Solomon Islands Government


August 2010 Update
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Forward by the Minister

In August 2009, the Government released the second Solomon Islands Government Medium Term Fiscal Strategy which updated the state of the Solomon Islands economy, the challenges the Solomon Islands faced and the Government’s plans 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 is the August 2010 edition of these annual updates.

The most significant challenge outlined in the 2009 edition of the Medium Term Fiscal Strategy was the effects of the Global Economic Crisis which caused a much steeper decline in log exports than expected, coupled with external shocks that rapidly increase the prices of fuel and rice and the foreseeable decline in the logging sector as our stock of natural logs runs out.

This 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 Government will look to work constructively with donors to promote development that can stimulate immediate economic growth while providing a basis for sustainable long term growth.

By continuing to plan for the future and updating the Medium Term Fiscal Strategy the National Coalition for Reform and Advancement (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 2010 Medium Term Fiscal Strategy (MTFS) is an updated version of the 2009 publication. It is a five year term strategy from 2010 – 2015 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
- **As 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 2009, the economy contracted by around one per cent due to weak external demand stemming from the Global Economic Crisis (GEC) effects, decline in agricultural output and slower growth in other sectors. In 2010, economic growth is expected to pick up to around 5 ¾ per cent, mainly due to the recovery in the world economy which has improved commodity demand and prices, increase in log exports and improvements in telecommunication, constructions and trade. In 2011, real GDP growth is expected to be around 6 ¾ per cent driven mainly by the mining sector as Gold Ridge (Allied Gold) mine is expected to recommence operations.

In 2010, the fiscal position of the Government remains under pressure due to the imbalance in revenue collections and spending decisions despite improvements in the Inland Revenue Division (IRD) and Customs collections. Logging is expected to decline in the medium term due to the depletion of the natural forest. This will add more pressure on the government revenue, restraint economic growth and would result in a decline in our foreign reserves in 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 making the following new 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 several major 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 growth falls in line with revenue;
   • tax reforms aimed at raising more revenue and diversifying the revenue base;
   • fully implementing the policy of reducing 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

In 2009, the economy contracted by around 1 per cent. This was largely driven by weakened external demand reducing commodity prices and log production, lower agricultural output due to floods in the first quarter of 2009 and slow growth in other sectors, including public administration, as government revenue became constrained.

Growth is expected to pick up in 2010, with the real growth rate expected to be around 5 ¾ per cent. This is mainly due to a slight recovery in world economy, improvement in commodity demand and prices, and log exports. Improvements in telecommunications and construction (led by Gold Ridge and Bemobile) have also contributed to a higher growth forecast in 2010.

Assuming no change to current policy, it is expected that real GDP growth will decline significantly from current levels and average around 2.5 per cent over the next five years.

As indicated in Chart 1, volume of log exports in 2010 is expected to slightly increase by around 15 per cent to 1.2 million cubic meters. However, in 2011 the logging sector is expected to decrease by around 18 per cent and continue to decline at an annual average of around 25 percent over the next four years. Our naturally harvested logs are expected to be fully depleted by 2015.

On the other hand, the Gold Ridge mine is expected to come into full operation in mid 2011 (See Box 1) which will contribute around 4 per cent to growth, resulting in an overall growth rate of around 6 ¾ per cent. Unfortunately, revenue collections from the Gold Ridge mine are likely to fall well short of that collected from the logging sector.

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**Chart 1: Volume of Log Exports**

Source: Solomon Islands Forestry Management Project II and Ministry of Finance and Treasury calculations.
Despite the strong growth in real GDP forecast from 2010 to 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 3 per cent. Given the nation's population growth of around 3 per cent growth per year, GDP per capita is likely to remain very low indicating that living standards are unlikely to improve much in the medium-term.

Chart 2: Real GDP growth against population growth

Source: Ministry of Finance and Treasury calculations.
Box 1: The economic effects of Gold Ridge on Solomon Islands economy

The reactivation of Gold Ridge Mine is significant in terms of growth prospects for the Solomon Islands economy in the first two years of operation (2011-12) and comes at an important time when logging production is expected to decline. From 2013, mine output will be steady and will therefore contributing little to growth (or even negative growth in some years). The project is expected to contribute a significant amount of revenue to the Government in terms of PAYE on expatriate salaries which are currently exempt during the reconstruction stage. Revenue from royalties will be very low because the negotiated rate is very low compared to the standard rate that is currently charged in other countries. At the initial stage of reconstruction it is expected that the mine will incur significant losses which will be carried forward offsetting future profits.

The Gold Ridge Mine has estimated reserves of 1.3 million ounces of gold and an expected mine life of seven to nine years. Management forecasts production to commence by March 2011, with an annual extraction rate of around 130,000 oz. A budget of US$150 million has been allocated for rehabilitation and refurbishment which is due for completion by February 2011.

Because the Gold Ridge mine is foreign owned, the majority of the proceeds from exports will remain offshore. Therefore, the reactivation of the mine is unlikely to generate significant gains for Solomon Islands outside directly related sectors, such as mining, trade and construction. Other beneficiaries include landowner groups, who will receive royalties and the communities around the mine and in Honiara will benefit from employment of almost 400 Solomon Islanders. There will also be second round effects and benefits from goods and services purchased by local and expatriate workers in certain sectors like wholesale and retail, hotels and restaurants, which will also generate increased employment.

The effect of the mine on foreign exchange reserves is expected to be minimal. This is because any export revenue will be mostly offset by the repatriation of profits.

In terms of the effect on the Solomon Island Dollar, a large inflow of foreign currency can cause the exchange rate to increase, making exports less competitive. This is known as ‘Dutch Disease’ and there is a risk that the mine could contribute to its occurrence. Given the country’s fixed exchange rate regime it is unlikely that the exchange rate will appreciate. It is, however, possible that there could be movement of resources (capital and labor) and skills into the mining sector from the traditional export sectors like agriculture, manufacturing and fisheries. This could result in a contraction of economic activities and employment in these sectors. Although ‘Dutch disease’ is generally associated with a natural resource discovery, it can occur from any event that results in large inflow of foreign currency including investment and aid.

The success of Allied Gold in reactivating Gold Ridge Mine will be an important signal to foreign investors that Solomon Islands is a viable and attractive investment location, especially in mineral resource development. Also, the existence of an infrastructure that supports mining and a workforce with mining experience will be important in attracting other mining exploration and development to Solomon Islands. There is already evidence of strong interest from other mining companies in exploring Solomon Islands.
1.2. Inflation

Inflation is a measure of the change in prices of goods and services in the Solomon Islands. The annual rate of inflation as measured by the three months moving average stood at 1.0 per cent in July 2010 compared to 5.9 per cent in July 2009 and 20 per cent in July 2008. The fall in fuel and food prices both domestic and internationally, together with the deregulation of rice importation in 2009 has been instrumental in reducing the inflation rate. However, inflation is expected to gradually begin increasing to around 3 per cent by end year as import prices begin to increase (see chart 3).

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 of 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 it is likely that these higher prices will inevitably be imported into the Solomon Islands. 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 development, 2007 - 2010

1.3. Balance of Payments

The 2009 MTFS projected that reserves would be depleted significantly in 2009 as a result of a deteriorating exports stemming from the Global Economic Crisis coupled with continued high imports, not offset by higher foreign income. In 2009, in anticipation of a potentially substantial decrease in foreign exchange reserves, the IMF allocated additional Special Drawings Rights (SDRs) to numerous developing countries including the Solomon Islands. This, together with a surge in donor funds and reinvested earnings, caused reserves to instead increase by almost 40 per cent to $987 million. This level of reserves is equivalent to import cover of about five months as oppose to the 2 months of import cover predicted in the 2009 MTFS and well above the 3 month benchmark.

In 2010, as a result of a surge of aid inflows, a slight increase in logging and improvement in agriculture and fisheries, foreign reserves are expected to increase to around $1.7 billion, as Chart 4 shows which will be equivalent to around seven and half months of import cover. However, in 2011, with logging exports expected to decline again and aid inflows and other foreign income expected to stabilise, the Ministry of Finance and Treasury predicts foreign reserves will again start to fall until 2014 where foreign reserves are expected to be exhausted unless alternative sources of foreign income can be found. Chart 4 also shows the size of the possible financing gap from 2014 onwards if imports continue to grow and no additional export revenue or foreign income materialises.

Chart 4: Foreign Reserves as months of import cover

![Chart 4: Foreign Reserves as months of import cover](image)

Source: Ministry of Finance and Treasury modelling

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.

Growing our economy by at least 3 per cent each year will be difficult and will require some difficult economic reforms and sensible investment in productive infrastructure. 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 over 26 per cent between 2004 and 2008. 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 29 per cent between 2004 and 2008. Export duties from logging grew by an annual average of around 31 per cent and donor funding grew by an annual average of around 8 per cent over this period.

The fiscal position changed towards the end of 2008 as the Global Economic Crisis negatively affected Government revenue and in particular, the duties earned from the export of logs. In 2009, log exports fell to 1.04 million cubic meters from 1.45 million cubic meters in 2008. This coupled with the resultant slower domestic economy growth meant that domestic revenue collection growth slowed to around 5 per cent in 2009.

This year, the Government has been under pressure with regards to its real cash position. Despite improvements in Inland Revenue and Customs administration, growth in revenue has not kept pace with the Government spending decisions. Therefore, in May 2010, Cabinet made a decision to place 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 to assist Ministries manage their expenditure for the last quarter of 2010.

Revenue growth in 2010 is expected to increase up to around 10 per cent but increasing cost pressures has resulted in the need to continue the freeze on recruitment, apply a permanent reservation on the ‘Other Charges’ component of the Recurrent Budget and to prioritise development expenditure.

The revised log output projection and slower growth over the next five years means that revenue growth will also slow substantially. Chart 5 shows the projected expenditure growth path for 2010 to 2015 as well as it also shows the Government’s maximum expenditure growth in the medium term excluding any possible European Union support that may come later in 2010. Notably, this means the excessive expenditure growth of the last five years must slowdown abruptly. To maintain fully funded budgets, nominal expenditure growth will need to slow from around 29 per cent in 2008 to around 8 per cent average per annum to 2015.
Chart 5 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 the current expenditure growth of the government has been increasing at an alarming rate. To avoid deficits and provide sufficient funding for the development budget, the government needs to cut back on its current expenditures in order to reduce the gap between the current expenditure growth and the expenditure required for a balanced budget.

Chart 6: Expenditure Projections under alternative rates of expenditure growth

Source: Ministry of Finance and Treasury calculations.
Box 2: IMF ASSISTANCE AGREEMENT AND STAND-BY CREDIT FACILITY

On 2 June 2010, the Government signed an 18-month assistance agreement with the International Monetary Fund (IMF) to access concessional loan financing for balance of payments difficulties. In return the Government has committed to a number of reforms relating to the fiscal and monetary sectors that ensure improved financial management.

The current Government, when it came into office in late August 2010, it further committed to the IMF Program, signed up by the previous Government administration, but did so not only because of the commitments it has making to the donor partners, but because it believed that sound financial and economic management will underpin sustainable and real growth in the Solomon Islands.

As a result of the Government’s commitment to the Program, the financial management of the Government has improved and the Government remains committed to continuing the reforms.

2.2. Debt

When expenditure exceeds revenue, the difference can be made up by increasing the Government’s level of indebtedness to domestic and international lenders. 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. Used unwisely, debt financing can impose a heavy burden on future generations requiring higher taxes and reduced expenditure on services like health, education, and infrastructure.

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. In the past, much of the debt incurred by government and the SOE (State Owned Enterprise) sector was not invested wisely. By 2003 Solomon Islands was in default on all of our debt, which has cost us greatly.
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. 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 and setting aside a fixed proportion of 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. 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 percent. 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’

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1 Box 3 on page 21 summarises the key elements of the Honiara Club Agreement.

2 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 June 2010, debt levels have fallen to around $1.5 billion.
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. 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 and 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. Since the 2009 MTFS was prepared three important new pieces of legislation have been commenced; the Secured Transaction Act 2008, the Companies Act 2009 and the Companies (Insolvency and Receivership) Act 2009.

The Secured Transaction Act 2009 commenced on the 31st of August 2009. The online Secured Transactions Filing Office (STFO) established by the Act enables the public to file notices of security interests and to search the notices listed. In the period since the commencement of the online filing office approximately 6500 notices have been filed. It is hoped that the Act and the STFO will lower risks for banks and other lenders by ensuring they have first claim over a debtor’s collateral. Lower risks should lead to increased lending.

The Companies Act 2009 and the Companies (Insolvency and Receivership) Act 2009 both became law on 1st July 2010. Responsibility for managing companies now falls under the registrar of companies, who manages Company Haus, which sits within the Ministry of Commerce. The new Companies Act has eliminated various barriers to registering a company. These barriers included pre-approval by a minister of a company’s name, multiples sets of fees being payable and less paperwork. In December, an electronic registry, funded by the Asian Development Bank (ADB), is expected to be launched, making the time for incorporation of companies among the fastest in the world.

New forms of companies are now available for creation by the business community, including a sole shareholder company (the law previously required at least 2 shareholders), and community companies. These will increase options available to people going into business. In 2.5 months of operation of the Company Haus there have been 88 new companies registered. This is an average of more than one new company every business day.

The new Companies Act also requires every existing company to re-register. The purpose of this is to create the most up to date registry, containing only those companies who are active in business today. The deadline for re-registration is the end of March 2011. This re-registration process has been publicised through the media and through direct discussions with agents, banks, industry associations and the general public. In the 2.5 months of operation, there have been 184 companies re-registered. Once the electronic registry is launched, it will be even easier for a company to re-register, which will be possible from company offices.
In addition, a project conducted during 2010 digitalised all existing business and company names. This has dramatically reduced the time it takes to search for business names. Previously the process could take days as all records were paper-based. The process now takes seconds to complete.

These improvements and the commencement of these laws significantly enhance the legal framework for businesses to start and operate in Solomon Islands. This new framework should assist the Solomon Islands economy to become much more dynamic and attractive to investors.

3.2. Infrastructure

In early 2010 the National Transport Fund Act 2009 and its associated regulations came into effect. The Act established the National Transport Fund Board which will be responsible for authorising payments from the National Transport Fund to fund the Government's transport priorities as set out in the National Transport Plan. A new National Transport Plan is being developed and will be released later in the year.

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. This should lead to improved infrastructure development and maintenance for the benefit of Solomon Islanders.

3.3. Telecommunication

The impact of competition has been startling. In mid 2009 when the Government and STCL (Solomon Telekom Company Ltd) announced they had reached a deal to end their exclusive license, STCL dropped their prices by 50 per cent. Later in 2009, STCL announced they were replacing their entire mobile network with a state of the art 3G GSM network. In April 2010 it became operational.

Bemobile who entered the telecommunication sector in December 2009 spent approximately $200 million investing in a 2.5/3G network and upon their launch prices dropped further again in both phone calls and texts. Further, sim cards and phones have also dropped in price and new innovations have emerged such as double top ups i.e. paying $100 for $200 worth of call credits. Both operators intend to expand their networks further into Solomon Islands with bemobile required to expand to 81 per cent of the population within two years.

In the future, the Telecommunications Commission of Solomon Islands intends to invite tenders for a third mobile license. Also limited data bandwidth is constraining growth as this is provided through expensive satellites. With the support of donors, the Government and the Commission are investigating the viability of an undersea cable landing in Solomon Islands to exponentially increase the availability of data bandwidth at lower prices.

3.4. 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. 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 from the ADB will be 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. The Government, with the help of the International Monetary Fund through its PFTAC office, will be designing a resource tax framework, which will be implemented to ensure that Solomon Islanders receive their fair share from the future profits made from the nation’s natural resources.

3.5. State Owned Enterprises (SOEs)

The SOEs still represent a fiscal risk in terms of calls on the National Budget when financial difficulties arise and a contingent liability risk in terms of the implicit government guarantee provided to the SOEs by having the Government as the 100 per cent owner.

The Government recognises these risks and has taken a number of actions to manage these risks. In 2007, Parliament passed a SOE Act which provides a simple, but effective, governance framework which increases accountability and transparency on the operations of SOEs. With the support of RAMSI, the Government assisted the SOEs to update and audit their accounts which resulted in a backlog of over 50 years of accounts being cleared. With support from the Asian Development Bank, Home Finance Ltd was privatised and Sasape Marina Ltd’s privatisation shall be completed by the end of 2010. The Solomon Islands Electricity Authority is the subject of a commercialisation project which is funded by the World Bank. New regulations were gazetted earlier this year covering the appointment and removal of Directors, Directors’ duties, economic regulation and community service obligations.

Much work is still needed. Recently RAMSI agreed to support a new SOE Governance Strengthening Program which 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 services (Community Service Obligations);
- Financial and commercial due diligence work to investigate some of the constraints to SOE performance and recommend ways to repair damaged balance sheets;
- investigating ‘shared services’ amongst the smaller SOEs, particularly in areas such as financial management; and
- establishing a SOE forum to enable SOEs to meet regularly to discuss issues of relevance to everyone.

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.

3.6. Productive Sector

The Government recognizes the importance of the private sector and shall vigorously pursue the development of the productive sector, especially in tourism, fishery, agriculture, and mining.

3.7. 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.
4. Fiscal Strategy

4.1. The Budget

The constraint on expenditure outlined in Section 2.1 could impact on future economic development or service provision, but there are various policies which the Government is undertaking right now to reduce this fiscal tightness and manage the impacts.

The Government will continue to improve its revenue collection mechanisms and ensure that it receives fair value for the country’s resources. In the 2008 Budget the Government announced a policy of reducing exemptions on imports and had implemented a review in mid 2009. A full implementation of this policy was undertaken in late 2009 which had helped reduced the prices of food imports. In addition, ongoing capacity building in the Ministry of Finance and Treasury is improving financial management and governance, and the Government will ensure this continues.

Finally, the tax reform that is being undertaken as part of the broader structural reform program (see Section 3.4) will be carried out 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 to enforce compliance. The Solomon Island Government has provided funding for Inland Revenue Division to increase its staff numbers and thereby continue this important work, and this is paying dividends in improved collections.

Timber and mineral resources are a valuable commodity 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 to match the market value for logs in the international markets from an average price of US$83 to US$90 and subsequently to US$98 for January to June 2011. These steps have been taken to ensure all Solomon Islanders benefit from the export of our natural resources. The determined value will be reviewed every 3 months.

In 2009, Government revenue collection was around $169 million under forecast due to the impacts of the Global Economic Crisis. The Government put a number of measures in place to manage the less than forecast growth in revenue including the application of a 10 per cent reservation of expenditure warrant, a freeze on new recruitment and various revenue policies. In 2010, revenue growth is expected to increase up to around 10 per cent but increasing cost pressures has resulted in the need to continue the freeze on recruitment, the application of a permanent reservation on the “Other Charges’ component of the Recurrent Budget and prioritising development expenditure.

These measures are being taken to ensure the cash position is maintained, that services continue to be provided and key structural and development reforms for future growth continue to be implemented.

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.
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 3) in the management of our debts.

**Box 3. The Honiara Club Agreement**

The Honiara Club is a multilateral forum that was convened by the Government in October 2005 to discuss our 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\(^3\) 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 World Bank has offered to assist with this 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:

1. Debt is affordable and sustainable for the long term;
2. Borrowing is for a good purpose;
3. The borrowing source is cost-effective, transparent and low-risk;
4. The decision-making process provides transparency and accountability; and
5. 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

\[^3\] As stated in the 2009 MTFS, this amount has been reduced to 10 per cent. This minor change reflects the improvements in our debt position and the expansion in Government revenue since the signing of the Agreement in 2005 and does not have any impact on our ability to meet future debt repayment obligations as they fall due.
less than 30 percent 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 percent 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 percent of revenue to service debt.

New debt funding must be applied in a manner that contributes positively to the country’s economic development. The core principal 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 recently 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 2010 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.

But without a concerted reform effort that begins today, it is likely that income per capita will fall and our budget and debt position will become unmanageable. Solomon Islands cannot afford for this to happen. 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.