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DEVELOPMENT POLICY OPERATIONS IN SMALL PACIFIC ISLAND COUNTRIES: WHAT WORKS?

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Background and purpose: Development policy operations (DPOs) provide quick-disbursing general budget support against a program of critical structural reforms in areas of sectoral or overall economic policy. DPOs have become a central platform of the World Bank's engagement with small Pacific island countries (PICs). DPO series are now underway or have been completed in Samoa, the Kingdom of Tonga, Tuvalu, Solomon Islands, Marshall Islands, and Kiribati, with 15 DPOs disbursed since 2010. Special characteristics of small PICs mean that DPOs can be especially effective in supporting economic reform programs, but implementation can also face particular challenges arising from thin capacity and difficult political economy typical of such contexts. The intention of this note is to share knowledge and experience gained from previous DPOs to inform ongoing and future DPO engagements.

Small Pacific island countries face common development challenges, often to extreme extents.

Small populations (ranging from 530,000 in Solomon Islands to less than 10,000 in Tuvalu) and the small absolute size of the public sector lead to particularly severe capacity constraints and a shortage of specialized skills within the public service. Functions that would be performed by a team in most countries are sometimes undertaken by a single individual. In Kiribati, for example, a single officer within the Ministry of Finance has responsibility for monitoring, reporting on, and overseeing asset managers for the nation's Sovereign Wealth Fund (which holds assets worth more than 200 percent of GDP). The agency responsible for women's affairs in Tuvalu has a single part-time employee. Pacific island public sectors frequently lack specialized skills and sometimes lack even general skills – with one Pacific island public service recently reporting that it did not employ any qualified accountants within central government.

Pacific island countries are among the most aid dependent in the world. Aid as a proportion of GNI ranges from 12.4 percent in the Kingdom of Tonga to 43.5 percent in Solomon Islands. Most small Pacific island countries have very large numbers of projects proportionate to their populations (more than 200 projects were listed in the 2012 Kiribati development budget despite a population of only around 105,000).

With small and undiversified economies, and heavily reliant on food and fuel imports, small PICs are heavily exposed to economic shocks. Natural disasters are also frequent, with annualized losses from natural disasters equal to

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6.6 percent of GDP in Vanuatu and 4.3 percent of GDP in the Kingdom of Tonga, compared to a South-East Asia average of 0.3 percent of GDP.

The governance context varies across PICs, which include four fragile states as well as countries with very strong institutional and policy settings. Governance is complicated by the presence of clientelist politics (Solomon Islands), recurring political instability (Vanuatu), ethnic and linguistic divisions (throughout Melanesia), and complex interaction between formal governance and political institutions and traditional lineage-based power structures (the Kingdom of Tonga, Samoa). Given very small populations, key players and elites are more likely to know or be related to one another, with personal and professional obligations more difficult to disentangle. Due to constraints of small island geography, the state sometimes has a very limited presence beyond the main population centers. Geopolitical factors heavily influence aid allocation decisions across and within countries and the desire to insulate aid from governance problems drives the use of parallel systems and ring-fencing of financing support to line-items, ministries, and sectors.

Development Policy Operations can be effective in driving policy discussion and reform in these contexts for three main reasons:

Multi-donor budget support provides an important avenue for coordination. Discussions around budget support have facilitated development partner/government cooperation on economic reform priorities. By establishing regular and dedicated fora for discussion of budget support, Bank teams have been able to move the policy dialogue beyond sector or project issues and towards broader questions of economic and financial management reform. The transaction burden on thin government capacity has been reduced through use of a single forum in each country.

Budget support provides an effective modality for delivering aid in small PICs. Budget support provides much-needed fiscal space in the context of frequent shocks and a persistent gap between domestic revenue needs. Filling this persistent resource gap through budget support avoids the additional capacity burdens and coordination problems associated with project aid. In heavily donor-dependent contexts, budget support can contribute to improved accountability relationships between citizens and policy-makers, with the government retaining full responsibility for how budget support resources are used.

Multi-donor budget support can get politically difficult reforms across the line. In complex political contexts, the incentive to access budget support can be useful to reformist elements within governments in maintaining broader commitment to and focus upon the implementation of key reforms.

Reform efforts will only be successful if the process is tailored to Pacific realities. Lessons include:[2]

Establishing an economic policy working group where representatives of government and selected development partners regularly meet to discuss economic policy issues has proven indispensable. Such working groups can prove immediately useful in creating an entry-point to discuss major economic policy issues with government, and to coordinate technical assistance between development partners in support of required reforms. The working group can also take responsibility for: i) discussing the policy actions to be used as triggers for DPOs and budget support from other development partners; ii) monitoring and verifying progress against reforms; and iii) coordinating any

[2] The World Bank and development partners recently met in Sydney to agree on Good Practice Principles for multi-donor budget support in Pacific island countries. While there is substantial overlap between those principles and lessons listed in this note, the views expressed here are solely those of the authors.

technical assistance that might be required for their implementation. Such groups are led and chaired by the government. There is no 'best' arrangement for policy dialogues, which vary in terms of frequency and representation. Having a lead donor represent all development partners is sometimes useful.

A coordinated reform matrix should be adopted by the government and all development partners under the ownership of the joint working group. The coordinated reform matrix can include a small number (8-15) of agreed critical reforms. While all donors may not use all policy reforms included in the matrix as prior actions for budget support, all are listed together in a single document, providing a unified basis for discussion. This approach ensures discipline and transparency in identifying budget support triggers, with all parties aware of what needs to be done by when, and the full extent and ambition of the reform agenda. Problems arising from multiple development partners developing multiple competing reform matrices can be avoided. At the same time, development partners retain flexibility to choose which actions they wish to negotiate for inclusion in the matrix and for which they will mobilize budget support.

Example: the Kingdom of Tonga's initial experiences with budget support led to confusion and frustration. With very thin capacity, the government was unable to fully complete the more than 40 policy actions separately identified by different development partners as conditions for budget support within a single year, leading to late and incomplete disbursement of expected budget support. Fragmentation of policy actions was driven by a lack of coordination between development partners, with each pursuing policy actions related to their specific priorities. Through closer cooperation, the World Bank was able to work with the government and other development partners to develop a coordinated policy matrix with only 10 policy actions. Able to focus policy attention and capacity, Government completed all actions with budget support mobilized in the following year.

Alignment between technical assistance, project engagements, and budget support triggers is vital. Technical assistance is often vital to support implementation of selected reforms, and the DPO implementation budget should be sufficient to cover such needs. Consistent with a spirit of mutual accountability, government and development partners can identify technical assistance requirements and plan to ensure that technical assistance needs can be met in a timely manner even as policy matrices are being negotiated.

Balancing clarity against flexibility is important when capacity is thin and shocks are frequent. Development partners and the government should be explicit as to: i) what actions mobilize budget support; ii) how progress will be assessed and verified; and iii) how much budget support will be provided, and to what timeframes. Events beyond the control of the government will sometimes delay or constrain reform progress in contexts where: i) capacity is thin; ii) development partner technical assistance is often relied upon to support critical reforms; and iii) there is extensive exposure to natural disasters and external economic shocks. Development partners need to have the flexibility to take such events into account when making decisions on disbursement while maintaining credibility and clarity. Dialogue with the authorities should include an explicit discussion of the main factors that could jeopardize budget support operations, as well as exogenous developments that could warrant flexibility. Open and frequent dialogue is vital. It is also important that the program document (especially for the first operation in a programmatic series) flags the risks associated with PIC contexts and clearly specifies the possibility and conditions under which policy actions might need to be adjusted.

Example: In several PICs, World Bank DPOs have supported reforms related to the privatization of SOEs, including hotels, shipyards, and telecommunication utilities. In some cases privatization processes supported by DPOs have failed due to inadequate private sector interest, despite governments doing

everything they can to support the transaction. Rather than delaying Board dates until transactions are completed, DPO teams have sometimes dropped or revised the relevant prior actions, or delayed them to subsequent operations within a DPO series. Such flexibility has allowed the World Bank to appropriately take account of efforts made in good faith by PIC governments, avoid disruption to the annual budget support cycle and expected budget revenues, and maintain the motivation to complete reforms in other areas where progress is possible within original timeframes.

It is important to support 'problem-driven' reforms rather than 'best practice'. Governments have a strong interest in implementing reforms once they are included in budget support policy matrices. Development partners may receive limited feedback regarding their practical appropriateness or relevance from governments focused on formal implementation within required timelines. Unless reforms are tightly targeted towards addressing specific identified problems or constraints, plans, processes, or laws implemented to fulfill budget support conditions may become inappropriately complex or burdensome, with successful ongoing implementation either unfeasible or requiring disproportionate ongoing allocation of scarce capacity. DPO teams should closely monitor and be aware of the full capacity implications of any plan or policy to be adopted as conditions for budget support, even if these are being developed by other development partners. Ensuring a focus on getting the basics right without imposing an undue capacity burden is essential.

Example: A prior action for a DPO in Kiribati was full implementation of provisions regarding SOE governance and composition of SOE boards prescribed in newly-introduced legislation. While improving the governance of several large SOEs was a priority for Kiribati, much effort and political capital was burned in ensuring that several small SOEs (which represented insignificant fiscal risks and undertook functions largely immaterial to Kiribati's many pressing economic development challenges) also complied with these provisions. In retrospect, the prior action could usefully have reflected a problem-based approach, specifying required governance changes in SOEs where substantial problems and fiscal risks existed, rather than requiring across-the-board adoption of good practices.

Conclusion: World Bank DPOs have proven to be a useful mechanism for pursuing economic policy reform in unique small PIC contexts. Experience to date suggests that World Bank influence through such engagements can be maximized by working closely with other development partners, including through use of a joint policy matrix and establishing a formal process for regular discussion of economic reform and budget support between development partners and government. It is also vital to take careful account of severe capacity constraints experienced by PICs through: i) focusing on a short list of high priority policy reforms; ii) allowing flexibility to deal with constraints to progress that are beyond the control of government; and iii) taking a problem-driven approach when selecting and monitoring reforms included in joint donor matrices.

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