



## GOVERNMENT OF KIRIBATI

GoK(12) DPF.2.3

### DEVELOPMENT PARTNERS FORUM

*Tarawa, Kiribati*

25 – 27 June 2012

#### AGENDA ITEM 2.3: PUBLIC FINANCIAL MANAGEMENT AND SOE REFORM

##### Purpose

1. There is an ADB Technical Assistance project (with AusAID funding) covering public financial management and SOE Reform. This paper provides a summary of the progress by the TA under the three main work streams – budgeting and accounting, human resource management within the Ministry of Finance and Economic Development, and SOE reform.
2. This TA is programmed to conclude in March 2013. Continuing support from donors is required to beyond this date to achieve full implementation of the reform programme for SOEs. The SOE sector is causing major financial costs with bailouts over the past three years totalling \$12 million and a further \$10 million likely over the next year. Kiribati has an opportunity to move from the current weak position to a situation where it minimises State risk, and impresses in the region with its reformed commercial state sector. The aim is to have a SOE sector that is properly governed, makes profits, pays its taxes, pays interest on its debt s and is able to pay dividends to Government so there is a return on the funds invested.
3. In addition, related to both the budget and SOE sector, the Government of Kiribati needs to borrow to fund the deficit of the Recurrent Budget and to refinance SOE debt, particularly debt to the ANZ Bank where the bank is calling upon the guarantee. At present the main source of borrowing available to Government and SOEs is the ANZ Bank at interest rates of 11-12%, despite all SOE borrowing being guaranteed. Total debt is around \$30 million and growing at around \$10 million annually. While direct donor support for the Recurrent Budget is an option for reducing the budget deficit, this would not remove the existing debt.
4. There are potential significant savings in interest if the Government is to be able to refinance most of this debt. In addition, at present the Government borrowing is the main lending by the ANZ and is potentially crowding out private sector borrowing.
5. The Government needs expert advice on sourcing debt at a lower cost than provided by ANZ. An appendix to this paper sets out the background and requirements for

assistance with the debt and financing issue.

## **Part A: The Existing Technical Assistance project**

### **Budgeting and accounting**

6. The main aim of this aspect of the TA was to move from a single year Recurrent Budget to a three year budget as part of a Multi Year Fiscal Framework (MTFF). A core element is a financial model that projects both revenue and expenditure for the second and third years of the three year budget. The 2011 Budget (prepared in 2010) was the first with three year budgets. The 2012 Budget also uses the same approach but with refinements to the financial model based upon experience gained in 2011. The 2012 Budget will include the outcome for 2011 – the first time actual results will have been included at the time the budget has been presented to Parliament.
7. The MTFF has become a key tool in the budget process as it demonstrates the impact of budget bids on future deficits and how these might be financed. For example, it shows the potential growth in debt servicing if the deficit is allowed to increase.
8. While the MTFF has been the major achievement of this work stream, it has also included:
  - Capacity building in techniques for projecting the likely outturn for revenue and expenditure and budget monitoring. This has been done for finance staff in ministries as well as within MFED.
  - A review of the centralised accounting system in MFED, which has led to a new ADB TA to support needed improvements.
  - A review of Development Fund budgeting and accounting with recommendations for improvements.
9. The TA will support preparation of the 2013 Budget as well as further improvements to Development Fund accounting and budgeting.

### **Human Resource Management**

10. A comprehensive review was completed of human resource management within MFED. This covered organisational structure, personnel management practices and the need to develop performance management and coaching. MFED implemented some of the recommendations but advised that they required further assistance to implement the majority, as they did not have the necessary skills.
11. As a result, the TA has been extended to provide a HR specialist who will work with MFED management on implementation, especially with performance management

and coaching with the aim of improving both quality and productivity.

## **SOE Reform**

12. SOE reform was initially focussed on a small number of problem SOEs. These were entities that had required financial bail outs. It soon became apparent that there were major problems with the SOE as a whole and that the cost of bail outs was having a significant impact on overall Government finances. Over the past three years, the cost of bail outs has been around \$12 million with potential for a further \$10 million required over the next year.
13. The TA developed a policy statement for SOE ownership, that was approved by Cabinet and used to decide that Kiribati Supply Company Ltd (KSCL) – an insolvent hardware supply business – should be sold. The TA supported the sale process, which was successfully completed in 2011. Preparation for sale generated lessons:
  - Though the company was technically insolvent, there was considerable value in the long term leases of scarce land in prime sites. The sale price was more than sufficient to pay all creditors.
  - Clear identification of assets and liabilities is a pre-requisite for sale.
  - Debt forgiveness by government and agreement for the government to take responsibility for paying creditors reduced uncertainty for purchasers. This probably increased price and meant that the company could be sold, rather than the business or individual assets.
  - Acknowledging the social impact of staff redundancy, government agreed to a policy for minimum redundancy of six months' salary.
14. A SOE Reform Steering Committee (SRSC) was formed and has been a significant factor in the success of the reforms. Its membership pools the expertise of experienced senior civil servants and has provided a link between the TA and Cabinet, provided clear and prompt decisions and acted to clear barriers to progress.
15. In addition to the successful sale of KSCL, the TA has worked on Business Improvement Plans (BIPs) for SOEs that sought bailouts. With the support of the SRSC, any SOE seeking financial assistance is now required to have a BIP that is accepted as being realistic. The policy includes withholding financial assistance until such a plan is approved - a form of "tough love". The TA has been closely involved with this policy and has either prepared or revised SOE action plans to make them realistic. The TA closely monitors implementation of these action plans – a role that will be passed over to the SOE Monitoring and Advisory Unit which is being established and staffed. So far, the SOEs with approved reform plans are implementing them and showing improvements in business results.
16. Examples of reforms resulting from the business improvement plans include:

- Moving from sales on credit (with poor debt collection) to mostly requiring pre-payment. Where credit is given, it is for very short terms and strictly monitored.
  - Improved controls over operations so that loss through theft no longer occurred.
  - Cost reduction including staff levels that appropriately match business volumes. While this has involved redundancies, in the case of a shipyard, some former staff have been rehired on short term contracts when there is construction work.
17. The TA has provided an international expert to act as the General Manager of the Kiribati Shipping Services Ltd (KSSL) for a year. A maritime surveyor has been recruited to provide expert advice on the condition of KSSL vessels, including their safety.
  18. Debt between SOEs and between SOEs and ministries is an issue, with many SOEs claiming that they are owed significant sums by government. The TA has an international expert identifying debt with the aim of a “one-time” clean up, e.g. with set-off of debts and some debt forgiveness, to provide a fresh start. In some cases, debt forgiven may be converted to equity to recapitalise an SOE. After this, both SOEs and ministries would be expected to pay their bills promptly.
  19. Under the TA, local accountants are being hired on contract to work with SOEs to improve their accounting systems and financial reporting. The aim is to have reliable data and financial reports that are up-to-date and enable managers to properly control the business. There is a chronic shortage of accountants which is a factor in why some many SOEs have poor financial systems and are so far in arrears with producing financial statements.
  20. In many ways the reforms so far are just a beginning and all involved agree that much more is required. A SOE Act is needed to set a framework for issues such as Community Service Obligations (CSOs – which are aspects of service that are non-commercial and need to be subsidised to be viable). Financial reporting is still often in arrears and formal planning is still rarely done to an adequate level. Most CSOs are still hidden and have not been properly identified and costed.
  21. The TA is continuing to work on SOE reforms, including the following:
    - Completion of a stocktake of all SOEs leading to a comprehensive report with a recommended “road map” for reform with priorities.
    - Completion of a SOE Bill that would introduce recognised good practice for governance and accountability of SOEs. The Bill has been drafted and is going through a consultation process.
    - Support for the establishment of a SOE Monitoring and Advisory Unit within MFED.
    - Development of a policy for CSOs through a pilot project using KSSL.

- Provision of a shipyard specialist to assist Betio Shipyard Ltd improve management.
- Support for further SOE sales, if these are approved by Government.

## **Conclusion**

22. The public financial management and SOE reform TA has been very successful with many worthwhile improvements. There is a willingness to tackle issues caused by the fiscal pressures caused by the rising recurrent budget deficit and the cost of SOE bailouts. The momentum for reform will need to continue beyond the TA which is due to conclude in March 2013.

## **Part B: Supporting Implementation of SOE Reform**

### **Background**

23. The current ADB TA on Public Financial Management and SOE Reform (supported by AusAID funding) has concentrated efforts on a small number of problem SOEs – with considerable success – and recently completed a stocktake of the sector as a whole as well as drafted a SOE Act. A roadmap for implementation of reform is being developed, particularly for making the SOE Act operational, but also for the determining the best future direction for individual SOEs. A pilot project will be completed on Community Service Obligations, (CSOs) which are loss-making activities that Government wishes to continue to meet social needs, but this will be for only one SOE. Identifying and funding CSOs is an important aspect of SOE reform as it removes a reason for underperformance and means SOEs can then be expected to operate as commercial businesses.
24. Practical implementation of the SOE Act will need to extend well beyond the end date of the current TA. It will also be able to support conclusion of reform for a small number of the problem SOEs. So far, one SOE has been privatised but there is potential for more to be privatised as well as possible Public-Private Partnerships. Support for further transactions will probably be incomplete when the TA ends, though actions may have been commenced for further sales.

### **Issues**

25. The existing TA has identified common problems within the SOE sector. These include:
  - a. Poor financial accounting and reporting so that Financial Statements may be years in arrears and management and Directors are effectively operating “blind” without current reports. The only reliable data may be the bank account balance.

- b. Lack of clear strategy often without strategic or business plans. Even where plans exist, these may be unrealistic and not linked to achievable financial budgets.
  - c. No financial budget or a budget for a single year without forward projections. Budgets are often over optimistic and rarely achieved.
  - d. Non-payment of interest or principal on loans from Government. (Only the Development Bank makes payments.)
  - e. Significant unpaid creditors and substantial accounts receivable that are likely to be uncollectible.
  - f. Significant trading losses by many SOEs, with some technically insolvent.
  - g. Even where an SOE has made profits, some may not pay corporate income tax and none pays a dividend.
  - h. Community Service Obligations (loss making services performed as a social service) are a significant factor for some SOE losses, but these are “hidden” by cross-subsidies and have not been explicitly approved by Government.
26. While not all these weaknesses apply to every SOE, they exist within a significant proportion of SOEs. Overall, it is clear that the sector as a whole is underperforming and Government is not receiving any return on the substantial sum invested. Rather, the sector is a financial burden with the cost of bail outs reducing funding for core Government Services such as education and health.
27. The proposed solutions will include potential privatisation of some SOEs and Public-Private Partnerships for others. In addition, improved governance and monitoring of SOEs is acknowledged as essential, no matter what other reform steps are taken. The proposed SOE Act would put in place formal processes aimed at addressing the weaknesses and create a SOE Monitoring and Advisory Unit (SOEMAU) that would provide expert advice to ministers and Cabinet.
28. The existing TA is assisting with initial establishment of the SOEMAU but SOEs themselves lack the necessary skills to implement the proposed new approach to governance and accountability reporting. These include strategic planning, multi-year budgeting and CSO identification and costing. Improved accounting and reporting will also be required as having current financial data is key to better management and performance. This will need to be supported by having audits completed on a timely basis so that public accountability also improves.
29. Another key aspect for successful SOE reform is to have capable directors who are able to provide governance. The proposed changes include creating a pool of potential SOE directors and then providing them with training and development. It would also be of considerable benefit if a small number of international experienced directors were appointed to SOEs to provide on-job capacity building and to model director behaviour, e.g. on conflict of interest. The international directors could serve on more than one SOE with two-monthly meetings organised for the same week so as

to keep the number of trips down.

## **Recommendation**

30. Donors provide continuing implementation support for SOE reform beyond the term of the existing TA for the following:
  - a. Support for privatisation or Public-Private Partnerships for some SOEs
  - b. Bringing financial statements up-to-date
  - c. Bringing audits of SOE financial statements up-to-date
  - d. Building the capacity of SOE managers for preparation of strategic plans and multi-year budgets so they can prepare realistic Statement of Intent (a requirement under the SOE Act)
  - e. Building the capacity of SOE managers for preparation and costing of requests for Government funding of Community Service Obligations
  - f. Identification of a pool of potential SOE directors and providing them with the capability to provide governance under the SOE Act
  - g. Funding a small number of international directors for SOEs

## LOAN FINANCING

### Background

1. The Recurrent Budget has a deficit and the level of the deficit has been growing. Basically, revenue has not been growing as fast as expenditure. Revenue for the Recurrent Budget is from limited sources with almost half from fishing licences. With 90% of this denominated in US dollars the strong rise of the Australian dollar against the US dollar has reduced fishing licence income. Most other revenue is import duty and income tax. Personal income tax growth depends upon employment growth. Currently around 60% is from public sector employees, yet the number of staff has not been increasing.
2. Kiribati has a Reserve Fund, currently valued at around \$570 million and investment income from the fund has been used to partially fund the deficit. With the global financial crisis, investments have fallen in value as has investment income, so financing from the Reserve Fund cannot be increased without reducing the value of the fund for future generations.
3. This has left an increasing portion of the deficit to be financed by borrowing. While Kiribati has received concessional loans from international institutions such as ADB and the European Investment Bank, this has been project based. The only practical source for funding the deficit has been an overdraft from the ANZ Bank at 11% interest.
4. In addition, SOEs in total have borrowed around \$20 million from ANZ. All this is guaranteed by Government. ANZ is calling up debt under the guarantees. The total already refinanced has been \$4.7 million with another \$7.5 million likely in 2012.

### Issues

5. The deficit on the Recurrent Budget is becoming a structural issue. Raising revenue requires growth of the economy as well as a broader tax base, e.g. a Goods and Services Tax (GST). This is planned for the medium term but requires technical assistance for new systems and processes within the Ministry of Finance before a GST would be able to be introduced. An alternative way to increase revenue would be for donors to provide general budgetary support, rather than restricting funding to projects.
6. Reducing expenditure – or at least constraining growth – would require stopping SOE bailouts and cuts to the size of the civil service. Reform of the SOEs sector is planned, but ongoing donor support will be required for the next few years while the reforms are implemented. Any major reduction in civil service expenditure would



need technical assistance from international experts.

7. Refinancing the Government's overdraft with ANZ would reduce the cost of servicing public debt.
8. Refinancing most SOE debt, not just the funds called up under guarantees, would reduce the interest cost to the sector. Having a borrowing pool for SOEs would provide a form of a revolving fund. Payment of interest and principal repayments of the loan pool would potentially come from the following sources:
  - Interest paid by SOEs whose debts had been funded or refinanced by GoK. The interest rate charged should be higher than the rate GoK had borrowed at to take account of the inability of some SOEs to repay.
  - Loan repayments by SOEs whose cash flows allowed this.
  - SOE privatisation proceeds.
9. Discussions on potential refinancing have been held with the IMF and World Bank. The IMF advice has been that their financing facilities would not be suitable as a mechanism for refinancing the debt. The World Bank has suggested that grants would be more appropriate than loans but as Kiribati is already receiving assistance through grants, there is no capacity to provide significant further grants at present.
10. This leaves the option of borrowing from commercial sources. Kiribati has low public debt and has always met its debt service obligations. As it uses the Australian dollar, borrowing should be able to be made in this major currency without exchange rate risk. With the backstop of the Reserve Fund, it is considered that Kiribati should be viewed as an attractive prospect for loans. However, sourcing such loans requires specialised expertise and would need assistance from an international expert. Donor governments will themselves have experts their Ministry of Finance/Treasury (or equivalent) in governmental borrowing.

### **Recommendation**

11. Donors are requested to consider whether they are able to assist with any of the following:
  - a. Grants for general budget support, rather than purely project funding
  - b. Loans to refinance existing debt of Government and/or SOEs
  - c. Expertise to assist source commercial loans