Solomon Islands Government

Medium Term Fiscal Strategy: 2011 – 2016

August 2011 Update

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Forward by the Minister

In August 2010, the Government released the third Solomon Islands Government Medium Term Fiscal Strategy (MTFS) which updated the state of the Solomon Islands economy, the challenges Solomon Islands faced and the Government's plan for meeting those challenges.

The Medium Term Fiscal Strategy commits the Government to two main objectives to ensure that the Solomon Islands is prepared for the challenges it will face over the medium term. These are:

- **Structural reform** to make the Solomon Islands an easy and reliable place to do business and invest and for industries to grow; and
- **An affordable and sustainable Government budget** which limits debt to a manageable and sustainable level, improves the Government decision making processes, and focuses on achieving the development goals of the Solomon Islands.

To ensure that the Strategy remains current, it is updated at least once a year before Budget time. Each update incorporates recent major changes in the economic environment, and includes a summary overview of key productive sectors which can potentially drive growth in our economy. This 2011 Medium Term Fiscal Strategy edition is the August 2011 annual update.

The most significant challenge outlined in the 2010 Medium Term Fiscal Strategy was the expected downturn in the logging sector which was forecast to cause pressure on government revenue collections, restrain economic growth and reduce foreign reserves in the medium term. However, as of mid 2011, logging exports was performing strongly on the back of strong Chinese demand and high international prices. Although current logging exports are very strong and are contributing a significant amount to the growth of the economy, it is still anticipated that from 2012 the supply of logs will become harder to source. The National Coalition for Reform and Advancement (NCRA) Government is facilitating a log stock survey project which will further enhance the Government's capacity to more accurately forecast the remaining stock of logs in the country and their rate of depletion.

The 2011 MTFS maintains a focus on progressing the twin reform objectives of structural reform and sustainable Government Budget, but also adds urgency to this focus. In particular, the NCRA Government will look to work constructively with donors to promote development while providing a basis for sustainable long term growth.

With the commencement of Gold Ridge mine in early 2011, it is expected that from around 2014, once upfront investment costs have been recovered and until the end of the Gold Ridge Mine's production life, revenue is likely to surpass the expenditure growth. Due to the temporary nature of the mine and the one-off high revenue that could be earned, the Government may need to consider putting in place measures to manage the higher revenue flows.

By continuing to plan for the future and updating the Medium Term Fiscal Strategy, the NCRA Government is demonstrating a strong and ongoing commitment to sound financial management and to implementing much needed economic reform for the benefit of all Solomon Islanders.

Hon Gordon Darcy Lilo
Minister for Finance and Treasury

Executive Summary

The 2011 Medium Term Fiscal Strategy (MTFS) is an updated version of the 2010 publication. It is a five-year term strategy from 2011 – 2016 which outlines the progress toward meeting the two main objectives of the government.

- **Structural reform** to make Solomon Islands an easy and reliable place to do business and invest and for industries to grow ; and

- **An affordable and sustainable Government budget** which limits debts to a manageable level, improves Government decision making processes, and focuses on achieving the development goals of the Solomon Islands.

The Medium Term Fiscal Strategy has two sections. The first section outlines the current economic conditions and outlook in the Solomon Islands. The second section covers the Government's economic and fiscal strategies in terms of the economic conditions and outlook. A number of boxes have been included to outline significant developments affecting the Solomon Islands economy.

In 2010, the economy bounced back to 6 ¾ per cent real GDP growth due to an improvement in the global economy which has increased commodity demand and prices, most notably for logs, and boosted growth in the telecommunication, constructions and trade sectors. In 2011, real GDP growth is expected to increase further to 10 per cent driven mainly by the mining sector with the commencement of the Gold Ridge (Allied Gold) mine in early 2011 and the logging sector far surpassing historic export levels. In 2012, growth is expected to fall back to around 6 per cent due to the contraction in logging from these record levels.

Despite improved economic growth in 2011, the fiscal position of the government, while solid, remains fragile reflecting a narrow base economy driven by logging and now gold. While 2011 has been a record year for logging, the industry is expected to decline in the medium term due to the depletion of natural forests. This will add pressure on government revenue, restrain economic growth and reduce our foreign reserves over the medium term.

The Government is therefore acting with urgency in pursuing the objectives in the Medium Term Fiscal Strategy. The Government is committed to new economic reforms and measures to create a sustainable base for economic development. The Government is continuing to engage in the following commitments to meet the challenges ahead and the decline of the logging industry.

1. **Remaining committed to the path of economic reform** by:
    - establishing economic growth centres and rural economic communities in rural areas;
    - introducing cottage industries for food processing in the growth centres through the introduction of appropriate technologies;
    - undertaking infrastructure projects, including the development of a new hydroelectric scheme at Tina River, the upgrade of Munda Airport, onshore fisheries developments, and the upgrade of wharves and roads across the country;
    - restructuring government operations to improve efficiency and effectiveness and sell or liquidate some state owned enterprises; and

- vigorously pursuing the development of the productive sectors especially tourism, agriculture, fishery, agriculture and mining.

2. **Continuing to pursue an affordable and sustainable budget,** which limits debt by:
    - adopting fiscal measures that aim to manage demand in a manner consistent with external viability;
    - strengthening the budget office and reforming budget processes with early involvement of stakeholders;
    - ensuring expenditure grows in line with revenue;
    - tax reforms aimed at raising more revenue and diversifying the revenue base;
    - fully implementing the policy of streamlining processes for exemptions on tax and duty;
    - committing 10 per cent of revenue to debt servicing;
    - refraining from borrowing until debt sustainability targets are achieved; and
    - establishing a medium term expenditure framework.

1. Economic Performance

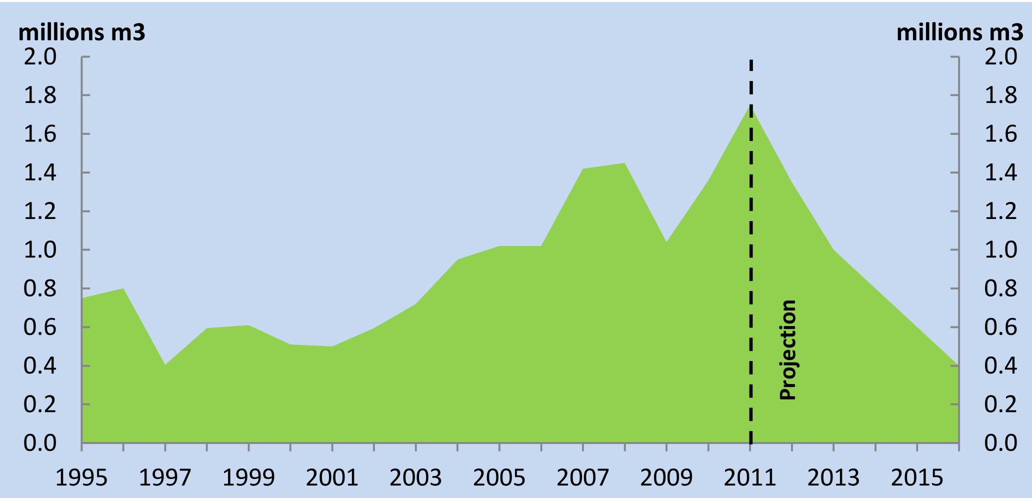
1.1. GDP and GDP per capita

The Solomon Islands economy recovered in 2010 from the negative growth recorded in 2009. In real terms, the economy is estimated to have grown by around 6 ¾ per cent compared to a 4 ¾ per cent contraction in 2009. The sharp turnaround was led by strong logging output. Log export volumes rose by around 30 per cent above the previous year, and around 42 per cent higher in export value. All agricultural commodities except for copra recorded an increase in volume and value during the year on the back of strong global demand and high commodity prices. Improvements in telecommunications, construction (led by Gold Ridge and Bemobile), trade and increased donor inflows have also contributed to growth in 2010.

GDP growth is forecast to accelerate to 10 per cent in real terms in 2011, driven by expansion in the mining sector following the commencement of production of the Gold Ridge mine in March 2011, and significantly increased logging output. Strong global demand for other major export commodities, such as palm oil, cocoa and fish and the general improvements across all the other sectors will also bolster growth.

As shown in Chart 1, logging output is expected to pick up strongly in 2011 to around 1.75 million cubic metres (around 30% above 2010 levels) as log exporters capitalize on historically high international prices and strong demand, especially from China. The jump in logging output reflects re-entry into previously logged areas, an increase in demand for new log species and the entry of additional logging companies.

Chart 1: Volume of Log Exports



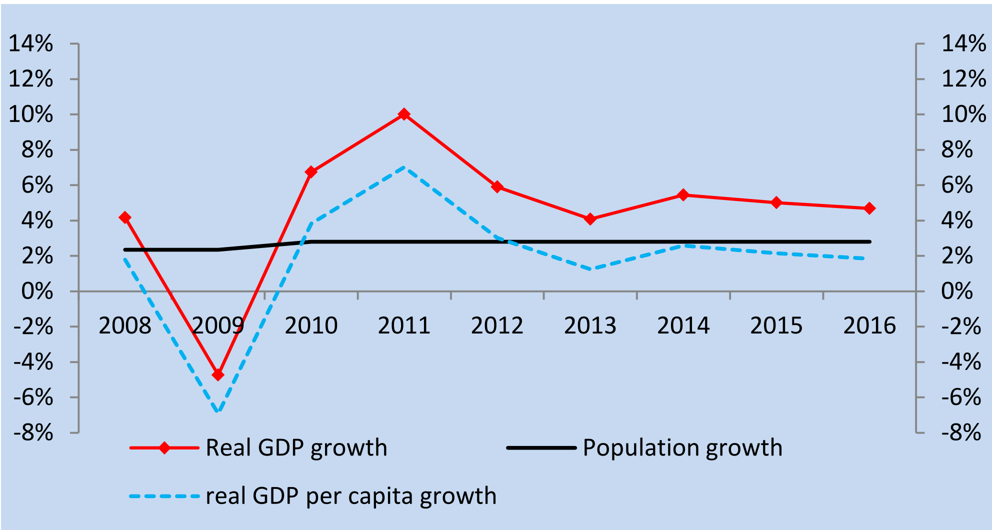
Source: Solomon Islands Forestry Management Project II and Ministry of Finance and Treasury calculations.

Whilst this development will increase GDP growth in the short term, this rate of harvesting is unlikely to be sustainable and will bring forward the expected demise of the logging industry. Log production is expected to decline by around 25 per cent in 2012 and continue to decline at an annual average of around 26 per cent over the next four years. This is expected to bring down real GDP growth to around 6.0 per cent in 2012 and around 4 per cent on average from 2013 to 2016.

On the upside, the resumption of gold production and exports is expected to add significantly to economic growth of around 4 percentage points in both 2011 and 2012. However, from 2013 onwards, it is expected that gold production each year will be steady and therefore, the mine will add very little to growth. The Gold Ridge effects are unlikely to generate significant gains for Solomon Islands outside the directly related sectors, such as trade, construction and other beneficiaries including local employees, landowner groups and communities around the mine. However, Government revenue could be significantly enhanced if the mine were to start making profits (for further discussion, please refer to **Section 2: Fiscal Performance**).

Despite the strong growth in real GDP forecast for 2011 and 2012, Chart 2 shows that the demise of logging and stabilization in output from the Gold Ridge mine will result in real GDP levels hovering just over 4 per cent over the medium term. Given the nation's population growth of 2.3 per cent per year, GDP per capita growth is likely to remain very low indicating that living standards are unlikely to improve markedly in the medium-term.

Chart 2: Real GDP, GDP per capita and population growth



Source: Statistical Bulletin 2/2011, National Statistics Office, Ministry of Finance and Treasury calculations.

1.2. Inflation

Inflation in Solomon Islands remained relatively low and stable throughout 2010, averaging 1.0 per cent (three-months-moving average) as compared to 9 per cent in 2009. This historically low inflation was driven by the lower imported fuel and food prices (both domestic and internationally). Despite the increasing trend in global food and fuel prices during the second half of 2010, overall inflation remained low given the time for global prices to impact locally (around 3 to 6 months reflecting the shipping contract and storage-related lags). Also, many of the global food prices that rose in mid-2010 (mainly wheat and sugar) were not relevant for most domestic households in Solomon Islands as most households rely on locally grown foods.

Since early 2011, inflation has started picking up in early 2011 and accelerated to 7.9 per cent in July 2011, reflecting the rising fuel and food prices in global markets. Over the course of the year, these external price pressures are expected to diminish as food and energy prices are expected to stabilize, resulting in average inflation through 2011 of around 6 per cent. Inflation is also expected to average around 6 per cent throughout 2012.

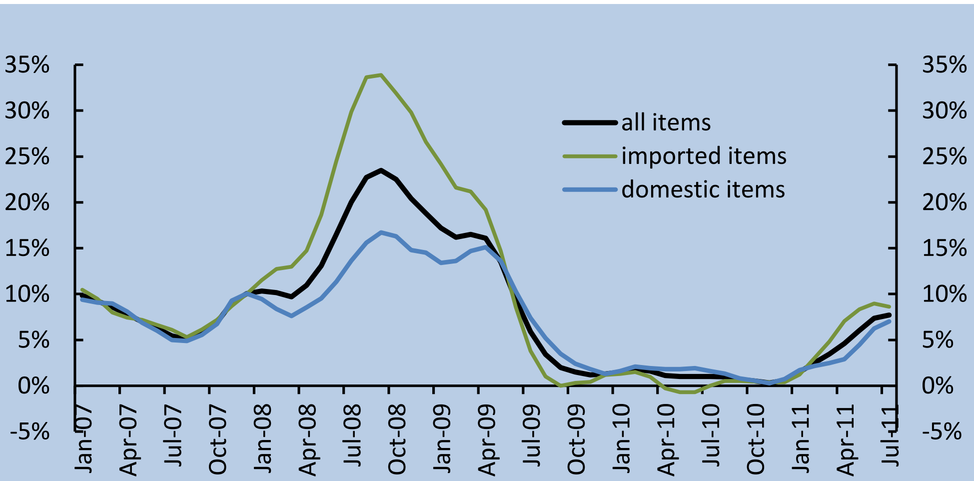
Government fiscal policy (revenue and expenditure) can directly affect the inflation rate. Generally, the more money the Government spends in the Solomon Islands, the higher prices will be. This is because suppliers cannot respond quickly enough to the increase in demand by producing more. With more people competing for the same amount of goods, the suppliers in turn put up their prices in response.

The most inflationary of Government spending is spending on goods and services. If the Government continues to spend more while the supply of those goods and services does not increase, suppliers will increase prices resulting in goods and services becoming more expensive. Sadly, this has the unintentional effect of hurting the poorest people most severely.

The least inflationary Government spending is spending on health, education, and infrastructure. That is because this expenditure actually improves the capacity of the country to supply all of the things people demand. This type of expenditure can actually lower inflation over time.

The economic recovery in the rest of the world is currently leading to higher food and fuel prices and has already fed through into domestic prices. Solomon Islands high dependency on fuel and imported items for production and the lack of immediate substitutes will add inflationary pressures to domestic prices. The high levels of liquidity being built up in the banking system is also a potential risk for inflationary pressure should lending activities pick up as the economic recovery continues. The CBSI has undertaken short term measures to alleviate the inflationary pressures including mopping up liquidity through issuing short-term bills, reducing banks' US Dollar exchange rate margins and appreciating the exchange rate against the US dollar. In the longer term, improving the supply capacity of the country as well as reducing demand for some imports (such as encouraging more efficient use of fuel imports through using alternative energy sources) can help to ensure that resulting pressures on prices are minimized.

Chart 3: Inflation Jan 2007 – Jul 2011 (% change, 3mma)

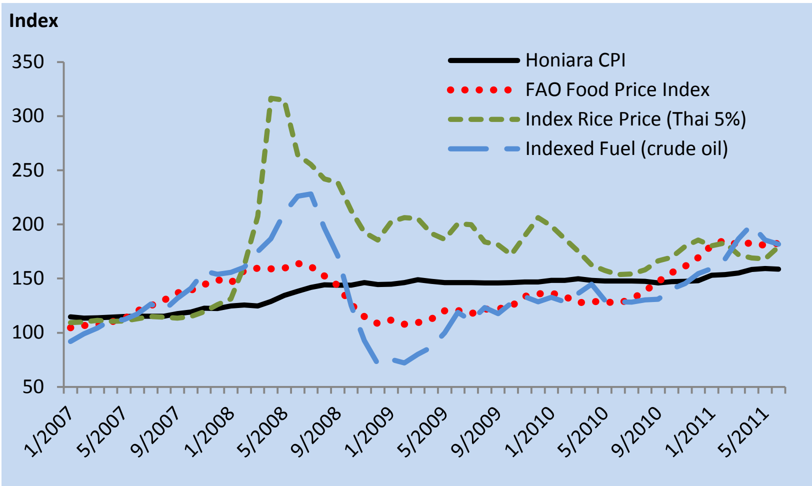


Source: Statistical Bulletin 07/2011, National Statistics Office, Ministry of Finance and Treasury calculations.

BOX 1: RISING FOOD AND FUEL PRICES

Throughout 2011, the Solomon Islands has felt a surge in world food and fuel prices. This has created concerns that prices may again begin to soar (as they did in 2008), foreign exchange reserves may deteriorate and living standards may worsen. The main reasons for the latest surge in international food prices include changes in market fundamentals such as weather-induced supply shortfalls, declining productivity, strong general food demand growth in emerging market economies, higher demand for meat and bio-fuels, tight stock levels, higher fuel, transport and agriculture feedstock prices, and loose monetary policies in some countries.

Chart B1: International commodity prices and Solomon Islands inflation (Index 2005 = 100)



Source: National Statistics Office, World Bank, Food and Agriculture Organization (FAO)

Being a net food importer, the Solomon Islands is vulnerable to rising international food prices. However, its overall effect is diminished because the vast majority (around 75 per cent to 85 per cent) of calories consumed comes from domestically produced food, mostly through subsistence agriculture. In addition, recent international food price rises have occurred in commodities where Solomon Islanders are not large consumers including vegetable oil, sugar and cereals (excluding rice). In contrast to 2008, rice prices have slightly fallen since 2009 and remain relatively flat.

A greater concern comes from fuel prices. Over the past two years, the US dollar price of oil has risen by almost 200 per cent. The dispersed and remote distribution of the population and very limited local production means higher fuel costs will translate into rising transportation, electricity and production costs and a higher cost of living. According to the ADB, the Solomon Islands is one of the most vulnerable countries in the world to rising oil prices.

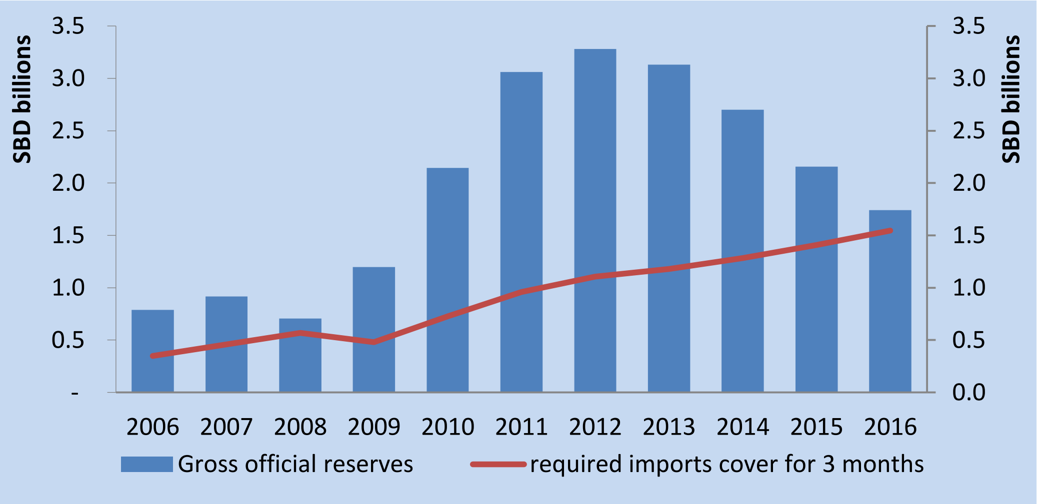
While the World Bank outlook for food and fuel prices is expected to remain reasonably flat, it is important to consider some general policy principles when faced with food and fuel price shocks. A well functioning, undistorted price system is desirable; and efforts should be placed on removing supply bottlenecks such as by investing in transport infrastructure, improving efficiency in the transport sector, facilitating land reform and improving agricultural productivity. In addition, reducing reliance on imported fuel (such as improving fuel efficiency and developing renewable energy), addressing inflationary effects (such as increasing competition and reducing barriers to entry) and monitoring impacts on living standards can help alleviate inflationary pressures.

1.3. Balance of Payments

In the second half of 2010, logging exports increased and there was also a surge in donor aid inflows. As a result the Gross Official Reserves increased (almost SBD$1 billion over 2010) to SBD$2.1 billion which was equivalent to around 7 ½ months of import cover.

In 2011, as indicated in Chart 4, foreign reserves are expected to increase by more than 40 per cent to around SBD$3.0 billion resulting from the increase in logging exports, surge in aid inflows, Foreign Investments and the general improvement across the agriculture and fisheries sectors. This level of reserves is estimated to be equivalent to more than 9 months of import cover. The Gross Official Reserve is projected to increase in 2012 due to donor inflows and foreign investments, however, due to the expected fall in the logging sector, the reserve is projected to fall in 2013 and if the donor aid inflows stabilize, reserves may continue to fall from 2013 to 2016.

Chart 4: Foreign Reserves as months of import cover



Source: Ministry of Finance and Treasury calculations

1.4. Summary

The Solomon Islands economy is slowly picking up after the Global Economic Crisis. However, there are many challenges that the National Coalition for Reform and Advancement (NCRA) government has to encounter in order to put the country forward.

The economy is projected to show high growth levels for 2011, however, the economy remains fragile over the medium term as it depends largely on the declining logging sector, a new narrow base of Gold Ridge Mine and donor funds.

The NCRA Government is committed to meeting these challenges and is already making progress on crucial economic reforms (summarised in Section 3)

2. Recent Fiscal Performances

This section of the Medium Term Fiscal Strategy outlines what the Government is doing to manage the challenges outlined earlier. In particular, this section outlines the policies the Government is putting in place firstly to manage the financial position, secondly to get full value from government expenditure and, thirdly to ensure debt is managed well and used productively.

2.1. The Budget

Funding in the Consolidated Budget has grown strongly over the last few years. Total consolidated funding grew by an annual average of around 22 per cent between 2006 and 2010. This growth has been driven by improvements in compliance by the Inland Revenue Division, strong growth in exports of logs and increased donor support to the Government's Budget. Domestic revenue collected by the Government has grown at an annual average of around 23 per cent between 2006 and 2010. Export duties from logging grew by an annual average of around 19 per cent and donor funding grew by an annual average of around 21 per cent over this period.

In the first half of 2010, the Government's cash position remained threatened by the ongoing impacts of the Global Economic Crisis. The Cabinet made a decision to combat this by placing a 35 per cent reservation on the 'Other Charges' component of the 2010 Recurrent Budget. This was designed to rebalance the 2010 Budget to ensure that the Government could meet expenditure commitments and assist Ministries to manage their expenditure. This action, combined with stronger than anticipated domestic revenue collection in the latter half of the year, allowed the Government to release 25 per cent of the reservation to allow Ministries to provide services to the people in the final months of 2010. Government finances ended 2010 with a surplus of SBD$193 million, and the receipt of SBD$157 million of budget support from the European Union has reinforced its cash position.

Revenue growth in 2011 is expected to increase by up to 20 per cent, largely attributed to strong growth in log exports, general growth in national economy and ongoing improvements in revenue administration and compliance efforts.

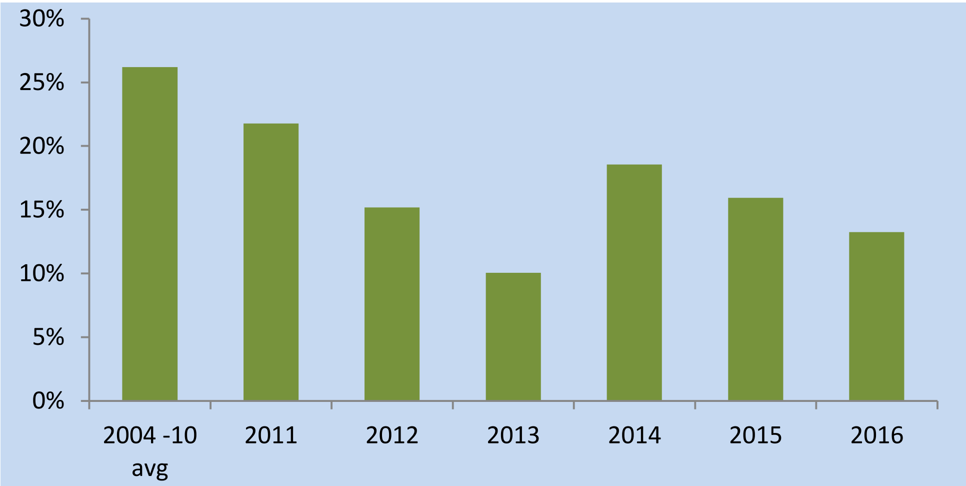
Reduced log output and slower growth over the next five years means that revenue growth will also slow. Up to 2013, the expected decline in logging will be only partially offset by the operation of the Gold Ridge mine as revenue from gold export duty, personal income tax, import duty and withholding taxes are expected to be modest. The Government in these years will therefore need to tightly control expenditure growth and maintain its cash reserves. The Government may also need to consider deferring some expenditure from 2012 and into 2013 to ensure that it does not have to significantly cut services[1].

However, from around 2014 until the end of the mine's production life in around 2021, revenue growth is expected to surpass expenditure growth (if the Gold Ridge Mine starts making a profit this is likely to result in a windfall in company taxes). Due to the temporary nature of the mine and the revenue that can be earned from it, the Government may need to consider putting in place measures that manage the higher revenue flows. This is to ensure that post 2021, the economy and

[1] Significantly reduced mining production, gold prices and an increased cost structure of the mining operation could see the need to tighten expenditure extend into 2014.

Government services can cope with a significant drop off in revenue should no other large revenue streams commence. This may include paying down debt, ensuring that an adequate cash reserve is legislated and incorporated in Budget planning, budgeting expenditure against non-resource revenue collections, ensuring that any additional expenditure (such as on infrastructure) builds long-term productivity but can also be cut back when revenue flows ease, or establishing a sovereign wealth or trust fund should the expected revenue flow be greater than expected. Chart 5 shows the projected expenditure growth path for 2011 to 2016 needed to balance the budget including maintaining an adequate cash reserve of 2 months recurrent budget expenditure for the same period. To maintain fully funded budgets, **nominal expenditure growth will need to slow from 27 per cent per annum for the period 2004 to 2010 to below 10 per cent in 2013 and around 15 per cent average per annum to 2016.**

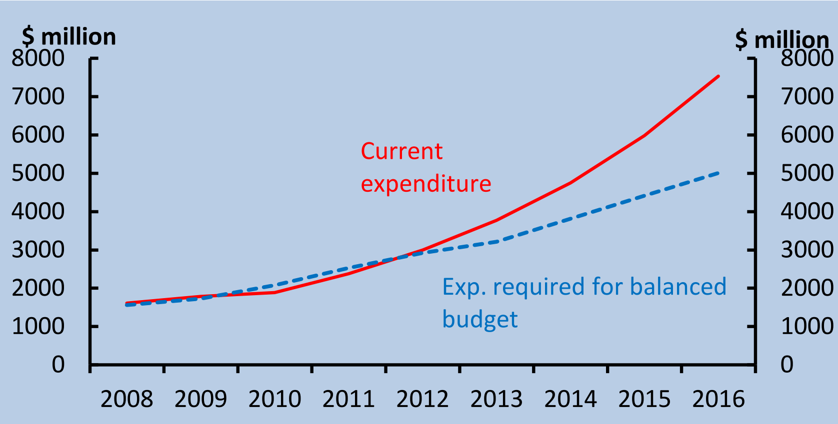
Chart 5: Expenditure growth required for balanced budget



Source: Ministry of Finance and Treasury calculations.

Chart 6 shows the projections of current expenditure growth against the expenditure growth that will be necessary to maintain a balanced budget (that is, expenditure growth necessary to maintain current levels of development expenditure as a proportion of total recurrent revenue). It indicates that despite strong revenue, Government expenditure is growing at an alarming rate. To avoid deficits and provide sufficient cash savings and funding for the development budget, the government needs to cut back on its current expenditures particularly in 2012 and 2013 in order to reduce the gap between the current expenditure growth and the expenditure growth required for a balanced budget.

Chart 6: Expenditure projections under alternative rates of expenditure growth



BOX 2: THE RESOURCE RENT FRAMEWORK

The natural resource tax framework proposes a way forward for the management of the mineral, forestry and fish resources of Solomon Islands. The focus of the framework is on introducing appropriate level of taxes that investors will have to pay to the Government for the extraction of the natural resources based on the principle that these taxes are not only fair but are also competitive and reasonable to investors. The framework also aims at creating clear and transparent expectations for companies coming into the Solomon Islands to ensure that any new investors willing to operate in any of these sectors understand the tax obligation that they need to abide with.

The framework covers all resource sectors; however the main focus is on taxation of mining. It does not concern directly those processes that are the responsibility of the line Ministries. For example, the Ministry of Mines retains responsibility for granting of exploration licences and the negotiation of mining agreements. While building technical capacity in the Ministries of Mines & Energy, Fisheries and Forestry and modernizing their legislation is considered essential to ensuring appropriate regulation in their areas of responsibility, the focus here is on taxation.

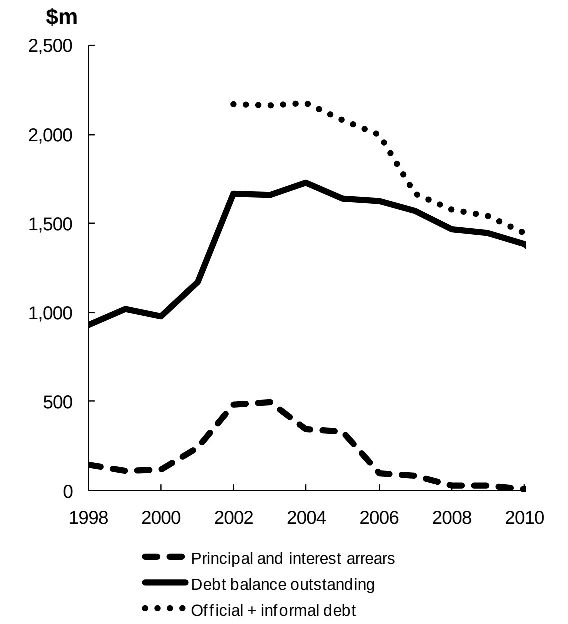
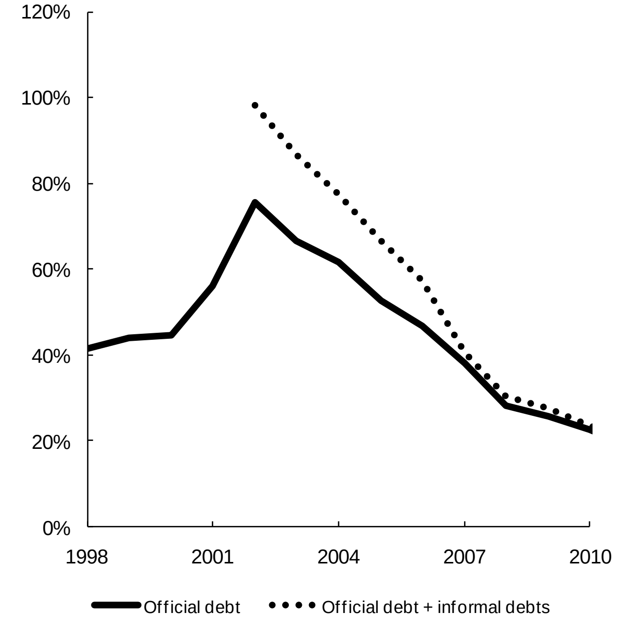
To compliment the Resource tax framework the Government is also committed to adopting the Extractive Industries Transparency Initiative (EITI) and to meet its disclosure standard to improve fiscal transparency within the mining sector. This will involve reconciling company payments and government revenue via a multi stakeholder process and signals a commitment to good governance which will enhance investment climate into the sector.

Source: Ministry of Finance and Treasury calculations.

2.2. Debt

Debt is an ongoing expense for the government. Debt servicing costs mean that less money is available for essential services like health, education, and infrastructure. Solomon Islands is currently paying for poor borrowing decisions in the past. Much of the money borrowed by past governments either directly or through State Owned Enterprises has not been invested wisely. Used wisely, to invest in a country's physical and social infrastructure to boost future productive capacity, debt financing can bring improved economic performance and higher living standards.

Solomon Islands has had a difficult history with debt. While the period of civil unrest led to a final blowout in government debt levels (see Chart 7 and Chart 8), many of the underlying causes of what was an unsustainable debt position came from earlier times. By 2003 Solomon Islands was in default on all of its debt, which has cost the country greatly.

Chart 7: Solomon Islands Public Sector Debt Stock (SBD million)	Chart 8: Solomon Islands Public Sector Debt to GDP ratio
	

Source: Ministry of Finance and Treasury calculations

To rebuild our nation's finances and fix our debt problems, major changes were required. A significant landmark on the path to achieving this was the signing of the Honiara Club Agreement in 2005.[2] The agreement committed the Government to applying a basic set of financial management principles to its fiscal and debt management strategies including balanced recurrent budgets, a freeze on all new borrowing (including guarantees) and setting aside a fixed proportion of

[2] Box 4 on page 21 summarises the key elements of the Honiara Club Agreement.

Government revenue for debt servicing. The principles developed with the Honiara Club Agreement continue to be central to the Government's approach to managing its debts.

The turnaround achieved in the debt position in the period since the agreement was signed has been significant. The Government is now meeting all its debt repayment obligations compared to not meeting any of them a few years ago. Debt levels have fallen significantly as has debt as a proportion of GDP [3]. These gains have been possible because of the improved economic performance of the Solomon Islands, the recommencement of debt repayments, the benefit of debt restructuring and debt relief negotiated with many of our creditors, and the impact of paying down our remaining debt arrears.

The Debt to GDP ratio (a measure of debt sustainability) has now fallen to 24 per cent (see Chart 8), while the debt service to revenue ratio (a measure of debt affordability) has fallen to 5 per cent. With the improvements in the debt situation, the capacity to again access concessionary debt funding is now within reach. For example, the World Bank recently upgraded the Solomon Islands' status from red light (high level of debt distress) to yellow light (moderate risk of debt distress) under the IMF/World Bank Debt Sustainability Framework. This means that Solomon Islands is now eligible for World Bank funding as a mixture of grants and concessional loans (with a ratio of 45/55).

Honouring the terms of the Honiara Club Agreement (Box 3) and acting in good faith to the Government's creditors means that the review of the Agreement must be completed before borrowing resumes. Currently there is no strategy or policy to guide borrowing decisions. This means that a new debt policy framework and strategy must be in place before there is any new borrowing of any kind. (For further information on this see section 4.2.)

The Government is confident that these improvements in our debt position can be retained and improved upon. However, this will be far from easy given the economic and fiscal challenges this country faces. As this Medium Term Fiscal Strategy highlights, the economic challenges over the coming years are considerable and will require us to make difficult and significant commitments, particularly around the Budget. The stark reality remains that without a continuing commitment to balancing the recurrent budget each year, debt levels could easily blow out again.

[3] Debt levels stood at an estimated $2.2 billion just prior to the signing of the Agreement (comprised of official external/domestic debt and informal debts arising from loan guarantees, contingent liabilities and trade creditor arrears). At end December 2010, debt levels have fallen to around $1.4 billion.

3. Economic Strategy

The Solomon Islands government has remained committed to its two main objectives. The first objective is to continue with the structural reform to make Solomon Islands an easy and reliable place to do business and to invest. The structural reform not only creates opportunities for the economy to grow, it also creates jobs, new investments, low inflation, a sound balance of payments level and an overall healthy economy.

3.1. Implementation of Business Laws

The NCRA Government is committed to the continued reform of the economy. Implementation of Business laws in the past years including the *Secured Transaction Act* 2008, *the Companies Act* 2009 and the Companies (*Insolvency and Receivership*) Act 2009 has contributed to providing a good environment for businesses to operate in. The improved environment has been reflected in continued improved rankings for the Solomon Islands in the World Bank's annual Doing Business report.

The implementation of the Secured Transaction Act has improved security for banks when issuing loans and should encourage them to loan more. Since the system began operation in September 2009, over 7500 notices of secured collateral have been filed.

The new Companies Act has significantly reduced the timeframe for business registration. Registering a company now takes only 1-3 days, a dramatic improvement on past registration times.

The Government intends to continue to reform in a number of areas related to the business environment. The 2011-12 Solomon Islands National Provident Fund (NPF) Act review will provide for better governance of this major financial institution. The review will look to ensure that the benefits of members of the fund are well protected and will consider ways in which NPF services could be extended.

Finally, the establishment of the National Financial Inclusion taskforce, chaired by the Central Bank of Solomon Islands, will provide better access to, and expansion of, financial services in rural areas. This will be done through achieving the Taskforce's action plan that is aimed at benefiting small and medium businesses and individuals with better financial services and higher standards of living. The Taskforce will focus on expanding access to credit, making transferring money easier, and developing savings. Expanding financial services is one of the means to achieve the Millennium Development Goals, particularly by reducing poverty.

3.2. Infrastructure

In early 2010 the *National Transport Fund Act* 2009 and its associated regulations came in to effect. The Act established the National Transport Fund Board which is responsible for authorising payments from the National Transport Fund to fund the Government's transport priorities as set out in the National Transport Plan. The National Transport Plan 2011-2030 along with a 3 year Transport Sector Development Plan was developed in 2010 and was further revised in 2011. The plans were approved by Cabinet in 2011. The 3 year Transport Sector Development Plan is a rolling plan that lists priorities for roads, wharves, airports and aids navigation for implementation each year over a three year period.

The members of the National Transport Fund Board are Permanent Secretaries of relevant ministries and a representative from the donor community. Funds are provided by donor partners and SIG. It is envisaged that the National Transport Fund will allow more strategic coordination of funds to meet priorities as has been set out in the 3 year Transport Sector Development Plan. This should lead to improved infrastructure development and maintenance for the benefit of Solomon Islanders.

3.3. Tax Reform

The Government continues to reform its tax system. The current tax legislation is outdated and exemptions in the system are costly to the Government and create opportunities for corruption. The current revenue system also depends too heavily on a narrow set of activities like logging and needs to be broadened and strengthened to reinforce the tax base whilst not impeding legitimate economic activity.

The Government is working with regional and international organisations, such as the Pacific Financial Technical Assistance Centre (PFTAC), to design major reforms to strengthen the tax system.

Work is progressing on modernising the tax base with a dramatic reduction in the granting of tax holidays and other exemptions, resulting in the overall tax burden being shared more fairly. Work has also begun in making further improvement to the exemption process with the focus on tightening, bringing more consistency in the process and establishing a statutory basis for the exemption committee. Further tax reform will be pursued with the clear objective of strengthening the tax base, shifting reliance away from direct taxation and simplifying the administration of tax for the government and compliance burden for taxpayers. These reforms will help to make Solomon Islands an easier place to do business and are also a critical part of the fiscal strategy outlined in Section 4.1.

As part of the effort in updating tax legislations the Ministry of Finance with the assistance of the Asian Development Bank (ADB) have now started reviewing the Customs and Excise legislation.

In addition, the Government is also committed to ensuring that the mistakes that have been made in the past with logging are not repeated with new resource sectors in Solomon Islands. A natural resource tax framework (see box 2) that encompasses the mining, fisheries and forestry sectors has been developed with the assistance of the International Monetary Fund. Drafting of the legislative changes has begun and is expected to be submitted to Parliament in 2012. The framework will ensure that Solomon Islanders receive their fair share from the future profits made from the nation’s natural resources. To complement the natural resource tax framework the government has also made a commitment to implement the Extractive Industries Transparency Initiative (EITI) to improve fiscal transparency and accountability within the mining sector.

3.4. State Owned Enterprises (SOEs)

The SOEs still represent a fiscal risk in terms of calls on the National Budget when financial difficulties arise.

The Government recognises these risks and has taken a number of actions to manage these risks. In 2007, Parliament passed a *State Owned Enterprises Act* 2007 (SOE Act) which provides a simple, but effective, governance framework which increases accountability and transparency on the operations of SOEs. With the support of donors, the Government assisted the SOEs to update and audit their accounts which resulted in a backlog of over 50 years of accounts being cleared, Home Finance Ltd and Sasape Marina Ltd were privatised, Kolombangarra Forest Products Ltd and Soltai were partially privatised, Solomon Islands Printers Ltd is being liquidated and commercialisation projects are underway in the Solomon Islands Electricity Authority and the Solomon Islands Water Authority. Section 24 of the SOE Act gives the Minister for Finance and Treasury the right to make regulations, and the State Owned Enterprises Regulations (2010) were gazetted and commenced in 2010 covering the process of appointment and removal of Directors, Directors' duties, economic regulation and community service obligations.

Much work is still needed. The SOE Governance Strengthening Program (SOEGSP) focuses on improving the governance, the financial management and Government oversight of the SOEs. This work program will cover a number of areas including:

- Increased focus and support to the SOEs on delivering the accountability requirements as stipulated in the SOE Act;
- Using the National Budget as an incentive mechanism to improve SOE performance and fund non-commercial goods and services (Community Service Obligations - CSOs), the CSO policy framework was recently approved by Cabinet to be implemented. Two CSO contracts, one had already been signed for the Solomon Islands Electricity Authority and the Solomon Islands Broadcasting Corporation which will be signed soon and this could be expanded in 2012;
- Financial and commercial due diligence work to investigate some of the constraints to the four infrastructure SOEs (Solomon Islands Electricity Authority, Solomon Airlines Ltd, Solomon Islands Ports Authority and the Solomon Islands Water Authority) has finished with the support of the external experts. Recommendations have been put forward to help improve their financial performance and clean up their balance sheets;
- Work has begun to assist the smaller SOEs (Commodities Export Marketing Authority, Solomon Islands Broadcasting Corporation, Solomon Islands Postal Corporation and the Investment Corporation of Solomon Islands) improve their financial management through the sharing of expert accounting services. This work will also enable the Ministry of Finance and Treasury to exert more control over the financial operations of these SOEs if improvements do not happen; and
- The establishment of an SOE forum to enable SOEs to meet regularly with the Ministry of Finance and Treasury to discuss issues of relevance.

This work program will be delivered over the next three years and should lead to improved financial and operational performance of the SOEs. This produces a number of benefits including better and expanded services to the people of Solomon Islands, better environment for investment as many of the SOEs supply critical infrastructure to the country, freeing up under-utilised assets, reduced fiscal risk from stronger balance sheets and cash-flow and potentially dividends to the Government.

3.5. Summary

The Government is committed to ongoing economic reform. The Economic Reform Unit in the Ministry of Finance and Treasury has identified development work and reforms that will grow the country's economy and is implementing these reforms quickly. At the same time, the Economic

Reform Unit is also examining each industry in the Solomon Islands. Their task is to find the impediments to growth in our important industries and to design and implement reforms that will remove these impediments. This will help those industries grow quickly in order to replace logging.

By committing to and implementing the range of reforms, the Government is giving economic growth its best chance in Solomon Islands. Through economic growth, new jobs and incomes can be created for all Solomon Islanders.

Box 3: IMF ASSISTANCE AGREEMENT AND STAND-BY CREDIT FACILITY

In December 2011, the current 18-month Standby Credit Facility (SCF) arrangement with the IMF will come to an end. The program had been initiated in order to access concessional loan financing for balance of payment difficulties and was generally considered a success, having achieved most benchmarks.

From a position of severe balance of payment difficulties in mid-2010, Solomon Islands Government has moved on to build a sufficient base of cash reserves covering two months forward recurrent expenditure, as well as cyclicality in revenue and expenditure flows. Significant progress has also been made in improving the country's financial management systems. Although this translates into a strong fiscal position in the short-run, the medium to longer term economic outlook remains vulnerable.

The Government has shown strong interest in sustaining its engagement with the IMF under a successor program in 2012. Besides further strengthening the Government's macroeconomic framework, a successor program will continue to provide positive signals to both the donor community and the private sector, and is testament to the Government's prolonged commitment to economic reform as a basis of achieving sustainable and real growth in the Solomon Islands.

4. Fiscal Strategy

4.1. The Budget

As outlined in Section 2.1, continued revenue growth can only have positive impact on future economic development or service provision. If the quality of spending improves; there will be a shift in the allocation to areas that gain better outcomes for Government and the people of the Solomon Islands. Continuous effort on improving revenue should be done, but at the same time, improving allocative decisions so that the growing revenue expands economic growth and service provision.

The Government will continue to improve its revenue collection mechanisms and ensure that it receives fair value for the country's resources. Ongoing capacity building in the Ministry of Finance and Treasury is improving financial management and governance, and the Government will ensure this continues.

The tax reform that is being undertaken as part of the broader structural reform program (see Section 3.3) will continue to be pursued and in a way that ensures the revenue base is broadened. This reform will continue and includes building the administrative and resource capacity of the Inland Revenue Division and the Customs and Excise Division to enforce compliance. The Solomon Island Government remains committed in improving the capacity of the revenue agencies through increasing the number of staff to continue this important work, and this is paying dividends in improved collections.

Timber and mineral resources are valuable commodities in the Solomon Islands. It is therefore important that the Government ensure that these are priced at the international market prices so that Solomon Islanders receive fair value for their resources. Recently, the NCRA Government increased the export price applied to logs for the purpose of determining duty to match the market value for logs in the international markets from an average price of US$98 in the first half of 2011 to an estimated average price of US$114 by January 2012. This step has been taken to ensure all Solomon Islanders benefit from the export of our natural resources. The determined value will continue to be reviewed every 3 months to ensure it reflects the price that Solomon Islands' logs are achieving on world markets.

Concurrently, a natural resources tax framework (see box 2) has been developed which involves a range of work across key resource ministries; the Ministry of Mines and Rural Electrification, the Ministry of Fisheries and Marine Resources and the Ministry of Forestry. The framework includes adopting a separate fiscal regime for the mining sector which will remove the need to negotiate individual taxation agreements with mining companies.

The Government continues to work to improve the quality of existing and future expenditures through continued capacity development within the accounting service, and through improvements to the transparency and legibility of the Consolidated Budget. These improvements will assist the Government in prioritising and managing its expenditure while implementing Government priorities.

In 2011, the Government decided to introduce a range of financial management reforms which includes crucial budget reforms that aim to improve spending and allocation decisions. The reforms will be implemented in parallel with capacity developments in line ministries. The key areas of the budget reform include:

- Improving the predictability and the stability of budget envelopes;
- Improving resource allocations and use;
- Linking Government objectives to the resource base and the outcomes and outputs of annual budgets; and
- Improving the accountability and transparency around the use of resources and the outcomes and outputs of annual budgets.

These reforms should help improve the credibility which in turn builds confidence and trust of Solomon Islanders and investors for the budget process. This will go a long way in building investor confidence in the country which in turn increases revenue as investments expands.

4.2. Debt

The current Government is committed to reducing the burden of public debt on the nation's finances and future prosperity. To this end, the Government will continue to be guided by the principles established under the Honiara Club Agreement (see Box 4) in the management of our debts.

BOX 4. THE HONIARA CLUB AGREEMENT

The Honiara Club is a multilateral forum that was convened by the Government in October 2005 to discuss the country's debt problems. The forum provided the basis for the Government to negotiate with its creditors concerning the provision of relief on its external debt obligations. In return for this, the Government gave undertakings to the creditors that it will observe good budget practices and proceed with implementing reforms to the economy and improve government services. Specific undertakings in the agreement include commitments to:

- no further borrowing or sovereign guarantees until the Solomon Islands achieves "green light status" under the IMF and World Bank's Debt Distress Rating system;

- maintaining a fully funded recurrent budget;

- allocating 15[1] per cent of revenue from the budget for debt servicing; and

- ensuring that funds set aside for debt servicing are only used for debt servicing purposes.

One of the undertakings of the Honiara Club Agreement was that it would be reviewed in five years time and before there was any new borrowing. It is now due for review. The Government must have a new agreement or debt policy framework to replace the Honiara Club Agreement before borrowing again. This is important to show current and potential creditors that the Government is committed to responsible debt management and to build investor confidence. The debt management framework must ensure that:

- Debt is affordable and sustainable for the long term;

- Borrowing is for a good purpose;

- The borrowing source is cost-effective, transparent and low-risk;
- The decision-making process provides transparency and accountability; and
- Debt policy and strategy are credible.

A debt management framework must be based on easily quantified and understood, and transparent, measures of debt sustainability and affordability. For example, a limit of total debt to less than 30 per cent of GDP is broadly consistent with international standards for low income countries. This is a modification of the World Bank's measure of sustainability and includes external debt, domestic debt and any explicit contingent debts such as Government guarantees. A limit of debt servicing expenditure as a proportion of domestically sourced government revenue set at 10 per cent ensures that expenditure on servicing the Government's obligations does not consume an unduly excessive portion of the national budget. This limit equates to the existing policy of setting aside 10 per cent of revenue to service debt. These limits also need to allow for shocks on the economy, such as a global economic crisis and the loss of logging revenues, as identified in a debt sustainability analysis.

New debt funding must be applied in a manner that contributes positively to the country's economic development. The core principle the Government should apply to future borrowing is that debt should not be incurred to fund an underlying deficit in the recurrent budget nor to fund the losses of State Owned Enterprises. Instead, borrowed resources must be channelled to fund development activities, like investment in infrastructure, which can drive growth into the future.

The agreed IMF program imposes a range of restrictions on borrowing over the life of the program. In essence, it effectively prohibits long and short term borrowing on commercial terms for any purpose while allowing some concessional lending from institutions like the ADB and World Bank. It should be noted that given the availability of concessional finance, commercial borrowing (which would be prohibitively expensive) would represent an inferior funding choice even in the absence of the IMF restrictions. More broadly, the IMF Program requires the Government's debt management strategy to be consistent with maintaining a low level of external and public indebtedness.

To promote confidence in the integrity of the debt management framework among current and prospective creditors there must be processes and procedures for the contracting and issuing of new debt. Establishing a Debt Management Advisory Committee is the first step. Its mandate will include the review of project financing proposals, annual borrowing programs, domestic debt market development and broader debt policy and strategy. The next step is strengthening the debt management framework by incorporating the debt affordability and debt sustainability limits into a 'Fiscal Responsibility Law'. This would be seen as a very strong and responsible action by creditors.

5. Conclusion

This 2011 update to the Medium Term Fiscal Strategy has reiterated the need for ongoing economic and fiscal reform in Solomon Islands. The Government remains committed to the twin objectives of **structural reform** and an **affordable and sustainable Government budget**.

In this update to the Medium Term Fiscal Strategy, the Government has also made a number of new commitments to reform. Structural reform coupled with sensible and well-managed Government investments and well-targeted donor investment can ensure our economy continues to grow sustainably without harming the fiscal position.

The Solomon Islands economy is growing well, however, remains fragile over the medium term and poses challenges in which the Government needs to address. That is why the NCRA Government is absolutely committed to reform. By taking all necessary steps to ensure Solomon Islands sees off this challenge, the Government will build a better country for everyone.