Solomon Islands Government

Medium Term Fiscal Strategy: 2012-2017

August 2012 Update

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Foreword by the Minister

The Medium Term Fiscal Strategy (MTFS) is the Government's framework for presenting the state of the economy, the challenges Solomon Islands faces and the Government's plan for meeting those challenges. The Government released its first edition in May 2008 and this is the fifth edition of the MTFS.

Through the MTFS, the Government commits 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
- An affordable and sustainable Government budget

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.

The most significant challenge outlined in the 2011 MTFS 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, logging output in 2011 turned out to be significantly higher than expected driven by strong Chinese demand, high international prices and re-entry into previously logged areas. In 2012, log exports are expected to remain at or possibly even exceed the 2011 record output level of 1.9m^3 as log exporters capitalise on high international prices and reduced costs made possible by significant re-entry logging.

Whilst record log exports have contributed substantially to economic growth in recent years, this rate of harvesting with a heavy emphasis on re-entry logging is unsustainable. Log production is expected to decline by around 4 per cent in 2013 and continue to decline at an annual average of around 8 per cent over the next four years due mainly to increasing supply constraints.

Over the medium term, real economic growth is expected to moderate to around 3½ per cent per year owing to the expected reduction in logging output and stabilization in output from the Gold Ridge mine. The slower rate of growth will also mean lower growth in domestically sourced revenue and a lower contribution to foreign exchange reserves. The 2012 MTFS maintains a focus on progressing the twin reform objectives of structural reform and a sustainable Government Budget. In particular, the Government will look to work constructively with donors to promote development while providing a basis for sustainable long term growth.

By continuing to plan for the future and updating the MTFS, the 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 Rick N. Houenipwela
Minister of Finance and Treasury

Executive Summary

The 2012 Medium Term Fiscal Strategy (MTFS) is an updated version of the 2011 publication. It is a five-year strategy for 2012 – 2017 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 the economy to grow; and
- **An affordable and sustainable Government budget** which limits debt to a manageable level, improves Government decision making processes, and focuses on achieving the development goals of the Solomon Islands.

The MTFS has two sections. The first section outlines 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.

In 2011, real GDP growth is estimated to have grown by an exceptionally strong 10 ½ per cent, largely driven by the significant increase in logging output and the mining sector following the commencement of gold production by the Gold Ridge (Allied Gold) mine in March 2011. In 2012, real GDP is expected to continue to grow but a slower rate of 5 ¾ per cent, with log output expected to remain unchanged from 2011 levels. The agricultural sector is also expected to grow by less than in previous years due to reduced international commodity prices and demand. On the up-side, the Gold Ridge mine is expected to have its first full year of production, contributing around 2¼ percentage points to economic growth. Despite the strong growth in real GDP estimated for 2011 and 2012, the expected reduction in logging output owing to supply constraint and stabilization in output from the Gold Ridge mine is expected to result in real GDP growth rates hovering between three and four percent over the medium term. The slower rate of growth will mean lower growth in domestically sourced revenue and a lower contribution to foreign exchange reserves. In 2013, real GDP growth is forecast to moderate to 4 per cent.

The Government of Solomon Islands is committed to implementing policies to broaden the economic base, reducing the reliance on a limited number of economic sectors for growth, and protecting our economy from the external shocks, particularly from sudden adjustments in the commodity prices.

The revenue growth outlook is expected to remain subdued over the medium term, reflecting the slowdown in economic growth and reduction in log output. Given the expected slowdown, it is critical that the Government continue to put in place measures that better prioritise and allocate expenditure.

This MTFS outlines the measures being taken by the Government in the following areas.

1. **Remaining committed to the path of economic reform** by**:**

- promoting rural infrastructure development;
- implementing business laws to improve the environment for business;
- promoting the private sector as an engine for growth, wealth creation, employment generation and poverty reduction;
- providing a framework to guide the Solomon Islands' debt management and new borrowing decisions;

- improving state-owned enterprise (SOE) performance by supporting their ability to deliver on their accountability and reporting obligations in the SOE Act;
- reviewing the Customs and Excise Act to improve revenue collection, border integrity and trade facilitation;
- undertaking key infrastructure projects, including the development of a new hydroelectric scheme at Tina River, the upgrade of Munda Airport, onshore fisheries development, supporting the provision of a broadband undersea cable, developing a Solomon Island National Infrastructure Investment Plan to improve prioritisation, efficiency and effectiveness of large scale investment, and selling or liquidating some state owned enterprises; and
- vigorously pursuing the development of the productive sectors especially tourism, agriculture, fisheries, 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 and reforming budget processes;
- ensuring expenditure does not exceed revenue;
- implementing reforms aimed at providing a fairer and more efficient tax base;
- fully implementing the policy of streamlining processes for exemptions on tax and duty;
- limited borrowing with the annual borrowing limit on acceptable on acceptable terms with low cost and risk in accordance with the debt management strategy; and
- establishing a medium term expenditure framework.

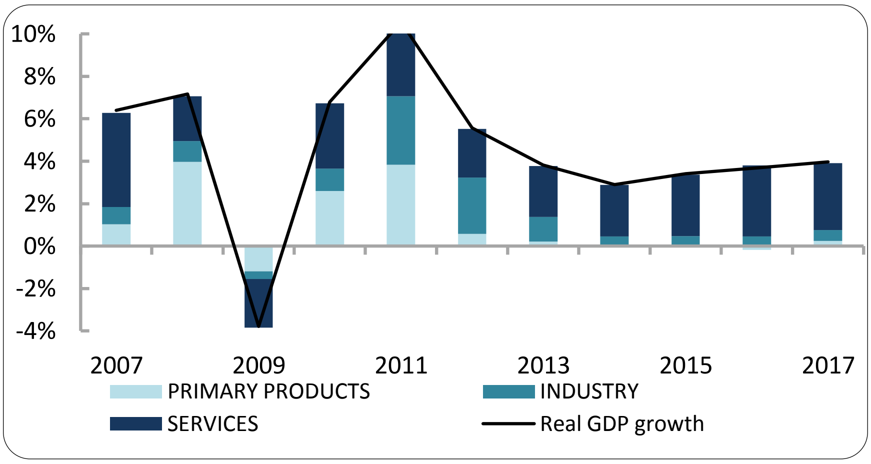
1. Economic Performance

1.1 Gross Domestic Product

The Solomon Islands continued its recent strong economic growth in 2011. In real terms, the economy is estimated to have grown exceptionally strong by around 10 ½ percent compared with 6 ¾ percent in 2010. Higher growth was largely driven by record logging output, the commencement of gold production at the Gold Ridge mine and increased agricultural production. Log export volumes rose by 42 percent above the previous year, and were 63 percent higher in terms of export value. All major agricultural commodities (palm oil, copra, and fish) recorded an increase in volume and value during the year due to strong global demand and high commodity prices. Improvements in telecommunications, construction, the trade and services sector aided by increased donor inflows and general improvements in the overall economy, also contributed to growth in 2011.

As shown in Chart 1, in 2012, real economic growth is forecast to moderate from 2011 to around 5 ¾ percent with log output expected to remain strong (around 1.9 million cubic meters) but unchanged from 2011 levels. Log exporters are capitalizing on very strong international demand and high international prices together with reduced costs made possible by re-entry into previously logged areas. The agricultural sector is also expected to grow by less than in previous years due to reduced international commodity prices and demand. On the upside, the first full year of production from Gold Ridge mine is expected to contribute around 2 ¼ percentage points to growth in 2012. In addition, strong construction activity, improvements in the transport, telecommunication and service sectors aided by donor inflows, and general development in business activities will also support growth in 2012.

Chart 1: Sector contribution to real GDP growth (%)



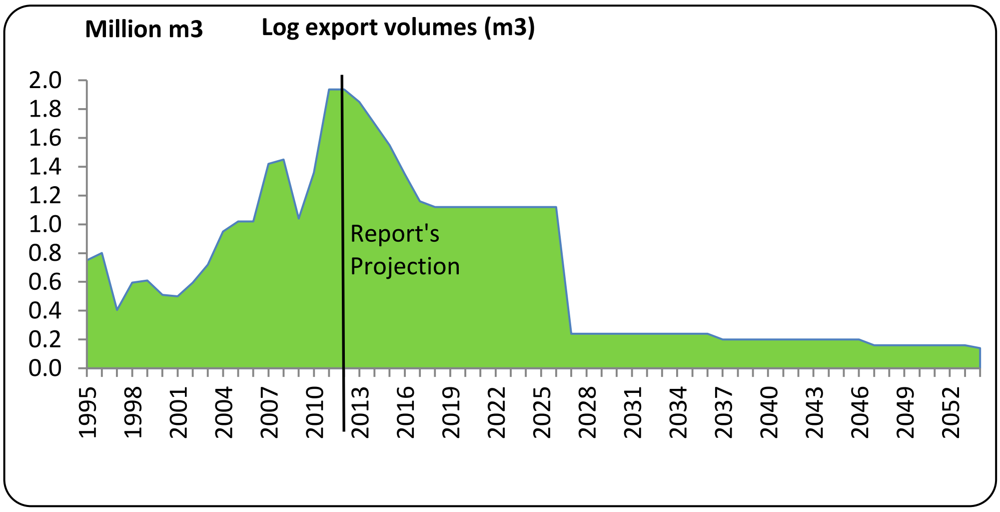
Source: Ministry of Finance and Treasury calculations.

Whilst record log exports have contributed substantially to economic growth in recent years, this rate of harvesting with a heavy emphasis on re-entry logging is unsustainable. In 2011, Solomon Islands exported almost 2 million m³ in log exports. By comparison Papua New Guinea, the world's second largest exporter of tropical logs after Malaysia, exported 3 million m³ in 2011. Log production is expected to decline by around 4 per cent in 2013 and continue to decline at an annual average of around 8 per cent over the next four years due to increasing supply constraints. This outlook has been factored into the economic and fiscal forecasts (see Box 1 below).

BOX 1: UPDATED NATURAL FOREST RESOURCES ASSESSMENT

Solomon Islands National Forest Resources Assessment: 2011 Update was commissioned by Regional Assistance Mission to Solomon Islands (RAMSI) and the Solomon Islands Government (MOFT), and authored by Sinclair Knight Merz (SKM). The objective of the assessment was to provide independent external estimates on the true remaining and potential economic value of Solomon Islands forest industry. This helps the Government to make informed estimates of the likely timing and rate of decline in logging production and provide a credible assessment of remaining forest stocks. This is an important input into economic and fiscal forecasting, as well as economic policy-making.

A key finding of the report is that due to the significant re-entry logging taking place, the forestry industry is expected to continue for longer than expected – around 10-15 years depending on the rate of log production and forestry policy. However, due to the sizeable scale of the re-entry logging and considerably reduced virgin commercial forests available, logging volume is expected to have peaked in 2011-12 and will reduce over the medium term before being exhausted before 2030. If this occurs, in less than twenty years, the Solomon Islands will have few remaining timber resources and will be unable to sustain a sizeable forestry industry. It would take at least 50 to 100 years before logging would again be commercially viable in Solomon Islands.



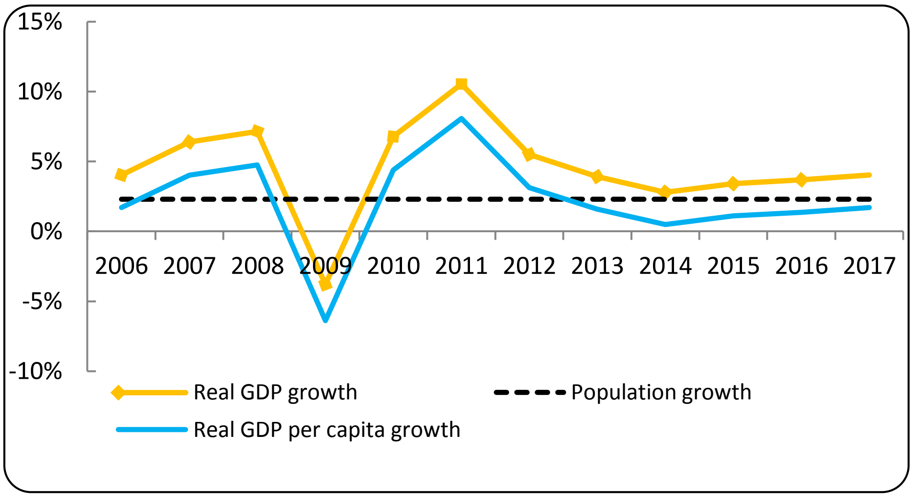
Source: Solomon Islands National Forest Resources Assessment: 2011 Update- Scenario B (mostly likely scenario of log exports depicting the continuation of current timber production in the Solomon Islands)

The report also makes a number of recommendations in support of a more sustainable forest industry, improving compliance and monitoring of logging operations, improving information systems for effective forest management, and further developing the plantation and agriculture sectors of the Solomon Islands.

The resumption of gold production and exports by the Gold Ridge mine is expected to be a large contributor to economic growth in 2012. Production is expected to expand to 80,000 ounces, contributing around 2¼ percentage points to economic growth. However, from 2013 onwards, it is expected that annual gold production will be steady at around 95,000 ounces. As a result, the mining sector is expected to add very little to growth over the medium term. The Gold Ridge effects are unlikely to generate significant gains for the 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 is expected to increase once the mine starts making profits, although its contribution will remain below that achieved by logging. (For further discussion, please refer to **Section 2: Fiscal Performance**).

Chart 2 shows that the reduction in logging output and stabilization in output from the Gold Ridge mine will result in real GDP growth rates of between three and four per cent over the medium term. With estimated population growth of 2.3 per cent per year, growth in GDP per capita is likely to remain very slow, suggesting that living standards are unlikely to improve markedly in the medium-term.

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



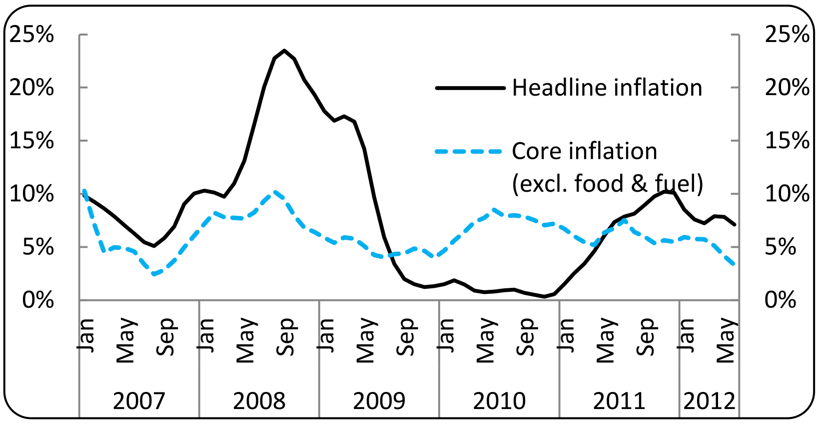
Source: Ministry of Finance and Treasury calculations.

1.2 Inflation

Inflation is the measure of the change in prices for goods and services in Solomon Islands. In 2011, annualised headline inflation (measured by the 3-months-moving average—3mma) was 6.7 per cent on average, after falling to 1.0 per cent in 2010. This was largely driven by higher fuel and food prices in global markets, strong domestic demand and domestic supply constraints. In 2011, core inflation (headline inflation excluding food and fuel) averaged 6 per cent as depicted in Chart 3 below. The Central Bank of Solomon Islands (CBSI) also allowed the Solomon Islands dollar to appreciate vis-a-vis the US dollar in an explicit effort to contain inflation.

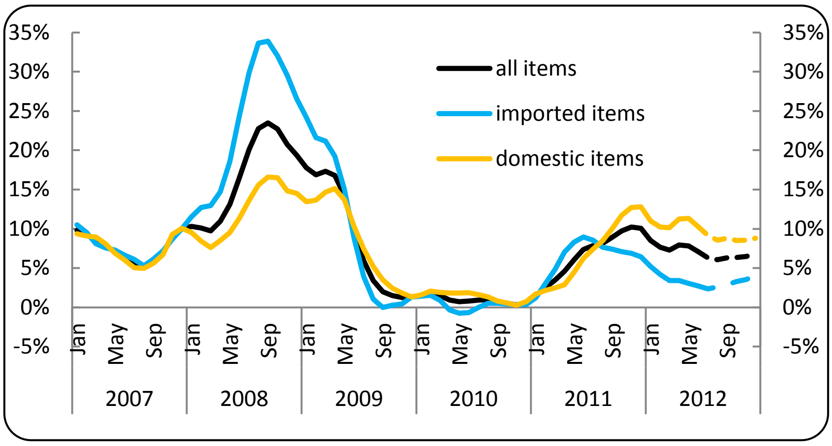
Since early 2012, headline inflation has gradually moderated to 7.1 per cent (3mma) in June, although fresh food prices, reflecting a particularly wet rainy season, created some volatility in the overall inflation rate. Core inflation (as estimated by the Ministry of Finance and Treasury) moderated to 3.3 per cent (3mma) in June, reflecting stabilizing non-fuel non-food prices both in domestic and international market. In 2012, headline inflation is expected to average around 6.5 per cent (see Chart 4 below) as international fuel and commodity prices and domestic prices continue to ease, while core inflation is expected to remain below 5 per cent. In 2013, headline inflation is also expected to average around 6 per cent.

Chart 3: Solomon Islands headline and core inflation, Jan 2007 – Jun 2012 (Y-o-y, 3mma)



Source: Ministry of Finance and Treasury calculations.

Chart 4: Solomon Islands: Inflation Jan 2007 – Jun 2012, Inflation forecast July – Dec 2012, (y-o-y, 3mma)



Source: Ministry of Finance and Treasury calculations.

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 in the short term to the increase in demand by producing more. With more people competing for the same amount of goods, the suppliers put up their prices in response.

The most inflationary of Government expenditure 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. 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.

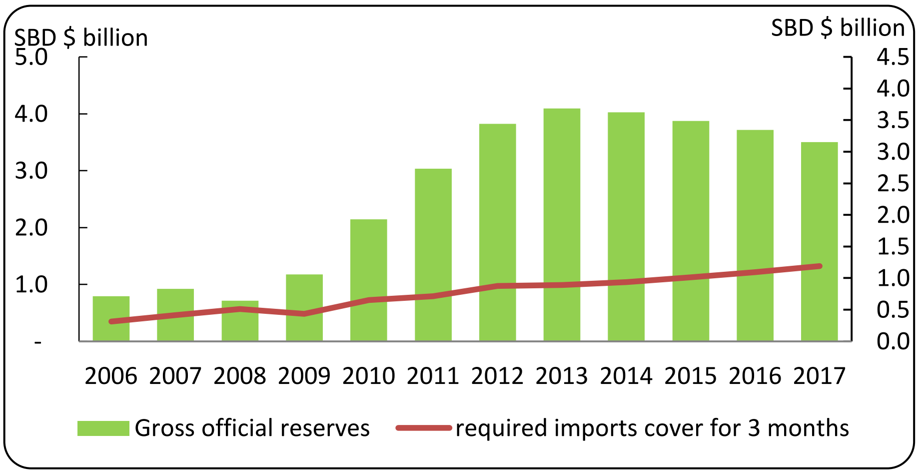
Volatility in international commodity markets remains the primary external risk to domestic inflation. Solomon Islands high dependency on fuel and imported items for production and the lack of immediate substitutes will also add inflationary pressures to domestic prices. The high levels of liquidity being built up in the banking system are also a potential risk for inflationary pressure should lending activities pick up. In 2012, the CBSI undertook 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. The Central Bank will continue to manage the monetary and exchange rate policies if the inflation risks persist. 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.

1.3 Balance of Payments

The Solomon Islands external position was favourable in 2011. The current account deficit narrowed to around 7 ¼ per cent of GDP compared to around 30 per cent of GDP in 2010, reflecting solid growth in the export sector and reduced imports of capital equipment following the reopening of the Gold Ridge mine. Foreign reserves increased by 42 per cent over 2011 to be SBD$3 billion at the end of the year. This was driven mainly by the surge in log exports, improvements in commodity demand and prices and aid inflows. This level of reserves was equivalent to over 9 months of imports, representing a reserve level well above the recognised benchmark of 3 months import cover.

The country's balance of payment position is expected to remain favourable in 2012. As of August 2012, the country's gross foreign reserves stood at SBD$3.6 billion (more than 9 months of import cover) on higher trade receipts from logs and donor inflows (See Chart 5 below). Foreign reserves are expected to increase by around 25 per cent over 2012 to be around SBD$3.8 billion by the end of the year. This reflects the increase in logging and gold exports, aid inflows and foreign investments. This level of reserves is estimated to be equivalent to more than 10 months of import cover. In 2013, the level of foreign reserves is projected to increase slightly as a result of continued donor inflows and foreign investments. The anticipated decline in the logging sector and expected stabilisation in donor inflows is expected to contribute to falling reserves over the medium term. However, these would still be expected to remain sufficient to finance Solomon Islands' trading needs.

Chart 5: Foreign Reserves as months of import cover



Source: Ministry of Finance and Treasury calculations.

1.4 Summary

The Solomon Islands rebounded quickly following the Global Economic Crisis, and has experienced strong growth in recent years. However from 2013, economic growth is expected to moderate to between 3 and 4 per cent over the medium term.

The impact on real growth of a decline in log production, slow agricultural exports owing to subdued international conditions over the medium term, and low non-agricultural production reveal the challenges of Solomon Islands' narrow economic base.

Broadening the base and achieving higher rates of real growth that will raise the living standards of Solomon Islanders is a significant challenge for the Government. The Government is committed to meeting that challenge[1].

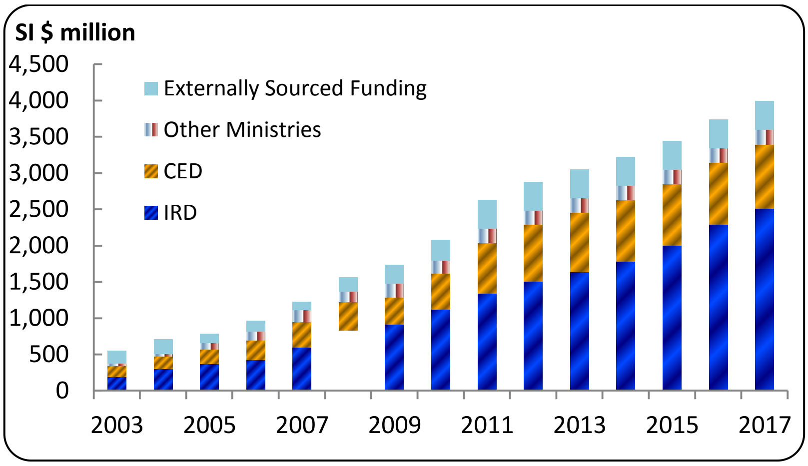
[1] Recent progress is described in section 3.

2. Recent Fiscal Performances.

2.1. Revenue

Funding in the Consolidated Budget has grown strongly over the last few years. Between 2006 and 2011 total consolidated funding increased by an annual average of around 22 per cent (Chart 6). Domestic sourced revenue grew by an annual average of around 23 per cent during this period. This growth has been driven by strong economic performance and to a lesser extent increased log exports. Export duties from logging grew by an annual average of around 20 per cent. Externally sourced funding provided by donors grew at an annual average of around 24 per cent from 2006 to 2011.

Chart 6: Composition of Government Revenue



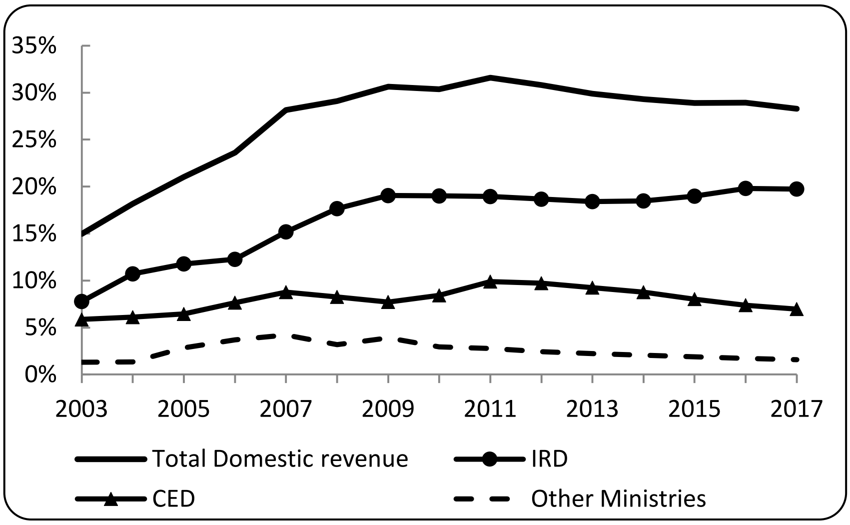
Source: Ministry of Finance and Treasury calculations.

In 2011, the Government's fiscal position was strong, resulting in an overall fiscal surplus of around $340 million, equivalent to around 5 per cent of nominal GDP. This reflects stronger logging revenues, improvement in tax collections, an increase in grants, and lower-than planned development spending as a result of the delay in the 2011 Budget. Domestic revenue increased by around 24 per cent, driven by a strong pick-up in general economic activity and through improved tax collections reflecting improvements in revenue administration. The Government continued to build up its deposits in the banking system to meet its policy objective of maintaining cash reserves equivalent to at least two months of recurrent expenditure.

In 2012, revenue is expected to grow at a slower rate of around 9 per cent, compared to the 23 per cent growth achieved between 2006 and 2011.The revenue outlook is expected to remain subdued over the medium term, reflecting slower economic growth.

Chart 7 below shows revenue growth is not expected to keep up with economic growth. This is expected to be the result of declining export duties from logs and Other Ministry revenue not being reformed. The challenge for Government will be to grow both Inland Revenue Division and Other Ministries' revenue faster than the growth in the economy to make up for the decline.

Chart 7: Composition of Government Revenue (% of GDP)



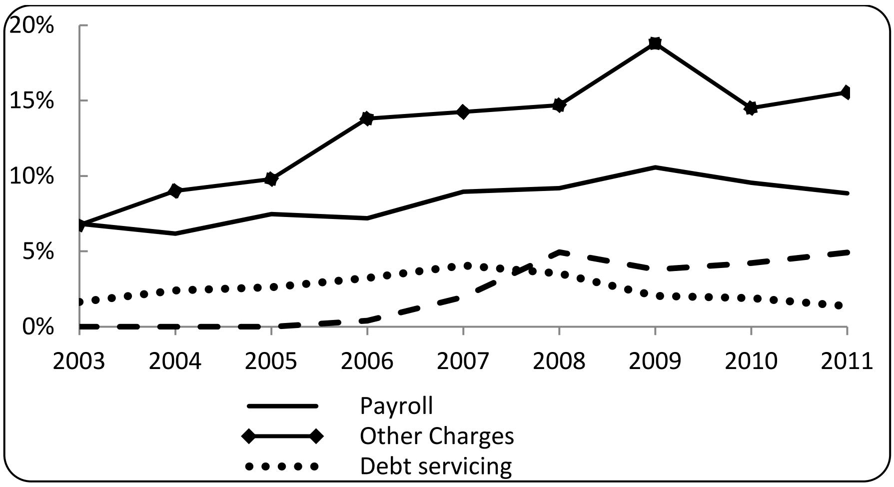
Source: Ministry of Finance and Treasury calculations.

2.2. Expenditure

Given subdued revenue growth expected over the medium term, it is even more critical that the Government continue with measures that better prioritise and allocate expenditure. It should also be noted that the end of the Gold Ridge mine in around a decade will create a revenue shock as temporary annual revenues of an estimated more than $200 million come to an end. This shock will be similar to the one felt over the next five years as logging revenues drop from current record levels. To cater for these shocks, the Government will need to keep recurrent expenditure growth low. This may be achieved by allocating the temporary revenue increase to the Development Budget or using it to pay high interest bearing Government debt.

Chart 8 shows how the Government has in recent years allocated increasing funding (larger than the rate of growth in the economy) to the Development Budget, while keeping payroll expenditure relatively flat. The benefits of increased debt repayments can also be seen through debt servicing now making up a lower percentage of Government expenditure.

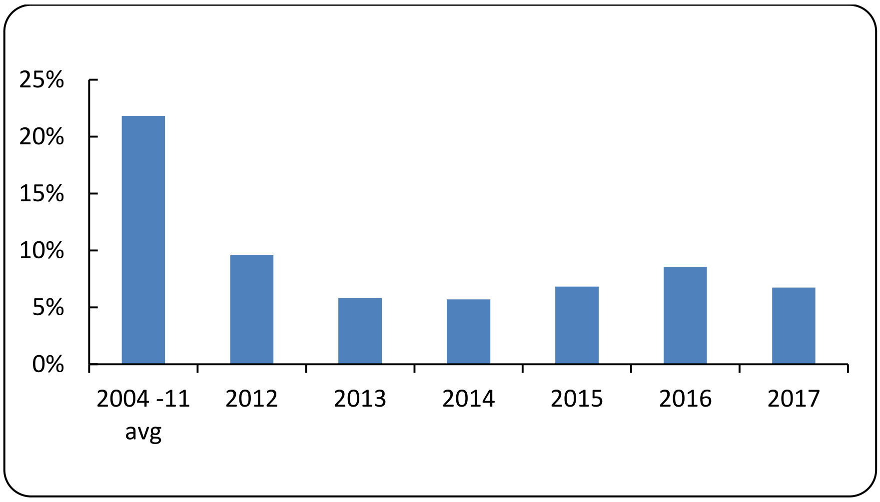
Chart 8: Composition of recent growth in Government expenditure (% of GDP)



Source: Ministry of Finance and Treasury calculations.

Chart 9 shows the projected expenditure growth path for 2012 to 2017 needed to balance the budget, given expected medium term revenue and donor funding. The projections include a cash reserve of 2 months recurrent budget expenditure. To maintain fully funded budgets, average **nominal expenditure growth will need to slow from 25 per cent per annum for the period 2006 to 2011 to a maximum of 8 per cent from 2013 to 2017.**

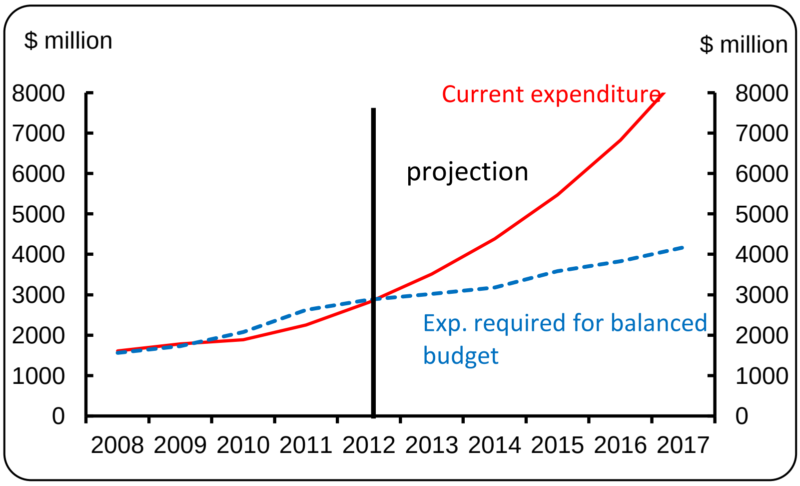
Chart 9: Maximum expenditure growth required for balanced Budget



Source: Ministry of Finance and Treasury calculations.

Chart 10 shows the projection 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 suggests that Government expenditure has been growing at an alarming rate that is unsustainable in the face of the challenges ahead. To avoid deficits and provide sufficient cash savings and funding for the development budget, the Government needs to substantially reduce the growth in current expenditure.

Chart 10: Expenditure projections under alternative rates of expenditure growth



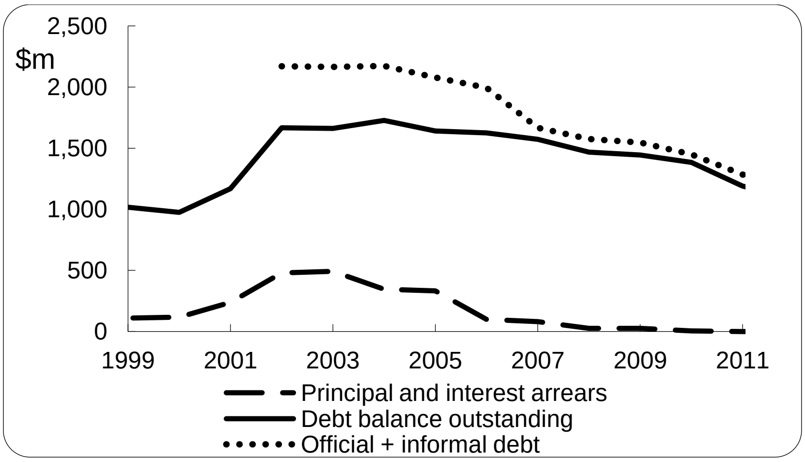
Source: Ministry of Finance and Treasury calculations.

2.3. Debt

Solomon Islands is continuing to pay for poor borrowing decisions made by past Governments—these debt servicing costs are an ongoing expense. Much of the money borrowed by past Governments either directly or through the 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 improve economic performance and lead to higher living standards.

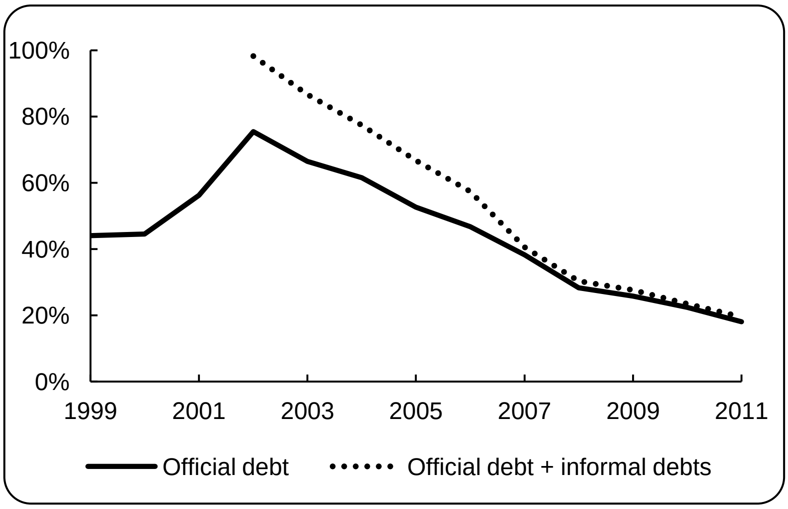
Solomon Islands has had a difficult history with debt. While the period of civil unrest led to a blowout in Government debt levels (see Chart 11 and Chart 12), many of the underlying causes of what was an unsustainable debt position came from earlier times. By 2003 Solomon Islands was in default on all of its debt.

Chart 11: Solomon Islands Public Sector Debt Stock (SBD million)



Source: Ministry of Finance and Treasury calculations.

Chart 12: Solomon Islands Public Sector Debt to GDP ratio



Source: Ministry of Finance and Treasury calculations

Major changes were needed to rebuild Solomon Islands' finances and address its debt position. 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 apply 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 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. (See Box 2 below)

BOX 2. THE 2005 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/ 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.

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. Debt levels have fallen significantly as has debt as a proportion of GDP [2]. These gains have been possible because of the improved economic and fiscal performance of the Solomon Islands, the recommencement of debt repayments, the benefit of debt restructuring and debt relief negotiated with many creditors, and the impact of paying down remaining debt arrears. The Government has agreed to a new Debt Management Strategy[3], endorsed by Honiara Club members, to guide debt management decisions going forward.

The Debt to GDP ratio (a measure of debt sustainability) has now fallen to 14 per cent (see Chart 12), 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, there is capacity to again access concessionary debt funding. 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)

Maintaining the improved debt position is a significant challenge for Solomon Islands, with implications for economic and fiscal policy. However, without a continuing commitment to balancing the recurrent budget, Solomon Islands' debt position could deteriorate again. Managing debt is an important element of the Government's fiscal strategy over the medium term. This is outlined in section 2.3 and 4.3.

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[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 December 2011, debt levels have fallen to around $1.3 billion.

[3] See Box 2 on the Debt Management Strategy below

3. Economic Strategy

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

3.1. Implementation of Business Laws

Recent reforms in the area of companies' law and the laws of secure transactions have improved the Solomon Islands environment for business. The Government intends to continue to reforms in this area. The 2011-12 Solomon Islands National Provident Fund (NPF) Act review will provide for better governance of this major financial institution. The review is considering ways to ensure that the benefits of members of the fund are well protected and how NPF services could be improved.

The National Financial Inclusion taskforce, chaired by the Central Bank of Solomon Islands, is working to provide better access to, and expansion of, financial services in rural areas. This is expected to be achieved by ensuring small and medium businesses and individuals have access to better financial services and higher standards of living. The Taskforce is focussing 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

The *National Transport Fund Act* 2009 and its associated regulations are in effect. The Act establishes the National Transport Fund Board that 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. This 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 all Solomon Islanders.

The *Solomon Islands National Infrastructure Investment Plan (SI-NIIP*) is currently under development. The SI-NIIP will present the medium term (5-10 years) needs and priorities in economic infrastructure for the Solomon Islands. This will also include formulating a funding strategy to cover the capital and recurrent costs of economic infrastructure and strengthening the capacity for planning and management.

A current significant infrastructure investment is the Submarine Cable Project described in Box 3 below. This project has significant potential for boosting economic growth and living standards for the people of Solomon Islands.

BOX 3: SUBMARINE CABLE PROJECT

Currently Solomon Islands' access to internet services is served by linking to the satellite network. This service however, is very expensive, unreliable and also has limited capacity and is unable to meet the growing demand of the country's population for internet services. The submarine cable system (SCS) project is an alternative to the satellite link. The Government in collaboration with the donors (Asian Development Bank) and the private sector are currently negotiating plans to link the Solomon Islands to the rest of the world through an undersea fiber cable running between Sydney and Guam. It has been proposed that there will also be two domestic cables linking Auki (Malaita Province) and Noro (Western Province) to ensure that the benefits of the SCS are distributed to a significant number of Solomon Islanders (approximately 75% of the population with potential for expansion with the use of satellite links).

Should the project be commissioned, the Government on its part will receive a USD 7.5 million grant and USD 10.5 million loan from ADB and will on-lend (the total USD 18 million) to a private company (Solomon's Oceanic Cable Company (SOCC)) co-owned by Solomon Islands National Provident Fund (SINPF) and Solomon Telekom Ltd (STL) to own and operate the cable. The on-lent loan will be repaid in full to the Government with interest. The total cost of the SCS project is estimated to be around USD 60 million with other contributions from SOCC and commercial finance.

The SCS once finalized will enable greater access and cheaper priced broadband internet services which will contribute to sustainable as well as improved economic and social outcomes for the country. It is expected that SCS will reduce the cost of doing business in Solomon Islands especially in terms of information flow (which is very expensive at the moment) enabling other services such as internet banking and access to more market information. Other benefits may include e-health and e-education which will allow information to be disseminated more efficiently boosting social well-being.

The Government has also taken necessary actions by committing itself to adopting a national Information Communication Telecommunication (ICT) strategy to ensure there is an enabling environment for secure election transactions, online security and protection against cyber-crimes. The Government has also committed to broadening access to broadband internet services.

3.3. Tax Reform

The tax reform efforts are aging. Much of the Solomon Islands tax legislation is out-dated and exemptions in the system are costly to the Government and create opportunities for corruption. The current system also depends too heavily on a narrow set of activities and needs to be broadened and strengthened to reinforce the tax base whilst not impeding 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 to ensure that the overall tax burden is being shared more fairly. Work on further improving the exemption process with the focus on tightening, bringing more consistency in the process and establishing a statutory basis for the exemption committee is well underway. Further tax reform will be pursued with the clear objectives 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 a better place to do business and are also a critical part of the fiscal strategy that is be outlined in Section 4.1.

A review of the Customs and Excise Act has been ongoing through most of 2012, supported by the Asian Development Bank. The review aims to improve revenue collection, border integrity and trade facilitation.

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[4] that focuses on the mining sector has been developed with the assistance of the International Monetary Fund (IMF). Legislation is expected to be introduced in the next sittings of Parliament. The framework will ensure that Solomon Islanders receive their fair share from the future profits made from the nation's mineral resources. To complement the Natural Resource Tax framework the Government has shown commitment to implement the Extractive Industries Transparency Initiative (EITI) to improve fiscal transparency and accountability within the mining sector. As of 28 June 2012, the EITI international Board approved Solomon Islands to become an EITI candidate.

3.4. State Owned Enterprises (SOEs)

State owned enterprise reforms are continuing. Following the introduction of the *State Owned Enterprises Act 2007,* there has been ongoing improvement in the performance of Solomon Islands' SOEs. The current focus is on supporting SOEs to deliver on the accountability and reporting obligations of the SOE Act and regulations, and to continue to improve SOE financial and service delivery performance.

Of particular note is the recent development that regularise the fiscal relationship between SOEs and the Government and provide incentives for improved performance. The Community Service Obligation (CSO) framework was agreed by the Government in June 2010. CSOs are used to fund non-commercial operations of SOEs and allow SOEs to focus on running other areas of the business in a profitable manner. CSOs are funded from the Government Budget. The Payment is based on results and SOEs need to provide adequate reporting as evidence of these results—this supports incentives for improved performance. In 2012, the Government has signed CSO contracts with Solomon Islands Electricity Authority and the Solomon Islands Water Authority. Further CSOs are expected to be signed in future years, supported by anticipated improvement in SOE financial management and reporting capacity.

Improved SOE performance makes an important contribution to economic growth and improved living standards. This arises from better and expanded services to the people of Solomon Islands, better infrastructure investment, and more efficient use of the national capital stock. Reduced fiscal risk frees up resources that can be devoted to providing other key services such as health and education. Over the longer term, the Government will look to see a financial return to the community on their investment in SOEs in the form of dividends.

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[4] Box 4 on page 22 summaries the key elements of the Natural Resource Tax Framework

4. Fiscal Strategy

The second objective of the MTFS is **an affordable and sustainable Government budget** which limits debt to a manageable and sustainable level, improves efficiency in Government budget processes, and focuses on achieving the development goals of the Solomon Islands. By doing this, the Government helps to increase economic growth, minimize the inflationary effect of Government expenditure, and maintain sound levels of foreign reserves.

This section of the MTFS outlines what the Government is doing to manage the challenges outlined earlier. In particular, this section outlines the policies this 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. The constraints on expenditure outlined in Section 2.1 could impact on future economic development or service provision. However, there are various policies which the Government is currently undertaking to reduce this fiscal tightness and manage its impact.

4.1. Revenue

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 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 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 moved the determined value for round logs to 100% which is in parity with the international market. 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 4 below) has been developed by the Ministry of Mines and Rural Electrification and the Ministry of Finance and Treasury. The framework includes adopting a fiscal regime for the mining sector which will remove the need to negotiate individual taxation agreements with mining companies.

BOX 4: THE RESOURCE TAX FRAMEWORK

The Natural Resource Tax framework proposes a way forward for the management of mineral resources in Solomon Islands. The focus of the framework is to introduce appropriate levels of taxes investors will pay to the Government for the extraction of mineral resources. Based on the principle that these taxes are not only fair but are also competitive and reasonable to investors. The framework aims to create clear and transparent expectations for companies coming into the Solomon Islands helping them understand the tax obligation that they will face.

The framework does not concern directly those processes that are the responsibility of the line Ministries. For example, the Ministry of Mines, Energy and Rural Electrification retains responsibility for granting of exploration licences and the negotiation of mining agreements. Building technical capacity, modernizing the associated mines and minerals legislation and effective monitoring of the mineral sector remain the responsibility of that Ministry. The focus of the framework is to ensure that an appropriate taxation regime is put in place for the mining sector.

To complement the Natural Resource Tax framework, the Government is also committed to adopting the Extractive Industries Transparency Initiative (EITI) and to meet its disclosure standards to improve fiscal transparency within the mining sector. This will involve reconciling company payments and Government revenue received from extractive industries via a National Stakeholder Group. In doing so, the Government is providing a clear signal to investors and international financial institutions that the Government is committed to greater transparency.

4.2 Expenditure

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 prioritizing and managing its expenditure while implementing Government priorities.

In 2011, the Government commenced a range of financial management reforms which includes crucial budget reforms that aim to improve spending and allocation decisions. These reforms will ensure public funds are spent on policy priorities and that funded activities achieve desired results and outcomes. The reforms will continue to be implemented in parallel with capacity developments in line ministries. The key areas of the budget reform include:

- continued fiscal consolidation including fully funded budgets and maintaining an overall surplus;
- 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;
- improving the accountability and transparency around the use of resources and the outcomes and outputs of annual budgets;
- extensive Budget consultation with Civil Society Organizations and Provincial Governments as part of annual budget process;
- improving budget consultation with line ministries and developing Ministry of Finance and Treasury's capacity to align budget allocation with needs;
- building the capacity of line ministries to improve budget allocation;

- developing a medium term expenditure framework based on forward estimates;
- strengthening budget financial accountability and reporting systems; and
- managing the debt servicing of the Government.

These reforms should also help improve 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 Solomon Islands which in turn increases revenue as investments expands.

4.3 Debt

The 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) as well as the new Debt Management Strategy.

BOX 5: DEBT MANAGEMENT STRATEGY

The new Debt Management Strategy (DMS) provides a framework to guide SIG's debt management decisions. The key objectives are:

1. Ensure that the servicing and management of the Solomon Islands government's financing requirements and payment obligations are met on a timely basis, and at the lowest possible cost over the medium to long run, consistent with a prudent degree of risk; and
2. Support the development of a domestic debt market.

The essential features of the 2012 DMS are:

- Pursue grant funding and budget support.
- Where a loan element of grant funding for priority development projects is mandatory, limited concessional borrowing may be sought.
- External borrowing by central Government is limited to concessional loans from multi- or bilateral donors or development partners, with a grant element of 35 per cent or more.
- Terms and conditions must be appropriate for the project being financed;
- Foreign exchange risk will be evaluated with preference given to loans in SBD;
- Debt servicing shall be sequenced to avoid large peaks in repayment expenses at certain times of the year;
- As part of the budget process, an annual borrowing limit will be set such that debt levels will not cause thresholds (described in Section 4) to be exceeded under stress scenarios;
- Guarantees will not be issued until SIG has the resources to assess the risks of proposed guarantees and negotiate means to mitigate these risks, and monitor and report on guarantees; and
- Any additional fiscal surplus arising from buoyant revenues will be used to retire domestic debt.

The DMS has been adjusted to allow low cost low risk but non-concessional domestic borrowing by State-Owned Enterprises under certain circumstances.

The stronger debt position of the Government (outlined in Section 2), attributable in part to the fiscal discipline imposed by the Honiara Club Agreement, has led to its reclassification by World Bank to 'yellow light status'. This means that applications for funding development projects must now be made as a combination of concessional loan and grant.

One of the undertakings of the Honiara Club Agreement was that it would be reviewed in five years and before there was any new borrowing. Representatives of the Honiara Club met in July 2012 and agreed to amend the Honiara Club Agreement to allow for:

> "New development expenditure proposals with an associated acceptable borrowing requirement being progressed in accordance with the Debt Management Strategy and associated prudent annual borrowing limit, including through the Debt Management Advisory Committee, which will provide advice to the Minister for Finance and Treasury on the efficacy, affordability and value for money dimensions of such proposals."

The new Debt Management Strategy (DMS) was developed by SIG and endorsed by Cabinet in May 2012 (Refer to Box 5 above) and by the Honiara Club representatives. The DMS provides a strong framework for debt management and allows for borrowing, provided that it is within prudent borrowing limits, the borrowing source is cost effective and low risk (all external borrowing must be concessional) and for a fit purpose. All forms of debt are covered by the strategy, including issuing guarantees and borrowing by State-Owned Enterprises and Provincial Governments.

Prudent borrowing limits to maintain debt at sustainable and affordable levels will be determined by debt sustainability analysis. A limit for new borrowing is determined annually as part of the budget process. The limit for 2012 is SBD 150 million. At this level of borrowing for 2012 to 2018 and using current economic projections, debt sustainability and affordability thresholds were not breached under realistic shock scenarios such as depletion of forest reserves, a Global Financial Crisis and currency depreciation. The total central Government debt (including domestic and external debt and any explicit contingent debts such as Government guarantees) to GDP ratio (a proxy for debt sustainability) must be less than 25 per cent and the debt servicing cost to domestically sourced revenue ratio (a measure of debt affordability) must be less than 8 per cent. These levels are consistent with the IMF/WB Debt Sustainability Framework thresholds for Low Income Countries.

Transparency and accountability are strengthened by all borrowing proposals being first assessed by a Debt Management Advisory Committee (DMAC). Borrowing must be (1) for a fit purpose (2) from an acceptable source and (3) with acceptable terms and conditions. The DMAC assists in guided decision making, through providing a recommendation to the Finance Minister on borrowing and debt related matters. The Finance Minister has sole authority for approving borrowing.

New debt funding must be applied in a manner that contributes positively to the country's economic development. Borrowed resources must be used to fund high priority development activities, including investment in infrastructure, which can drive growth into the future. Debt must not be incurred to fund an underlying deficit in the recurrent budget or to fund the losses of State-Owned Enterprises.

The MOU signed with IMF for the use of the Standby Credit Facility imposes a range of restrictions on borrowing over the life of the program. It effectively prohibits long and short term external borrowing on commercial terms for any purpose while allowing some concessional borrowing from institutions like the ADB and World Bank. (See Box 6 below for more information about the IMF standby credit facility.)

BOX 6: IMF ASSISTANCE AGREEMENT: PRECAUTIONARY STAND-BY CREDIT FACILITY

In December 2011, Solomon Islands Government successfully concluded its first program under the IMF. The 18-month Standby Credit Facility (SCF) arrangement had been initiated in 2010 to access concessional loan financing given the balance of payment difficulties experienced at the time, and to catalyse donor support. By the end of the program all quantitative targets had been met by large margins and the structural reforms agreed to under the program had been implemented.

To anchor its policy agenda and maintain reform momentum upon conclusion of the first program, the Solomon Islands Government entered a successor 12-month precautionary SCF arrangement. The Government has moved on to build a sufficient base of cash reserves now covering ten months of imports of goods and services. 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, given the economy's strong dependence on the export of commodities (including logs), and its exposure to international price fluctuations.

The Government has indicated a strong interest in sustaining its engagement with the IMF once the precautionary SCF expires at end-2012. Having achieved major steps in 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.

The *Public Finance and Audit Act* is currently under review. A new *Public Financial Management Act* is being drafted which will incorporate key features of the DMS. The Honiara Club Agreement will be reviewed again once the new Act is in force. A strong debt management framework encourages investor confidence through demonstrating a commitment to keeping debt at affordable and sustainable levels, to accountable and transparent decision making processes and to fiscal responsibility.

5. Conclusion

This 2012 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**. This 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. This update to the Medium Term Fiscal Strategy reaffirms the Government's commitment to such reform.