series of Development Policy Operations supported key steps towards EITI implementation, including all four conditions for candidacy (commitment to work with all stakeholders; appointment of a national EITI Champion (Finance Minister, and subsequently the Undersecretary Economics); establishment of a national EITI Multi-Stakeholder Steering Committee (MSG) consisting of key members of civil society, industry and government; and production and publication of a national EITI Work Plan. Solomon Islands was admitted to EITI candidacy in June 2012. Submission of the first EITI report will represent significant progress with these efforts, with the report to become publicly available once approved by the EITI Board.

50. **The Government's efforts towards EITI compliance have been strongly supported by its development partners.** Implementation support has been provided by the World Bank

and other donors. The World Bank is also supporting civil society capacity building to increase understanding of benefit sharing mechanisms and their role in EITI, potentially including through a specific program developing the capacity of women in mining. Civil society has participated in EITI through the MSG, along with representatives from Government and mining companies. Although the Gold Ridge mine has ceased operations, the MSG has prepared and submitted to the EITI Secretariat the first EITI report covering FY2012 and FY2013. Future mining activities will be required to comply with the existing EITI framework.

51. **Result –** Increased transparency regarding revenues from extractive industries as measured by the number of provincial consultations held using data from the EITI Report.

Prior Action #4: The Recipient's Parliament has passed the Mines and Minerals (Amendment) Act No. 6 of 2014 and the Income Tax (Amendment) Act No. 7 of 2014 which establish a transparent and predictable mining tax regime.

52. **Despite abundant and high quality mineral deposits, the development of mining faces important hurdles in Solomon Islands.** Important capacity and institutional constraints, including an inadequate policy and regulatory framework, currently preclude significant new mining developments. Recent Technical Assistance provided to the Ministry of Mines, Energy and Rural Electrification (MMERE), including by the World Bank, suggests that mobilization of substantial mining investment will require: i) amendments to the Mines and Minerals Act to lengthen the time frame of prospecting licenses, necessary to conduct adequate exploration activities and landowner consultations; ii) preparation and adoption of a National Minerals Policy to provide policy certainty to prospective investors; iii) establishment of a corporatized Minerals Regulatory Authority to overcome the lack of financial, human and material resources in MMERE and the Ministry of Environment, Conservation and Meteorology that has previously hampered the advancement of the Solomon Islands mining sector. Given the breadth of and capacity requirements for these reforms, sustainable development of the mining sector is a medium-term goal with mobilization of substantial new investment unlikely over the short-term.

53. **In the past, ambiguity around benefit-sharing and taxation arrangements for mining activities has also discouraged investment and created risks to government.** In the absence of a unified framework governing mining activities, tax and benefit-sharing arrangements around potential mining projects were negotiated on an ad hoc basis. This presented substantial risks to government, with ad hoc arrangements creating opportunities for corruption and risking negotiation of agreements without adequate time and capacity devoted to ensuring fair distribution of rents. At the same time, the absence of a formal framework introduced important uncertainties for potential investors who faced the prospect of multiple negotiations for resource access, with very uncertain outcomes.

54. **A new tax regime for mining therefore represents a vital complement to EITI**

implementation. As a first step towards creating an attractive enabling environment for new mining investment, Parliament approved amendments to the Mines and Minerals Act, as well as to the Income Tax Act, effectively establishing a new mining tax regime. This framework will ensure adequate public capture of mining benefits and provide certainty to investors. The new mining tax regime principally requires the establishment of a Mining Royalty Special Fund in which all royalties are to be deposited. Subsequently, and depending on what kind of mineral revenue is generated, the new regime provides clear guidelines on what royalties are directly due to land-owners, what portion is due to the respective Provincial Government, and what portion will be included in the Government's consolidated revenue. The new mining tax regime has been formulated with IMF technical assistance. This policy action represents a vital and appropriate first step towards establishing a regulatory environment capable of attracting sustainable mining investment. Ongoing work will be required to further strengthen regulatory agencies and establish institutional frameworks to govern the specific use and management of mining-related fiscal flows. Such work is likely to commence following the identification and further development of specific mining sector projects, with little information currently available regarding the location, scale and expected fiscal impacts of new mining operations.

55. **Results –** An appropriate, transparent, and predictable revenue regime for extractive industries is established as measured by publication in annual budget documents of balances and transfers into and from the Mining Royalty Special Fund.

Improving Conditions for Private Sector Investment

Prior Action #5: The Recipient's Parliament has passed the Land and Titles (Amendment) Act No. 11 of 2014 transferring power to allocate perpetual and fixed-term estates from the commissioner of lands to a new Lands Board.

56. **Access to land is an important constraint to private sector activity in Solomon Islands.** The Doing Business Survey ranks Solomon Islands 172nd of 189 countries in the 'registering property' category. Problems with accessing urban land are commonly cited by businesses as a barrier to operation and expansion, with firms often facing long delays in accessing land and processing transactions of legal title. Constraints to the transaction of urban land are also imposing broader social costs in the context of rapid urbanization. The inability of migrants to access property within Honiara, partly due to weaknesses in systems for transacting titles, is contributing to the rapid expansion of squatter settlements outside town boundaries, posing challenges to service provision and contributing to conflict pressures as settlements spread to customary land. Improvements in the administration of urban land therefore represents a vital priority for private sector growth, job creation, and easing pressures on social cohesion arising from poorly managed urbanization.

57. **Since gaining independence, public lands in Solomon Islands are vested as perpetual estates in the Commissioner of Lands and held in trust for the benefit of the Solomon Islands Government.** A remnant of the former British Protectorate, the Lands and Titles Act provides the Commissioner of Lands with the power to hold and deal with interests in land for and on behalf of the Government, subject to the directions of the Minister of Lands. It is also the duty of the Commissioner to advise the Minister of Lands on land policies. The Commissioner has the power under the Act to grant or transfer estates to any person, and impose conditions on such grants and transfers, and is also able to forfeit an estate, if the owner fails to pay rent or fails to perform any obligation incidental to the estate. The Commissioner reports directly to the Minister of Lands, Housing and Survey. The corruption risks implicit in this arrangement of powerful semi-technical offices (with no supervisory boards or appeal mechanisms) coming directly under ministers were not foreseen by the architects of independence.[5] However, this power and discretion over dealings of public lands has resulted in wide-spread (to some extent substantiated) perceptions of corruption and rent-seeking. The rent seeking opportunities inherent in the arrangement are also widely perceived to be an important driver for long processing times for the approval of transactions.

58. **To address perceptions of corruption and reduce discretion in land dealings, Parliament has passed an amendment to the Land and Titles Act which shifts the responsibilities of the Commissioner of Lands regarding land allocation to a Land Board.** The amended Act dilutes the powers of land allocation accorded to the Commissioner of Lands and transfers these powers to a newly established Land Board. The newly-established Land Board will have full responsibility for all land allocation decisions, including: i) transferring, granting and leasing of estates; and ii) issuance of temporary occupation licenses. Membership of the Land Board is specified in legislation. The Board will have 13 members, only five of which are selected by the Minister of Land. Of these five, one must be selected from a list provided by the Ministry of Women's affairs to represent women's interests. One must be selected from a list provided by the Chamber of Commerce to represent business interests. One must be an expert on land issues. The remainder of the Board is comprised of senior public officials. The transfer of responsibilities from an individual land commissioner to a Land Board is expected to substantially reduce opportunities for corruption, therefore providing certainty to the private sector and reducing delays in processing of land transactions. This action only affects transactions in alienated land (urban centers) and would have no bearing on customary land.

59. **The amendment to the Land and Titles Act will significantly increase transparency of land transactions, further reducing scope for corruption.** Under new amendments, the Land Board is required to provide a yearly report to the Minister of Lands on all land allocated, including: i) the names of all applicants for land transactions; ii) the names of successful

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[5] Williams, Shaun. 2011. Public Land Governance in Solomon Islands. World Bank, Washington, DC.

applicants; iii) the premiums and rentals imposed; iv) the conditions and covenants applied; and v) method of land allocation. This report will be tabled in parliament. The Commissioner of Lands is also required to post the list of successful applicants at a public place, and notify the media of the publication of the list. The Ministry of Lands, Housing, and Survey, also intends to publish this list online, following the establishment of the ministry website, expected to be completed in 2015.

60. **The proposed action is also expected to generate positive revenue impacts.** The amendment mandates that the Commissioner of Lands revise rent for town land every seven years, and rent for other land every fifteen years. Currently, alienated land under the Commissioner of Lands is often rented out at below-market rates, severely undermining government revenue collection. A mandatory review of rents is expected to lead to rents being better aligned with market prices, increasing government revenue.

61. **Results –** Processes for land transactions are more transparent as measured by publication in the Ministry of Lands Annual Report of all information on land transactions approved by the Land Board.

4.3. Analytical Underpinnings

Table 5: Prior Actions and Analytical Underpinnings

Prior actions	**Analytical Underpinnings**
Operation Pillar 1: Improve Public Financial Management	
The Recipient's Cabinet has adopted a policy within its Debt Management Strategy to guide on-lending and issuance of guarantees to State-Owned Enterprises and provincial governments.	IMF and Bank macroeconomic monitoring engagement have consistently identified weaknesses in debt management for SOEs as posing threats to debt sustainability and broader macroeconomic stability.
The Recipient, (a) through its Ministry of Education and Human Resource Development, has implemented revised procedures for the approval of tertiary scholarships, and (b) through the National Education Board, has approved a new scholarships policy, establishing a clear and transparent policy governing the award of all government funded scholarships.	The World Bank public expenditure review and ongoing work on Line Ministry Expenditure analysis has identified poor management of scholarships as a key constraint to improved expenditure management and control.
Operation Pillar 2: Improve Extractive Revenue Transparency	
The Recipient, through its Multi Stakeholder Group, has submitted its first 'Extractive Industries Transparency Initiative' Report.	World Bank analytical work has consistently identified sound management and regulation of natural resource industries as a priority for Pacific island countries, including the 2010 Solomon Islands Source of Growth study, the Pacific Futures work-stream and recent analysis on employment generation in Pacific Island
The Recipient's Parliament has passed the	

Mines and Minerals (Amendment) Act No. 6 of 2014 and the Income Tax (Amendment) Act No. 7 of 2014 which establish a transparent and predictable mining tax regime.	Countries under the WDR2013 work-stream.
Operation Pillar 4: Improve Conditions for Private Sector Investment	
The Recipient's Parliament has passed the Land and Titles (Amendment) Act No. 11 of 2014 transferring power to allocate perpetual and fixed-term estates from the commissioner of lands to a new Lands Board.	The World Bank Sources of Growth analysis and recent work under the WDR2013 work-stream has emphasized the importance of improving urban land administration for economic growth, employment creation, and social cohesion. Increased transparency and reduced transaction costs for transactions or urban land were identified as vital for realizing the potential benefits of rapid urbanization and managing associated pressures on services and social cohesion.

4.4. LINK TO CAS AND OTHER BANK OPERATIONS

62. **The proposed operation is aligned with Country Partnership Strategy priorities and other Bank operations.** The World Bank Group's Country Partnership Strategy for Solomon Islands, covering FY13-17, is structured around two engagement areas: strengthening economic resilience and improving public service provision. These engagement areas directly correspond to the Program Development Objectives of the proposed operation. In addition, the proposed operation will support several specific outcomes specified in the Country Partnership Strategy, including: i) strengthened public expenditure and fiscal management through scholarship policy and debt management reforms; ii) an enhanced regulatory framework for the mining sector through mining legislation reforms; and iii) an improved business climate through reforms to land regulation. The proposed operation aligns closely with broader World Bank Group assistance provided to SIG in achieving EITI accreditation, strengthening public expenditure management, and investment and analytic work focused on economic growth.

4.4 CONSULTATIONS, COLLABORATION WITH DEVELOPMENT PARTNERS

63. **The proposed DPO will complement and leverage the support of other development partners, especially as coordinated through the CEWG.** The specific areas for IDA support have been identified in close coordination with other development partners, aiming for synergy with their respective interventions, and building on IDA's comparative advantage in these areas. The Bank will continue to collaborate closely with these donors during implementation of the government program supported by the proposed operation, especially through the mechanism of the CEWG.

5. OTHER DESIGN AND APPRAISAL ISSUES

5.1. POVERTY AND SOCIAL IMPACT

64. **The measures supported by this proposed development policy operation are expected to have significant positive direct and indirect impacts both on reducing extreme poverty and improving living standards of the bottom 40 percent of the population.** No adverse social or poverty impacts are expected from the actions supported by the proposed operation.

65. **The operation will help mitigate fiscal pressures arising from the need for government to provide vital financing for reconstruction activities included in Government's reconstruction plan.** The Guadalcanal floods have had a disproportionate negative impact on the poor, with extensive damage to housing in informal squatter settlements and to agricultural crops upon which rural populations rely for subsistence. The Government program aims to: i) restore agriculture market links through infrastructure repairs; ii) repair government properties, to restore service delivery to the poor; and iii) implement disaster risk management principles in reconstruction and rebuild fiscal buffers to ensure increased resilience to future shocks. Disruption to services during disasters has been shown to disproportionately impact women and girls due to household responsibilities that rely on availability of water, electricity, education, health and sanitation. Disaster recovery implementation that restores and expands access to services is therefore likely to have a positive gender impact.

66. **Improving the coverage and quality of public services is vital to reducing poverty and vulnerability to conflict.** More effective delivery of public goods and services benefits women and children disproportionately, and is vital to expanding state legitimacy in contexts of fragility. The present operation will help improve service delivery by improving access to finance of SOEs, the providers of key public services including water and electricity, through the new guarantee and on-lending policy. Actions related to regulation and transparency in the mining sector will ensure that adequate fiscal resources are raised from mining investments, providing a vital source of financing for provision of public services in the context of an expected decline in logging revenues. Improving the management of scholarship expenditure is also expected to have positive impacts for poverty reduction, reducing sharply regressive expenditure on scholarships and allowing improved prioritization of education expenditure to basic education. The poor are expected to benefit from increased investment in basic education, including through broadened employment opportunities and increased agricultural productivity. Availability of gender-disaggregated data on scholarship allocations may inform future gender-informed policy reforms to improve women's access to scholarship opportunities.

67. **Land reforms will benefit some of Solomon Islands' most vulnerable.** Land markets in Honiara are currently highly dysfunctional, leading to artificial scarcity and allocation

decisions that frequently benefit the better off. Reforms to legislation governing processes for transaction of urban land are expected to ease access to land in Honiara, presenting several important benefits to the poor. Increased availability of land will facilitate private sector investment and job creation, creating new economic opportunities for the urban poor. At the same time, a more functional land market with fewer opportunities for rent-seeking is likely to reduce costs of residential land and land rents, benefiting the poor and recent migrants to Honiara.

5.2. ENVIRONMENTAL ASPECTS

68. **The specific actions supported by the proposed operation are not likely to have significant positive or negative effects on the Solomon Islands environment, forests or other natural resources.** Solomon Islands has an adequate regulatory framework to manage the impacts of new mining investment. Actions related to transparency in mining could be expected to have a positive environmental impact by encouraging broader civil society engagement and oversight in the mining sector. Land reforms will have impacts only within Honiara municipal boundaries, where most areas have already been heavily developed, with no significant impact on land with high biodiversity values. Proposed reforms will have no impact on zoning arrangements and are not expected to lead to new environmentally destructive activities.

5.3. PFM, DISBURSEMENT AND AUDITING ASPECTS

69. **Fiduciary risks have decreased since the Second Development Policy Operation and are expected to decrease further as implementing regulations for the new Public Financial Management Act are adopted.** However, fiduciary risks remain substantial. Key documents for issues related to the fiduciary aspects of public resource management include the Solomon Islands Public Financial Management Performance Reports (EC, 2008, and 2012), the Solomon Islands Operational Procurement Review (IDA, 2008 and 2012), the Financial and Economic Management Strengthening Program (RAMSI, 2010), and the Public Expenditure Review (IDA, 2011).

70. **The budget is published at the time of initial presentation to Parliament, and is available through the MoFT website and in hardcopy from the ministry.** Budget documentation includes a comprehensive presentation of economic developments and outlook, revenue and expenditure outcomes, policy changes, and spending performance and activities of all ministries. Within-year fiscal performance is reported through the central bank's regular publications, which are available on its website. Further, under the new Public Financial Management Act, MoFT is for the first time obliged to publish a comprehensive mid-year Macroeconomic and Fiscal Update.

71. **The 2012 Public Expenditure and Financial Accountability (PEFA) Assessment found broad improvements compared with the 2008 assessment.** Seventeen of the 31 indicators improved, 10 indicators were stable, and 2 indicators worsened. The two deteriorating indicators were both with respect to the external scrutiny and audit, which largely reflects weaknesses in the parliamentary Public Accounts Committee process and the use of Supplementary Appropriations Acts to legalize within-year reallocations of funds. These issues are being partly addressed with respect to the Office of the Auditor General in the current SIG EFRP matrix and are likely to be further addressed through the revised *Public Financial Management Act* and *Public Financial Management Reform Roadmap*. Other areas of fiduciary risk showed improvement (e.g., indicator 9 on risks from other public sector entities; indicator 17 on cash and debt management; and indicators 18 through 21 on internal controls). Overall, the Bank has judged the Government's commitment to and its performance in implementing the PFM reform program as showing adequate improvement. In this light, additional fiduciary arrangements beyond those already included in the EFRP and Public Financial Management Reform Roadmap – including updated procurement processes, tightened expenditure controls, and strengthened internal and external audit – are not considered necessary for this operation.

72. **In 2013, the authorities substantially completed an update to the Safeguards Assessment which confirms that the central bank continues with its well-established good practices in financial transparency and accountability.** The central bank website continues to publish financial statements prepared and audited in accordance with international standards. A new law for the central bank, enacted in 2012, provides adequate financial and legal autonomy. Improvements are needed in oversight by the Audit Committee and in the internal audit function. The updated assessment also recommended that central bank should publish the audit opinion of its international audit firm along with the audited financial statements for financial year 2012. The central bank has committed to taking the necessary steps to implement the recommendations of the safeguards assessment update.

73. **The operation would consist of a single tranche of SDR 3.3 million (US$5 million equivalent), including SDR 1.1 million (US$2 million equivalent) of Crisis Response Window resources, to be available upon effectiveness.** The proposed operation will follow IDA's disbursement procedures for development policy grants. Once the operation becomes effective, and at the request of the Recipient, the proceeds will be deposited by IDA into an account at the Central Bank of Solomon Islands (CBSI), and on the same day the recipient will deposit an equivalent amount in its local currency budget accounting system. As a due diligence measure, within 30 days of receipt the Recipient will provide a written confirmation to IDA that the amount has been transferred to a local currency account available to finance budgeted expenditures. Disbursement would not be linked to specific purchases. The proceeds of the operation would not be used to finance expenditures excluded under the Financing Agreement. If, after being deposited in a Government account, the proceeds of the operation

are used for ineligible purposes as defined in the Financing Agreement, IDA will require the Recipient to either: (a) apply the corresponding amount to eligible purposes, or (b) refund the amount directly to IDA. No designated account is required for this operation.

5.4. MONITORING AND EVALUATION

74. **Monitoring of the operation will be conducted jointly between the MoFT and donors, under the CEWG.** The MoFT Financial and Economic Development Unit (FEDU) is the main office responsible for monitoring the program and all outcome indicators. FEDU will provide half-yearly reports to the World Bank and other CEWG budget support partners on implementation progress against established timetables and agreed performance indicators. This will be done as part of the reporting process established earlier for the CEWG. The overall reform effort will be reviewed by the Government in close coordination with the World Bank's in-country office and regular Bank missions to ensure continued implementation of the program within an adequate macroeconomic policy framework.

75. **A review of the CEWG process was recently completed.** The review team noted that the CEWG continues to serve a valuable purpose in providing a forum for economic dialogue and focusing policy attention on vital economic and financial management issues. The review team recommended: i) increased focus on actions that will support economic growth and improved livelihoods in future policy matrices; and ii) increased involvement of sector ministries in the CEWG process, including through the establishment of a technical working group comprising technical staff from line ministries and donor agencies to track progress against reform actions and coordinate regarding technical assistance needs.

6. SUMMARY OF RISKS AND MITIGATION

The overall risk rating level for the DPO is substantial.

76. **Macroeconomic.** Solomon Islands is highly vulnerable to external shocks. Macroeconomic disruption arising under several feasible scenarios would distract available capacity and resources from implementation of actions under government's reform program, as well as undermining the impact of these actions on growth and poverty-reduction. Solomon Islands also remains vulnerable to further natural disasters, which could have severe impacts on growth and revenue, or exacerbate existing expenditure pressures, as well as diverting scarce Government administrative capacity towards emergency operations. This risk is being mitigated to the extent possible by strong policy dialogue between development partners and Government on macroeconomic conditions, challenges, and policy responses – including the IMF, which is working closely with Government under the current Extended Credit Facility program.

77. **Political and governance risks**. While there is strong Government support for the current program of policy actions, the reform program includes areas that have previously been subject to political contestation by vested interests in Solomon Islands, including reforms to mining taxation and transparency, enhanced control of scholarship expenditures, and improvements to urban land administration arrangements. Pressures for increased public expenditure, especially through discretionary funds made available to members of parliament (commonly known as Constituency Development Funds) presents some risk to broader fiscal control and alignment of expenditure with national development priorities, in the lead-up to elections. Risks of opposition from special interests are being mitigated through broad consultation around and ownership of reform actions through the CEWG mechanism.

78. **Operational implementation.** Solomon Islands experiences the thin capacity typical of public sectors in small states, with a small number of public servants called upon to implement the many tasks of a Central Government. A range of unexpected events may lead to competing calls on the time of the small number of staff with required technical qualifications and experience, meaning that the reform program cannot be implemented as successfully or as quickly as expected. This risk is exacerbated in the context of upcoming elections, with several senior public servants running for office and policy-makers' electoral responsibilities sometimes reducing time available to support reform implementation. As in other small states, there is substantial turnover in vital public service positions, and there is risk that key capacities required to implement supported reforms may be lost. Dedicated technical assistance from various development partners is being provided across the reform program. But this also presents risks, given possibilities of delays and disruption in the mobilization of required technical assistance beyond government control. These risks are being somewhat mitigated by strong dialogue through which the Government and the development partners have carefully selected a limited number of policy actions that are key priorities to the Government. The Government and development partners have also discussed the implementation requirements for each action at length through the CEWG process, to ensure that expectations regarding the timeframes for implementation are realistic.

ANNEX 1: POLICY AND RESULTS MATRIX

Policy Action	Result Indicator
Improved Management of Public Expenditure and Debt	
The Recipient's Cabinet has adopted a policy within its Debt Management Strategy to guide on-lending and issuance of guarantees to State-Owned Enterprises and provincial governments.	**Result: Government provides on-lending and guarantees to SOEs only for high-value projects** Indicator: Proportion of on-lending and guarantees to SOEs endorsed by the Debt Management Advisory Committee Baseline: 0% (2013) Target: 100% (2015) **Result: Government provides on-lending and guarantees to SOEs only within sustainable limits** Indicator: IMF/WB Debt Distress Rating Baseline: Moderate Risk (January 2014) Target: Moderate Risk (June 2015)
The Recipient, (a) through its Ministry of Education and Human Resource Development, has implemented revised procedures for the approval of tertiary scholarships, and (b) through the National Education Board, has approved a new scholarships policy, establishing a clear and transparent policy governing the award of all government funded scholarships.	**Result: Control is established over scholarship expenditure** Indicator: Variance between budgeted and actual scholarship expenditure Baseline: +101.8 % (2013) Target: <10% (2015) **Result: Government has sufficient information to monitor achievement of gender targets relating to tertiary scholarships.** Indicator: Availability of gender-disaggregated data on scholarship awards and student performance from the Scholarship Management Information System Baseline: Not available (2013) Target: Available (2015)
Strengthened Management of Extractive Industries	
The Recipient, through its Multi Stakeholder Group, has submitted its first 'Extractive Industries Transparency Initiative' Report.	**Result: Increased transparency regarding revenues from extractive industries** Indicator: Number of provincial consultations held using data from the EITI Report. Baseline: None (January 2014)

	Target: At least two (June 2015)
The Recipient's Parliament has passed the Mines and Minerals (Amendment) Act No. 6 of 2014 and the Income Tax (Amendment) Act No. 7 of 2014 which establish a transparent and predictable mining tax regime.	**Result: An appropriate, transparent, and predictable revenue regime for extractive industries is established** Indicator: Balances and transfers into and from the Mining Royalty Special Fund reported in annual budget documentation. Baseline: None (2013) Target: Established (2015)
Improving conditions for Private Sector Investment	
The Recipient's Parliament has passed the Land and Titles (Amendment) Act No. 11 of 2014 transferring power to allocate perpetual and fixed-term estates from the commissioner of lands to a new Lands Board.	**Result: Processes for land transactions are more transparent** Indicator: Information on all land transactions approved by the Land Board publicly available in the Ministry of Lands Annual Report Baseline: No (2013) Target: Yes (2015)

ANNEX 2: LETTER OF DEVELOPMENT POLICY

MINISTER OF FINANCE AND TREASURY

MINISTRY OF FINANCE & TREASURY
P.O BOX 26, HONIARA
SOLOMON ISLANDS

SOLOMON ISLANDS GOVERNMENT

Ref: 459/10/

Date: 26th September, 2014

Mr. Jim Kim
President
The World Bank
Washington DC, 20433
USA

Dear President Kim

RE: Letter of Development Policy

As you are aware, Solomon Islands experienced major flooding during April 2014, imposing tragic loss of human life, extensive damage, and disruption to economic production. The total economic value of the flooding's impact is estimated at SI$787.3 million (US$107.8 million). This is equivalent to 9.2 percent of Solomon Islands' Gross Domestic Product (GDP), which gives an indication of the scale of the flooding. The flooding severely disrupted commercial and retail activity as well as cash crop production, and led to the discontinuation of production at the Gold Ridge Mine. Growth is now forecast to be around zero percent for 2014 (from an initial forecast of 4.0 percent). Revenue is projected to decline by around SBD150 million, while government faces costs of reconstruction activities under a new reconstruction strategy of more than SBD170 million. From an initial balanced budget, Government is now forecasting a deficit of 1.6 percent of GDP for 2014.

The impacts of the flood have been far-reaching. Disruptions to local food production have introduced new inflationary pressures, which our Central Bank is monitoring closely with the possibility of further contractionary monetary policy measures. With the cessation of gold production, our foreign reserves, while still at comfortable levels, are likely to decline in future years.

The recent flooding comes in the context of longer-term challenges. The Solomon Islands economy has long been reliant on logging, which now accounts for around 16 percent of output and 15 percent of government revenues. With natural forest stocks nearing exhaustion, and the Gold Ridge Mine no longer operating, it is vital that we continue to pursue our established program of financial and economic management reforms in order to realize new sources of growth and ensure prudent macroeconomic management during this difficult time.

Mr. President, I wish to assure you that recent events have in no way distracted Government from its commitment to reform. It is clear to all that the Government's capacity to respond effectively to recent flooding was predicated on the availability of substantial fiscal and foreign exchange buffers, built up during several years of strong growth and prudent macroeconomic management. Budget support and other assistance being provided by development partners will also play an important role. We continue to work with development partners in implementing shared priority

Telephone: (677) 21058 Website: www.mof.gov.sb Facsimile: (677) 27855

reforms listed in the Economic and Financial Reform Program, overseen by the Core Economic Working Group (CEWG) which the World Bank is also an active member. The CEWG have a shared understanding that such reforms can contribute to our ability to both improve the living standards of Solomon Islanders and increase our resilience to any future shocks.

Our ongoing reform program for 2014 is organized under three themes: i) improved management of public expenditure and debt; ii) improved management of extractive industries; and iii) improved conditions for private sector growth.

Under 'improved management of public expenditure and debt' government has recently achieved several major reforms. A new Public Financial Management Act was passed in late 2013, overhauling the legislative framework for public financial management in Solomon Islands. In 2104, a PFM Reform Roadmap was approved, outlining a detailed and prioritized reform program for further improving PFM systems and processes, and fully implementing the provisions of the Public Financial Management Act. Consultative processes for budget formation have been improved, with provincial level consultations in 2013 being used to inform 2014 budget proposals. A mid-year budget report was prepared and published on the Ministry of Finance and Treasury's website for the first time in July 2014, significantly enhancing budget transparency.

In December 2013 the Government adopted on-lending and guarantee policies as part of the Debt Management Framework. These policies place control around the provision of on-lent loans and government guarantees to ensure that Solomon Islands' debt levels remain sustainable and affordable over the long-term. Finally, the Ministry of Education and Human Resource Development has implemented revised procedures for the approval of tertiary scholarships and the National Education Board has approved a new scholarships policy, establishing a clear and transparent policy governing the award of all government-funded scholarships. This reform will promote improved allocative efficiency in education spending while contributing to overall budget discipline.

Under 'strengthened management of extractive industries', the Multi Stakeholder Group (MSG), coordinated through the Recipient's Ministry of Finance and Treasury, has submitted Solomon Islands' first EITI Report, completing a long process towards full implementation of this international mechanism for financial transparency in the mining sector. Also under this theme, Parliament has approved legislation for a transparent and predictable mining tax regime. The introduction of this regime is necessary both to bring mining investment to Solomon Islands, but also to ensure that the benefits of this investment are widely and equitably shared.

Under 'improving conditions for private sector investment', several important reforms have taken place. Government passed revised Business Names legislation in 2014. The new legislation allows sole traders, partnerships, and companies to operate a business under a registered business name. This has a range of benefits including encouraging businesses to enter the formal economy, fraud detection, protection of a business' goodwill, and tax compliance. A draft Customs and Excise Bill to update an outdated and inefficient Customs and Excise Act is now in its final version and will shortly proceed to vetting. The Solomon Islands National Infrastructure Investment Plan 2013–2023 has now been endorsed by Cabinet and launched. The Plan presents the priorities of SIG and the strategic direction for major initiatives in economic infrastructure over the next five to ten years. This is the first attempt to compile in one document the development needs for the various sub-sectors of economic infrastructure, including energy, land, sea and air transport, water and sanitation, telecommunications, and solid waste management. The Plan presents a prioritized list of infrastructure investment projects and identifies a funding strategy underpinning the priority investments. The Ministry of Development

Planning and Aid Coordination will be the agency responsible for taking the Plan forward and will oversee implementation of the plan. Finally, Parliament has approved amendments to the Land and Titles Act transferring power to allocate perpetual and fixed term estates from the Lands Commissioner to a new Lands Board. We are confident that this measure will bring important benefits in reducing transaction costs and increasing transparency of land transactions, enabling accelerated private sector development.

Government remains committed to the Core Economic Working Group process and the implementation of reforms included in the Economic and Financial Reform Program. We appreciate donor support through this process, especially in response to recent flooding.

We look forwards to working together with our development partners, including the World Bank, in recovering fully from the recent disaster and moving ahead with further growth-enhancing reforms.

Yours sincerely

Hon. Rick Houenipwela
Minister of Finance and Treasury

Telephone: (677) 21058 Website: www.mof.gov.sb Facsimile: (677) 27855

ANNEX 3: FUND RELATIONS ANNEX

INTERNATIONAL MONETARY FUND

COMMUNICATIONS DEPARTMENT

Press Release No. 14/298
FOR IMMEDIATE RELEASE
June 23, 2014

International Monetary Fund
Washington, D.C. 20431 USA

IMF Executive Board Completes the Third Review Under the Extended Credit Facility Arrangement for Solomon Islands and Approves US$0.23 Million Disbursement

The Executive Board of the International Monetary Fund (IMF) on June 20 completed the third review of the Solomon Islands' economic performance under the Extended Credit Facility (ECF) arrangement.

An IMF team visited Honiara, the capital, in May to conduct the third review of the ECF-supported economic program and to assess the impact on the economic outlook of the severe floods that hit in April 2014. The unprecedented floods have undermined economic activity, causing loss of life and widespread damage to key infrastructure, water and sanitation systems, housing, and agricultural output. One fifth of Honiara's population was displaced to shelters. Rural areas around the capital were also heavily affected.

Completion of the third review enables the Solomon Islands to draw an amount equivalent to SDR 0.149 million (about US$0.23 million) immediately, bringing total disbursements under the arrangement to an amount equivalent to SDR 0.594 million (about US$0.92 million).

The three-year ECF arrangement was approved December 7, 2012, in an amount equivalent to SDR 1.04 million (about US$1.59 million), or 10 percent of the country's quota (see Press Release No. 12/479).

Following the Executive Board's discussion on the Solomon Islands, Mr. Min Zhu, Deputy Managing Director and Acting Chair, stated:

"The severe floods that hit parts of the country in April 2014, coupled with the closure of the country's gold mine, have adversely affected the growth outlook and aggravated the challenges that Solomon Islands faces as a small and fragile state.

"While fiscal policy should support economic activity in the near term, reviewing spending priorities is paramount to preserve fiscal discipline, particularly in view of the uncertain economic and fiscal outlook. Part of the fiscal buffer should be used for reconstruction and

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capital projects and to absorb cyclical revenue losses while expenditure on this year's elections should be strictly contained.

"The authorities should sustain their efforts in building sound fiscal institutions. To this end, the forthcoming public financial management roadmap, budget strategy, and mid-year budget review, together with the recent strengthening of debt management, are key in fostering budget discipline and improve budget planning. The pending broader review of policies on tertiary education, in addition to containing the size of spending, is critical for signaling the government's commitment to promote transparency and accountability in the use of public resources.

"Current inflationary pressures are expected to be short-lived. However, the central bank should stand ready to act should credit growth trigger a deterioration of credit quality and demand-driven inflation. While the basket peg is an appropriate exchange rate regime for Solomon Islands, its implementation could be improved through a gradual widening of the operational band and a better alignment of the base rate with the basket peg.

"The financial sector appears sound, and the authorities' efforts to strengthen supervision and regulation—including the forthcoming National Provident Fund Act, Financial Institutions Act, and the Credit Union Act—will help promote financial sector stability and financial inclusion."