

Solomon Islands Government



Medium Term Fiscal Strategy: 2013-2018

August 2013 Update

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 sixth 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:

- Necessary structural reform
- An affordable and sustainable Government budget

To ensure that the Strategy remains current, it is updated at least once a year before the release of the Budget. Each update incorporates recent major changes in the economic environment, and includes a summary overview of key productive sectors that drive growth in our economy.

The most significant challenge outlined in the 2012 MTFS was the expected downturn in the logging sector which was forecast to put pressure on Government revenue collections, restrain economic growth and reduce foreign reserves in the medium term. However, logging output in 2012 turned out to be stronger than the 2011 result driven by continued strong Chinese demand, high international prices and re-entry into previously logged areas. In 2013, log production is expected to be below the 2012 record output level of 1.9m³ reflecting short-term disruptions from weather, as well as increasing supply constraints associated with the decline of log stocks.

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. As a result, log production is expected to decline by around 4 ½ per cent in 2013 and continue to decline at an annual average rate of around 8 per cent over the next four years.

Over the medium term, real economic growth is expected to moderate to around 3-4 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 gradual decline in the level of foreign exchange reserves. The 2013 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 pursue reform opportunities and provide 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 2013 Medium Term Fiscal Strategy (MTFS) is an updated version of the 2012 MTFS. It is a five-year strategy for 2013 – 2018 which outlines the progress toward meeting the two main economic objectives of the Government:

- structural reform to make Solomon Islands attractive, 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 economic and fiscal strategies that the Government is pursuing in order to raise long-run economic growth, and improve living standards.

In 2012, real GDP is estimated to have grown by around 2.6 per cent compared to growth of around 6 ½ percent in 2011 and 10 ½ percent in 2010. In 2013, real GDP is expected to accelerate to around 3 per cent, with lower output in the primary (agriculture, fisheries, logging) and minerals sectors expected to be more than offset by solid growth in the manufacturing and services sectors. Growth in the agricultural sector is forecast to moderate in 2013 (although it is still expected to make a modest contribution to growth) because of lower commodity prices affecting production of export commodities. The services and the industry sectors are expected be the main drivers of growth in 2013, contributing around 3 percentage points to economic growth. In 2014, real GDP growth is forecast to accelerate to 4 per cent, reflecting increased production in the fishery, mining and agriculture sectors and continued solid growth in the services sector.

Despite the relatively strong growth in real GDP over recent years, the expected reduction in logging output owing to resource depletion 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 gradual decline in the level of foreign exchange reserves.

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. The *Public Financial Management Act 2013* is an important first step towards achieving this objective.

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 the economy from the external shocks, particularly from sudden adjustments in commodity prices.

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

1. Remaining committed to the path of economic reform so that the private sector can act as the economies engine of growth, wealth creation, employment generation and poverty reduction by:
 - implementing business laws to improve the environment for business;
 - implementing a framework to guide the Solomon Islands' debt management and new borrowing decisions;
 - improving state-owned enterprise (SOE) financial and service delivery performance;
 - revising the Customs and Excise Act to improve revenue collection, border integrity and trade facilitation;
 - supporting 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, finalising 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
 - pursuing the development of the productive sectors by removing barriers to growth especially tourism, agriculture, fisheries, agriculture and mining.
2. Continuing to pursue an affordable and sustainable budget that limits debt, by:
 - adopting fiscal measures that aim to manage demand in a manner consistent with external viability, in particular, ensuring expenditure does not exceed revenue;
 - strengthening and reforming budget processes;
 - implementing reforms aimed at providing a fairer and more efficient tax base, including by strengthening processes for exemptions from taxes and duties;
 - limited borrowing that is consistent with the annual borrowing limit and 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

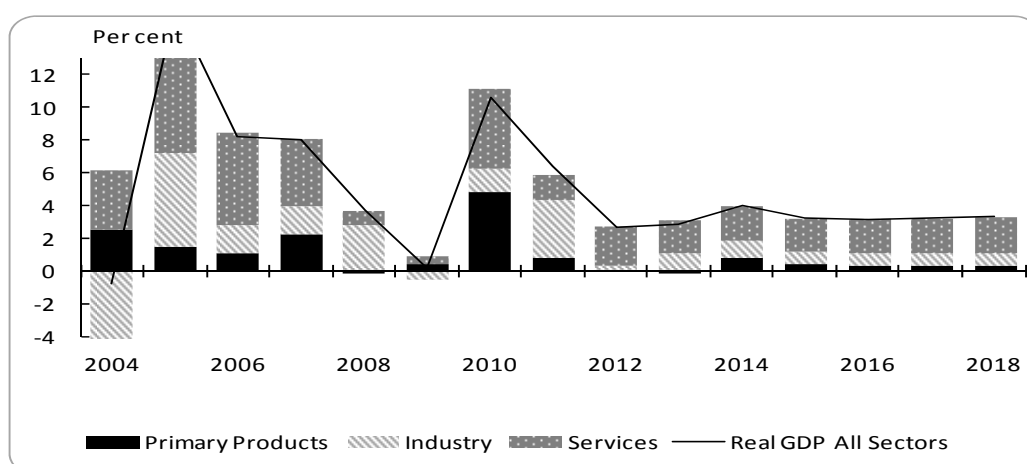
1.1 Gross Domestic Product

The outlook for the Solomon Islands' economy is becoming increasingly challenging. This is because most of the key contributors to growth over recent years are slowing down. In real terms, the economy is estimated to have grown by a modest 2.6 per cent in 2012 compared with 6 ½ percent in 2011 and 10 ½ percent in 2010. Slower growth was largely driven by a sharp contraction in output in the agricultural sector, along with stabilizing logging production and gold production. Log export volumes remain unchanged from 2011 levels while export value increased by 12 per cent in 2012. Exports of all major agricultural commodities (palm oil, copra, and cocoa) recorded a decrease in volume and value during the year due to softening global demand and declining commodity prices. Growth in 2012 was supported by improvements in telecommunications, construction, manufacturing and the trade and services sector aided by increased donor inflows.

As shown in [Chart 1](#), in 2013, real economic growth is forecast to accelerate slightly to 2.9 percent, with log output expected to decline (to around 1.83 million cubic meters) as a result of increasing supply constraints. A modest decline in output at the Gold Ridge Mine (which is now in its second year of full production) and lower production in the fishery sector are also expected to subtract from growth in 2013. However, solid growth in the construction, manufacturing and services sectors, supported by donor inflows and an expansion in production at the Noro tuna processing factory, is expected to more than offset the weaker production in the mining and primary production sectors.

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 and 2012, Solomon Islands exported almost 4million m³ in logs over two years. This by far has been the record level of logging output compared to the previous years. 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.

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



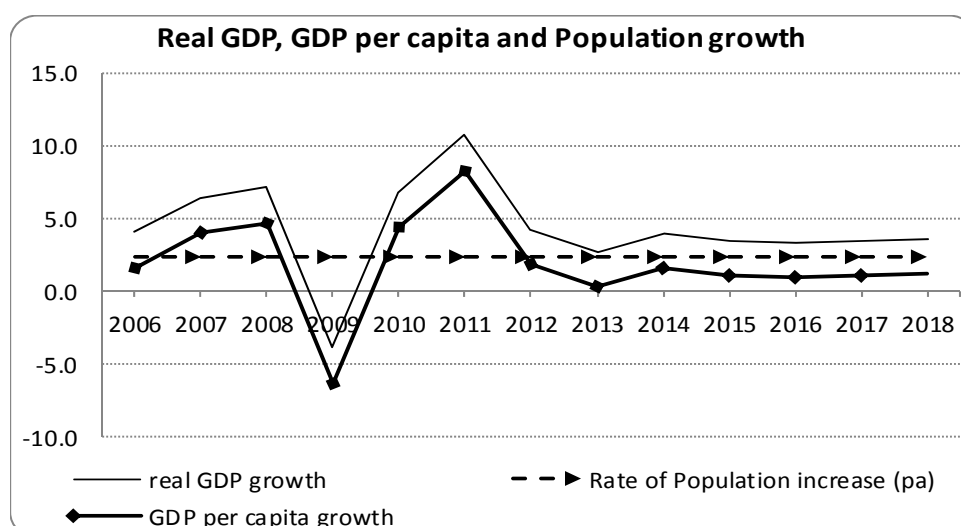
Source: Ministry of Finance and Treasury calculations.

In 2013, production of all the major agricultural export commodities has continued to decline (29 per cent lower over the year to September 2013), reflecting the impact of falls in commodity prices over the past 18 months. As a result, growth in the agricultural sector is forecast to be well below trend in 2013, although it is still expected to contribute to overall growth in real GDP. The decline in the price of agricultural commodities, along with a sharp fall in the price of gold, has contributed to deterioration in the Solomon Islands' terms of trade and downward pressure on the value of the merchandise trade balance, real GDP growth, and domestic-sourced revenue. These developments have been factored into the economic outlook for 2013 and the medium term (see [Box 1](#) page 8).

Production for Gold Ridge is expected to moderate to around 60,000 ounces in 2013, before recovering to remain steady at around 65,000 ounces from 2014 onwards. As a result, the mining sector is not expected to contribute to growth in 2013 and is projected to contribute little to growth over the medium term. Current gold mining operations 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, revenue is expected to increase once the mine starts making profits (noting that the level of profits is highly sensitive to movements in the gold price), 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 hovering 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 slow, suggesting that living standards are unlikely to improve substantially in the medium-term.

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



Source: Ministry of Finance and Treasury calculations

In 2014, real GDP growth is expected to accelerate slightly to around 4 percent. This reflects increased contributions from the agriculture, fisheries and services sector. Growth in the agriculture

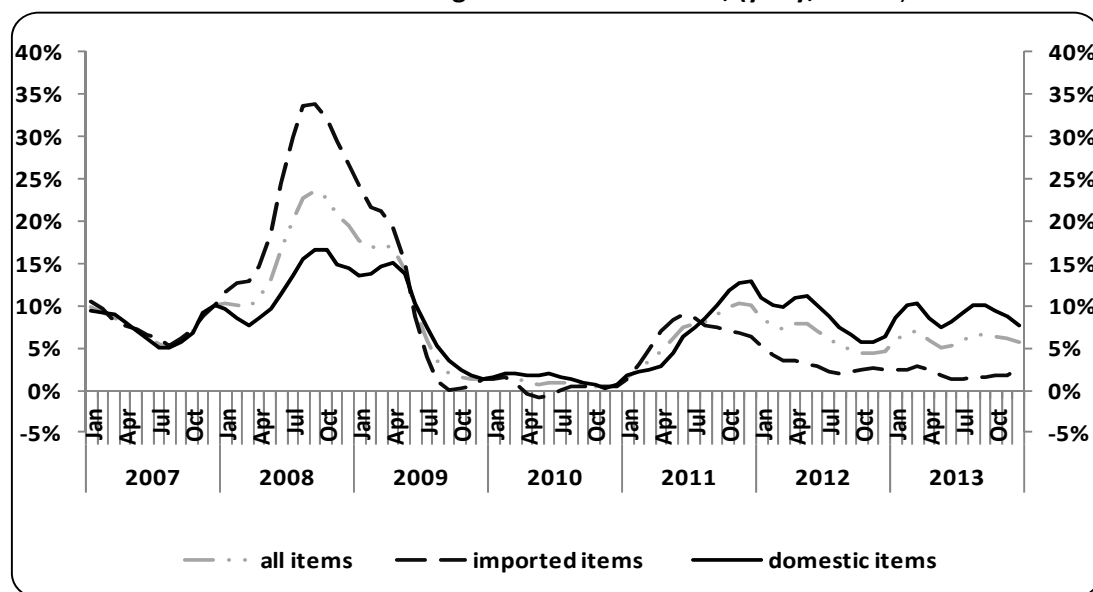
sector is forecast to accelerate in 2014 as the prices of major export commodities stabilise. The contribution of the industry sector is forecast to increase in 2014 and support real GDP growth over the medium term, reflecting the impact of strong investment in the manufacturing and construction sectors.

1.2 Inflation

Inflation is the measure of the change in prices for goods and services in Solomon Islands. In 2012, annualised headline inflation (measured by the 3-months-moving average—3mma) was 6.2 per cent on average, a slight fall from 6.7 per cent in 2011. The inflation growth was driven by higher fuel and food prices in global markets, strong domestic demand and domestic supply constraints.

Headline inflation increased to an annualised rate of 6.5 per cent (3mma) in August, although fresh food prices, reflecting a particularly wet rainy season in the first quarter, created some volatility in the overall inflation rate. In 2013, overall headline inflation is expected to average around 6 per cent (see [Chart 3](#) below) an international fuel and commodity prices and domestic inflation moderates. In 2014, inflation is forecast to average around 5.5 per cent.

**Chart 3: Solomon Islands: Inflation Jan 2007 – Aug 2013,
Inflation forecast August – December 2013, (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.

BOX 1: DECLINING COMMODITY PRICES AND SOLOMON ISLANDS' TERMS OF TRADE

Solomon Islands export base is very narrow, with major export commodities including copra, cocoa, palm oil, coconut oil, fish, logs and gold. In addition, production of Solomon Islands' key exports (and the economy more broadly) are highly sensitive to developments in international commodity prices (particularly agricultural exports), meaning that a decline or increase in prices typically results in production of these commodities following the same trend.

Substantial falls in the price of Solomon Islands' key export commodities over the past 12-18 months has resulted in the terms of trade deteriorating (by around 10 per cent). This has contributed to the merchandise trade balance (which excludes services trade) moving into a deficit over the first half of 2013, and is also likely to have underpinned slower growth in national income.

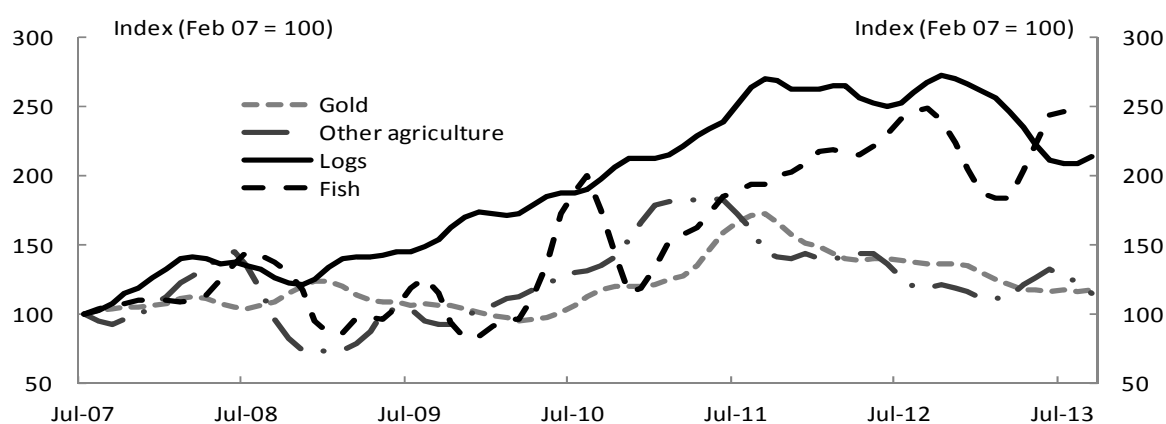
- In aggregate, the prices of the Solomon Islands key agriculture exports (cocoa, copra, Palm oil) has declined by around 35 per cent since mid-2011.
- The gold price has fallen from USD 1650 per ounce to around USD 1300 per ounce since the beginning of 2012. A further sharp downward movement in the price remains a clear risk to the economic outlook.

In response to the deterioration in the terms of trade and adverse weather conditions, production of the Solomon Islands' key primary commodities (agricultural production, fishing and logging) declined markedly over the first half of 2013 (on the basis of consultation with industry, weather has been the primary reason for lower fishing and logging production rather than lower prices). This follows the sharp contraction in agricultural production recorded in 2012.

- As a result, production of primary products (agriculture, fisheries and logging) is now expected to subtract around 0.2 percentage points from real GDP growth in 2013 compared with a 0.1 percentage point subtraction from growth in 2012.

While prices of key commodities are expected to stabilize over the medium term, recent developments highlight the sensitivity of the Solomon Islands economy to fluctuations in global commodity markets, and the need for on-going improvements in the public financial management and structural economic reform.

Chart 1: Prices of Solomon Islands' Export Commodities



Source: World Bank

The most inflationary of Government expenditure is spending on consumable goods and services. If the Government continues to spend more while the supply of those goods and services does not increase (assuming the other components of real GDP remain unchanged), 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 significantly.

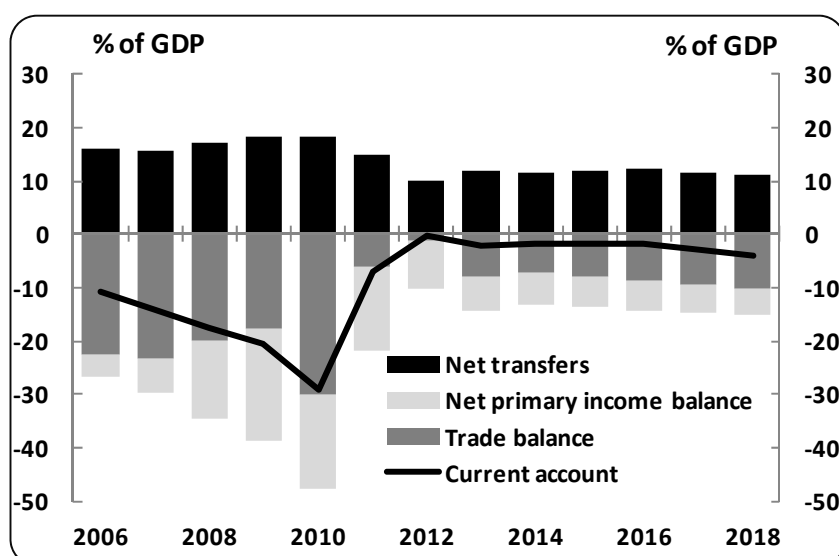
In 2012 and 2013, the Central Bank Solomon Islands (CBSI) undertook short term measures to alleviate inflationary pressures including mopping up liquidity through issuing short-term bills, reducing banks' US dollar exchange rate margins and appreciating the exchange rate against the US dollar. CBSI will 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 or using alternative energy sources) can help to ensure that resulting pressures on prices are minimized.

1.3 Balance of Payments and external sector

The International Monetary Fund (World Economic Outlook, October 2013) continues to expect a modest acceleration in global economic activity, driven largely by the advanced economies. Global growth remains modest however, averaging 2½ percent during the first half of 2013. While the advanced economies have recently gained some speed, the emerging market economies continue to account for the bulk of global growth. The IMF estimates that after growing by 3.2 per cent in 2012, global economic growth will slow to 2.9 per cent in 2013 before accelerating to 3.6 per cent in 2014.

The Solomon Islands external position improved in 2012. The current account deficit narrowed from around 7 per cent of GDP in 2011 to around ¼ per cent of GDP in 2012 (see [Chart 4](#)), largely reflecting strong export growth associated with higher production at the Gold Ridge Mine. Foreign reserves increased by 21 per cent over 2012 to be around SBD\$3.7 billion at the end of the year. This was driven mainly by the strong growth in mineral exports and an improvement in the primary net income deficit. This level of reserves was equivalent to around 9 months of imports, representing a reserve level well above the recognised benchmark of 3 months import cover.

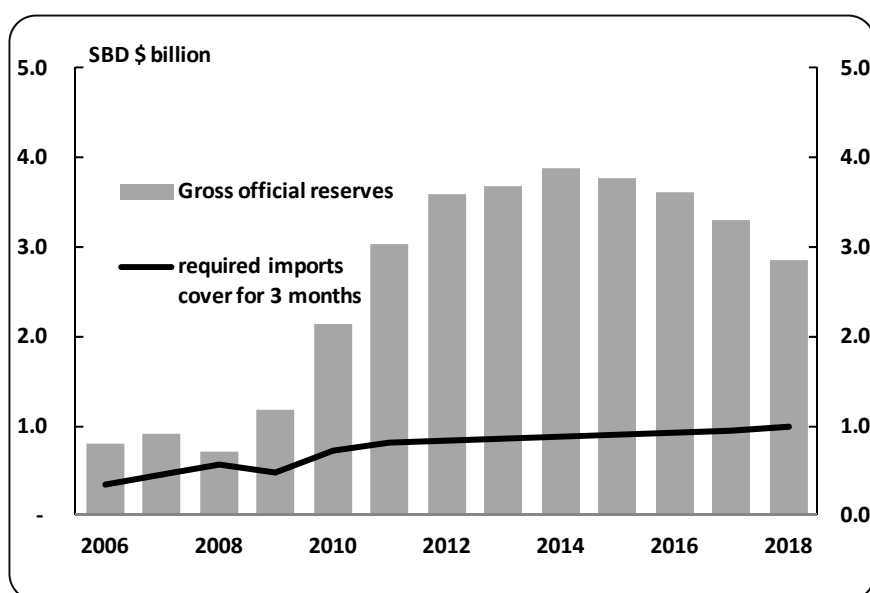
Chart 4: Solomon Islands' current account balance (per cent of GDP)



Source: Ministry of Finance and Treasury Calculations

The country's balance of payment position is expected to remain favourable in 2013. Foreign reserves are expected to increase slightly around 3 per cent over 2013 to be around SBD\$3.7 billion by the end of the year (see [Chart 5](#)). This reflects a broadly balanced current account position, continued donor inflows and net foreign investment. This level of reserves is estimated to be equivalent to around 10 months of import cover. 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 be more than adequate to ensure monetary and exchange rate stability.

Chart 5: Foreign Reserves as months of import cover



Source: Ministry of Finance and Treasury calculations.

1.4 Summary

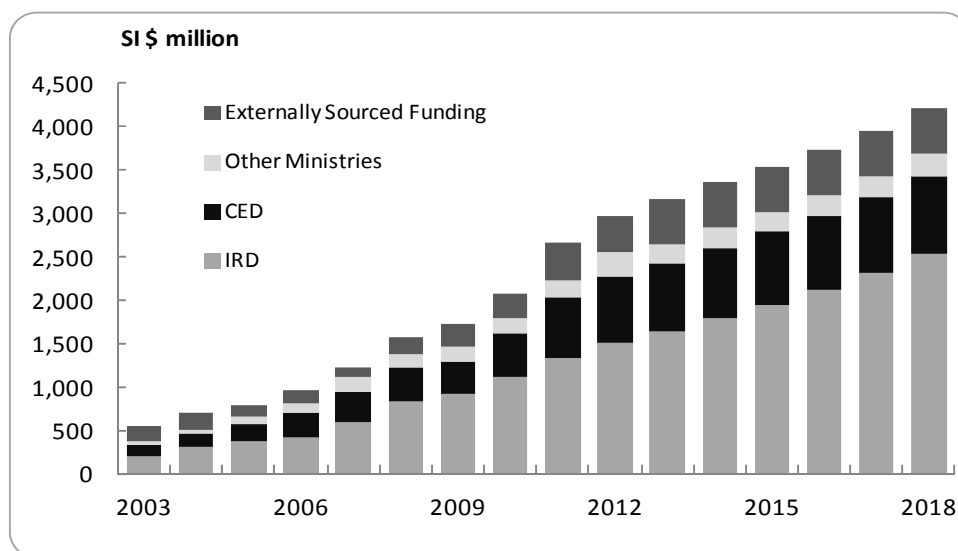
The Solomon Islands rebounded quickly following the Global Economic Crisis, and has experienced relatively strong growth over recent years. However, from 2013 economic growth is expected to moderate to between 3 and 4 per cent over the medium term in line with modest, or declining, growth in the logging, mining and agricultural sectors. The impact on real growth in 2013 of a decline in log production, lower agricultural exports (owing to weaker international commodity prices), and relatively modest growth in non-agricultural production, demonstrate the challenges of Solomon Islands' narrow economic base. Broadening the base and achieving higher rates of real economic growth that will raise the living standards of Solomon Islanders is a significant challenge for the Government. The Government however is committed to meeting that challenge¹ and working on potential sources of growth areas for the economy.

Recent Fiscal Performance

2.1. Revenue

Funding in the Consolidated Budget has continued to grow strongly over the last few years. Between 2006 and 2012 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 24 per cent during this same period. This growth has been driven by strong economic performance and to a lesser extent stabilizing of both the log exports and the mining sector. Externally sourced funding provided by donors grew at an annual average of around 23 per cent from 2007 to 2012.

Chart 6: Composition of Government Revenue



Source: Ministry of Finance and Treasury calculations.

In 2012, the Government's fiscal position remained sound, resulting in an overall fiscal surplus. Domestic revenue increased by around 12.8 per cent, driven by general economic activity and through improved tax collections reflecting improvements in revenue administration. The

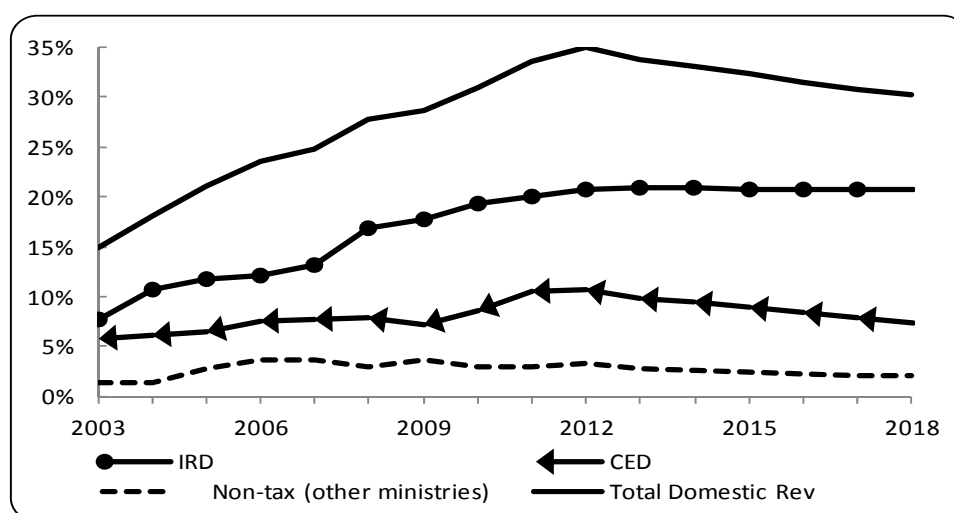
¹ Recent progress is described in [section 3](#).

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 2013, domestic revenue is expected to grow at a slower rate of around 5 per cent, compared to the annual average 24 per cent growth rate achieved between 2006 and 2012. The slower growth in 2013 largely reflects a modest decline in the level of export duties on logs (which accounted for around 16 per cent of total domestic-sourced revenue in 2012) and a fall in non-tax revenue. 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 nominal economic growth. This is the result of the expected slowdown in collections of export duties from round log, continued challenges around non tax revenue revenues collection. The latter may argue for future reform efforts. Generating sufficient revenue to fund the publicly provided goods and services that Solomon islanders need and want is largely dependent on pursuing the economic growth agenda. The challenge for the government will be to strike a balance between the need to generate enough revenue but at the same time to ensure that this does not itself detract from growth.

Chart 7: Composition of Domestic Source Revenue (% of GDP)



Source: Ministry of Finance and Treasury calculations.

2.2. Expenditure

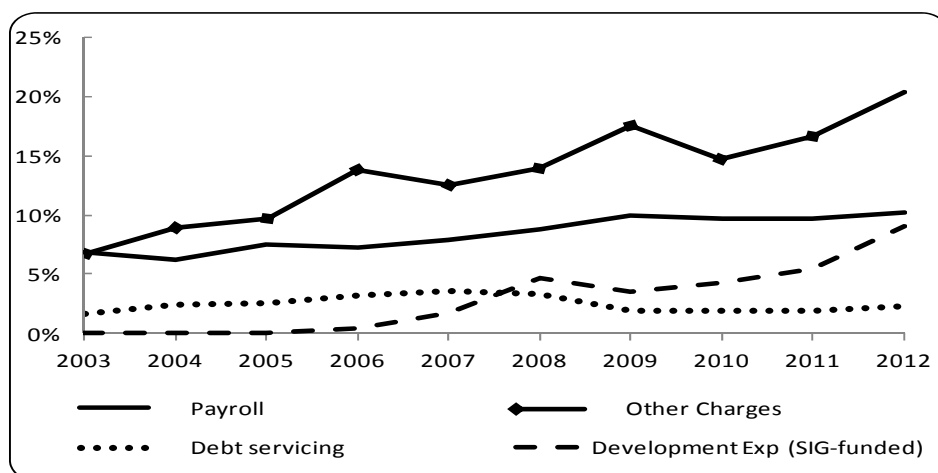
Given subdued revenue growth expected over the medium term, it is even more critical that the Government continue with measures that better prioritise and allocate expenditure. It should also be noted that the end of the Gold Ridge mine in around a decade will create a revenue shock as temporary annual revenues of an estimated \$100 million come to an end². To manage the impact of 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 (including major

² The estimated revenue from gold production over the medium term is highly sensitive to assumptions about the outlook for the gold price. The estimated revenue over the medium term from production at Gold Ridge has been revised down, reflecting the recent sharp decline in the price of gold.

projects that could be expected to deliver substantial economic gains) 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.

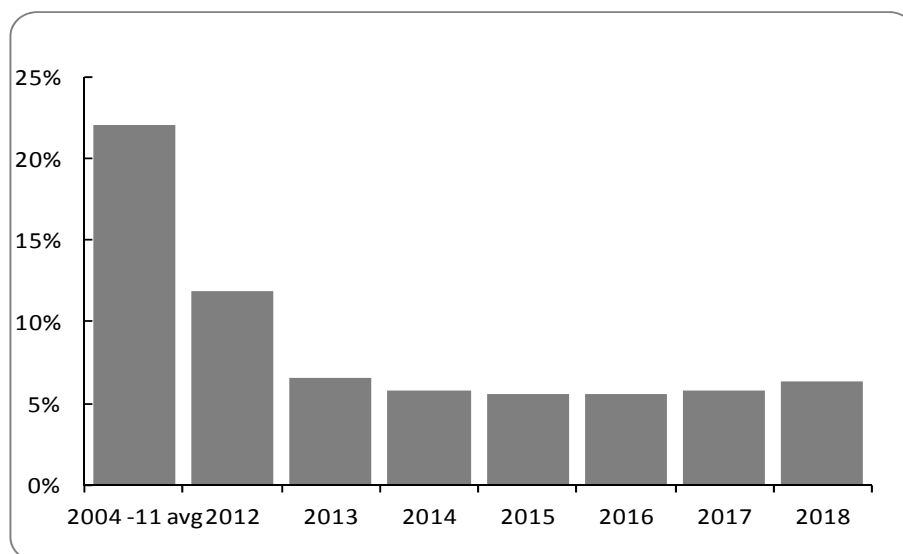
Chart 8: Composition of Government expenditure (% of GDP)



Source: Ministry of Finance and Treasury calculations.

[Chart 9](#) shows the projected expenditure growth path for 2012 to 2018 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 around 23 per cent per annum for the period 2006 to 2012 to an average annual growth rate of around 7 per cent from 2013 to 2018.

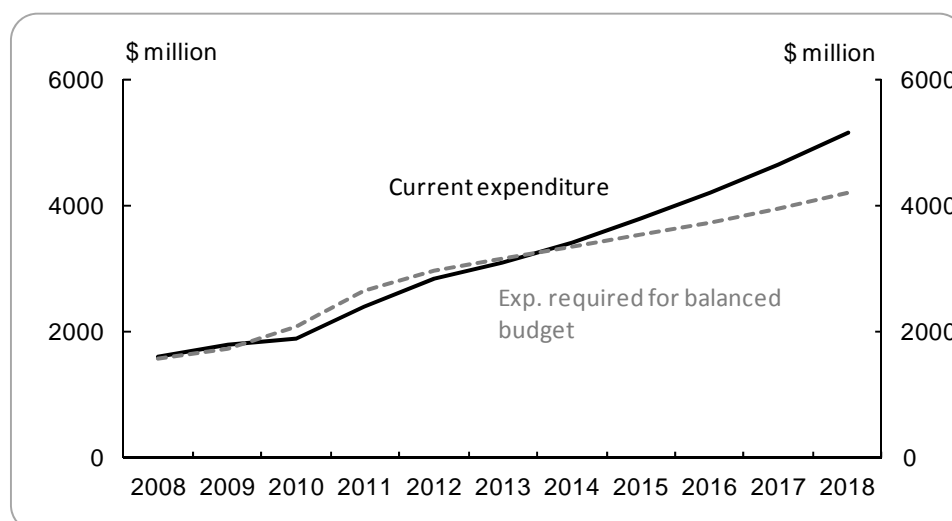
Chart 9: Maximum expenditure growth required for balanced Budget



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



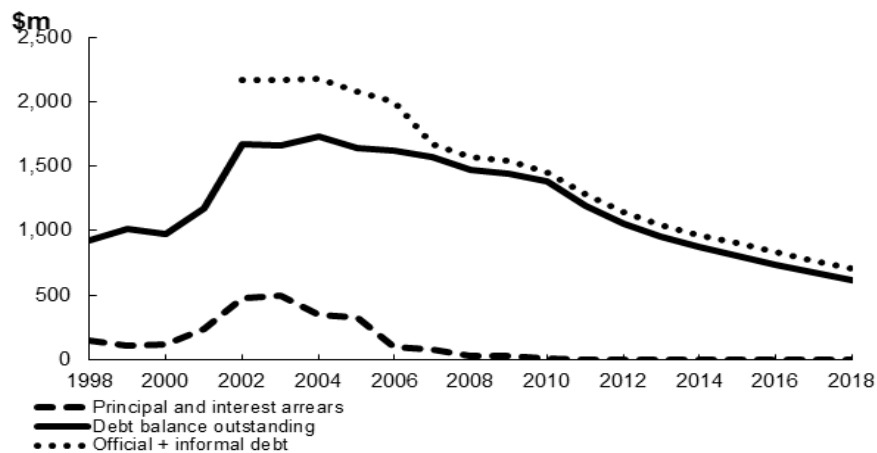
Source: Ministry of Finance and Treasury calculations.

2.3. Debt

Debt, when taken on within a robust framework and used to invest in a country's physical and social infrastructure, can contribute to improved economic performance and living standards. Conversely, debt that is taken on to fund unproductive ventures, in the absence of a robust framework, can have the opposite impact on an economy and living standards. Unsustainable debt can generate undesirable fiscal pressures that may divert funding away from essential services like health and education.

Debt in the Solomon Islands has gradually fallen to a more sustainable level since peaking in 2004 (refer to stock of total debt (official and informal) in [Chart 11](#)). Official debt as a proportion of GDP (a measure of debt sustainability) has fallen from 62% in 2004 to 14% as at end 2012 (refer to [chart 12](#)). Total debt servicing (including for informal debts) as a proportion of domestically sourced revenue (a measure of debt affordability) has fallen from 25% in 2004 to 6% in 2012. The guiding principles, agreed to by the Government as part of the 2006 Honiara Club Agreement, have provided the foundation upon which this improved debt position has been achieved. Improved economic performance and fiscal discipline have also played a major role in bringing debt levels down.

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

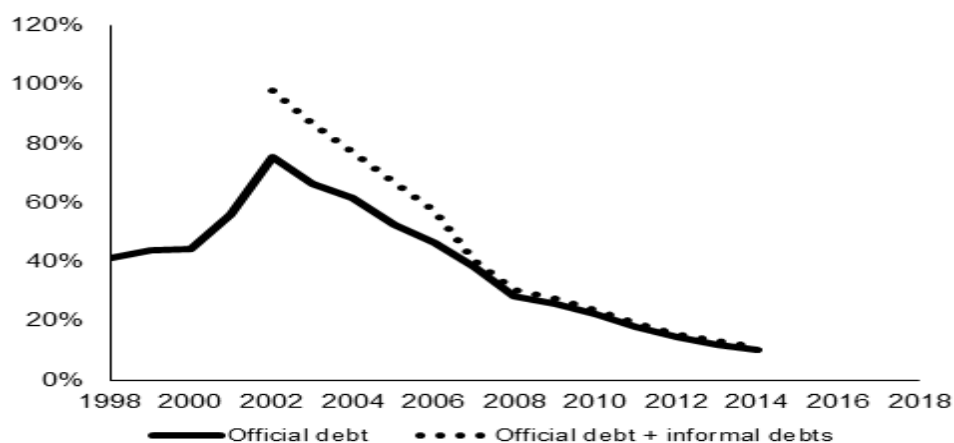


Source: Ministry of Finance and Treasury calculations.

The improved debt position means that the Solomon Islands is now in a position to access debt funding on a concessionary basis. This capacity was confirmed in 2010 when the Solomon Islands' debt status was upgraded from red light (high level of debt distress) to yellow light (moderate risk of debt distress) under the IMF/World Bank Debt Sustainability Framework.

Given this capacity to once again borrow, care must be taken to not repeat the mistakes of the past. Although the deterioration in the debt position leading up to 2004 could be largely attributed to the period of civil unrest, poor borrowing decisions made before this period also contributed to the build up of debt to these unsustainable levels. The Government has therefore embarked on a process to develop a Debt Management Framework to ensure that debt does not again reach unsustainable and unaffordable levels.

Chart 12: Solomon Islands Public Sector Debt to GDP ratio



Source: Ministry of Finance and Treasury calculations

The guiding principles of the Honiara Club Agreement (reviewed in 2012) and the Debt Management Strategy (endorsed by Cabinet in 2012) are the cornerstone components of this Framework. The Public Financial Management Bill, passed by parliament in September 2013, is now the overarching component of the Framework. A SOE Borrowing Policy was incorporated into the Framework in 2013

and it is anticipated that further policy will be developed to govern on lending arrangements and Government provided guarantees.

Keeping debt at more sustainable and affordable levels is a significant challenge for Solomon Islands. Continuing the commitment to balance the recurrent budget is important if Solomon Islands intend to meet this challenge. Solomon Islands' debt position could easily deteriorate were this commitment not upheld. Managing debt is an important element of the Government's fiscal strategy over the medium term. This is outlined in section 2.2 and 4.2.

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. The Government is also seeking to facilitate a number of private and public-private investments projects that, if implemented, would expand the productive potential of the Solomon Islands economy ([Box 3](#) provides a summary of these potential investments).

3.1. Business Regulation and Financial system Reforms

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 reforms in this area. The 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 to ensure that the fund governance and operation does not weaken confidence in the financial market.

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 so that the small and medium businesses and individuals have access to better financial services to improve their standard of living. The Taskforce is focussing on expanding access to credit, making transferring money easier, and developing savings. Other reforms that are currently being reviewed are the Credit Union Act and the Financial Institutions Act. Expansion of financial services is one of the means to achieve the Millennium Development Goals, particularly by reducing poverty.

BOX 3: POTENTIAL DRIVERS OF LONG-RUN ECONOMIC GROWTH

Tina River Hydro Development Project and Savo Island Geothermal Power Project

Tina River Hydro Development Project (TRHDP) was initiated in 2007. It is located in North East Guadalcanal and it will involve the building of a dam in the Tina River catchment. This project, if approved by Cabinet to proceed, will act as an alternative to the power stations run by SIEA on diesel. A project of this size involves a large number of risks and will require detailed cost-benefit analysis before a decision to proceed is taken by the Government. The Tina River Hydro Project provides an opportunity for the Solomon Islands to diversify away from diesel generation, reducing exposure to fuel price volatility and placing the Solomon Islands' balance of payments on a more sustainable path.

In addition, to the Tina River project, Savo Island has been identified as a potential source of geothermal energy for Honiara. Geodynamics, a private company, has progressed work over the past 12 months (and will continue to be undertaken) to determine the feasibility of the Savo Islands project. While the project is still at a relatively early stage of consideration, it has the potential to provide reliable electricity at reduced end user prices for Honiara.

The Submarine Cable project

Currently the Solomon Islands access to internet services is via to the satellite network. This is very costly. The undersea cable project is an alternative to the satellite link. This private sector project, financed in part by sovereign backed debt, looks to connect Solomon Islands to the undersea cable network. The cable once commissioned and finalised will enable greater access and cheaper priced broadband internet services. This will contribute to sustainable and improved economic and social outcomes to the economy of the Solomon Islands. While it is difficult to be definitive about timing, it is hoped that construction on the project will commence in 2014.

Fisheries sector

The Solomon Islands currently has one tuna processing facility—Sol Tuna—which has been in operation for more than 20 years. Sol Tuna's operations are primarily canning and loining. However, only a proportion of the fish catch are being processed on shore. A number of key policies relating to the management of the fisheries sector are currently being finalised by the Government. These policies, once implemented, are intended to facilitate increased on-shore investment in the fisheries sector (with two projects already under active consideration). These projects could be expected to generate significant benefits, including the creation of jobs, and an expansion of the export base of the country.

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. Revised in 2010, the National Transport Plan 2011-2030 also produced a 3 year rolling Transport Sector Development 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 draft *Solomon Islands National Infrastructure Investment Plan (SI-NIIP)* was completed in 2012 and is being considered by the Government. This outlines Solomon Islands priorities and plans for major infrastructures over the next 5-10 years. The aim of SI-NIIP is to identify and prioritise the package of infrastructure investments which best meets Solomon Islands needs in the coming years. The SI-NIIP plans for the funding and implementation of the project. SI-NIIP also recommends actions for the government consideration regarding the long term sustainability of infrastructure assets and identifies the implications of climate change and disaster risks for these types of infrastructures. The SI-NIIP covers the infrastructure sub sectors of: transport (land, aviation, and shipping) water supply and sanitation, solid waste management, energy and power, and telecommunications and information technology.

3.3. Tax Reform

Tax reform efforts are ongoing. 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 largely complete. 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 to be outlined in [Section 4.1](#).

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

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.

The fiscal relationship between the Government and its SOEs has continued to improve as the SOE Act is bedded in. In recent years the community service obligation (CSO) framework, which was agreed in 2010, has underpinned improved financial and service delivery performance. Under the CSO framework the Government contracts SOEs to provide socially important but non-commercial services, allowing SOEs to focus on running the commercial areas of their business in a profitable manner. An increasing number of CSO contracts are being put in place as SOE financial management and other practices improve to support them.

A more recent focus has been on improving SOE corporate and financial planning, and its interactions with broader Government fiscal processes. Improvement in financial planning and management, together with the application of the Borrowing Policy, will support critical investments in SOEs, which will, in turn, contribute to Solomon Islands growth in the medium term.

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 facilitates 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 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. 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 is complemented by building the administrative and resource capacity of the Inland Revenue Division and the Customs and Excise Division to enforce compliance. The Government remains committed to improving the capacity of the revenue agencies including through increasing the number of staff and this is paying dividends in improved collections of taxes and duties properly owing.

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. The determined value for round logs

has been increased to achieve parity with the international market. The determined value is now 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.

As outlined in the 2012 Medium-Term Fiscal and Economic Strategy, since 2011 the Government has pursued a range of financial management reforms that are designed to improve spending and budget allocation decisions. The Government's commitment to improved financial management is

demonstrated in the new Public Financial Management Act, which was passed by the National Parliament in 2013 (see [Box 5](#) for additional information). The key areas of fiscal 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. These reforms will also help to maximise the benefits of public expenditure, and ensure that the public supports, and improves, the long-run growth potential of the Solomon Islands economy.

BOX 5: PUBLIC FINANCIAL MANAGEMENT ACT

The Government has recently passed a new Public Financial Management (PFM) Act 2013. The new PFM Act is a clear demonstration of the Government's commitment to ensuring that the use of public resources contribute to the welfare of the people of the Solomon Islands. More specifically, the purpose of the PFM Act is to promote sound financial management, including through the administration of the Consolidated Fund, according to budgeted priorities, monitoring and reporting and to ensure Government accountability to parliament.

In achieving the purpose of the Act, the following set of principles must apply:

- the Minister of Finance and Treasury shall ensure that the use of public resources contribute to the ongoing economic prosperity and welfare of the people of the Solomon Islands
- the accountable and accounting officers shall be prudent in the use of public resources to ensure sustainability and stability for the benefit of future generations and be transparent in making decisions about allocating and using public resources
- be accountable to the National Parliament and the People of Solomon Islands for their economic, fiscal and financial management decisions and their performance on behalf of the Government

In addition to these principles, the PFM Act clearly outlines the roles and responsibilities of the Finance Minister and public officials. In particular, the PFM Act specifies that the Minister for Finance:

- promote sound fiscal and macroeconomic policies by developing and implementing policy frameworks, supervising and monitoring government finances and coordinating inter-governmental financial resources;
- ensure appropriate financial management and review of proposals before their consideration by the Cabinet;
- establish standards of good governance and define the roles of key stakeholders;
- establish internal control measures; and
- provide full account of the finances of the National Government to the Cabinet and the National Parliament.

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 be guided by the Debt Management Framework, that includes, as cornerstone components, the principles established under the Honiara Club Agreement and the Debt Management Strategy (DMS). The Framework also currently includes the new SOE Borrowing Policy. It is anticipated that the Framework will be further enhanced with the development of policy that will seek to govern on lending arrangements and the provision of Government guarantees.

BOX 6: SOE BORROWING POLICY

The SOE Borrowing Policy sets out guidelines for SOE borrowings and outlines how the DMS applies to SOEs. The objectives of SOE borrowing policy are to:

1. Harmonise the debt management framework with the SOE Act and enabling legislation;
2. Provide the Government with a means of controlling, measuring and monitoring the risks associated with borrowing by SOEs; and
3. Pave the way for the Public Financial Management Act and subsidiary legislation, including new Regulations and Financial Instructions.

SOEs need to address the following criteria, to the satisfaction of the Minister, to be eligible for direct borrowing:

- I. Entity credit worthiness.
 - SOE must have up-to-date audited financial statements that can exhibit credit worthiness.
 - SOE must be able to demonstrate strong management and ability to operate as a profitable business.
- II. Whether borrowing is for a fit purpose. Proposed project:
 - needs to be identified in Corporate Objectives of SOE; and
 - outlined in SOE's business plan
- III. Borrowing source, terms and condition.
 - Source needs to be acceptable and indicate a willingness to lend at acceptable terms and conditions.
- IV. Project viability
 - The project is viable and can generate enough income to repay the debt and contribute to the SOE's future capital requirements.
- V. SOE borrowing will count as part of the annual borrowing limit.

The Debt Management Framework provides for the Solomon Islands to enter into new borrowings provided strict requirements are met. As outlined in [Section 2](#) above, Solomon Islands' debt status under the IMF/World Bank Debt Sustainability Framework was upgraded to 'yellow light status' in 2010. This means that SIG is currently eligible for concessional debt funding that is on a mix basis (i.e. between loan and grant).

This upgraded status is inconsistent with the 2006 Honiara Club Agreement that does not allow for any new borrowings. This inconsistency prompted a review of the Honiara Club Agreement in 2012 where the original signatories to the Agreement agreed to incorporate an amendment 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 fiscal discipline imposed by the original Honiara Club Agreement still remains. That is, the Agreement is conditional on Solomon Islands maintaining a fully funded recurrent budget, excluding the use of borrowing to fund recurrent expenditure.

The DMS outlines key requirements that need to be met if new borrowing is to be allowed. Only borrowing that: (1) is for a fit purpose; (2) is from an acceptable source; and (3) comes with acceptable terms and conditions may be entered into.

A key feature of the DMS is the annual borrowing limit. This places a limit on how much new debt can be taken on by SIG in any given year. All forms of debt are covered by the DMS and the annual borrowing limit, including direct borrowing by SOEs, on lending arrangements and guarantees provided by central Government.

Annual borrowing limits will be determined by undertaking a debt sustainability analysis each year as part of the budget process. The limit for 2013 is SBD 160 million. At this level of borrowing for 2013 to 2018, the SIG debt sustainability and affordability thresholds are not expected to be breached under prescribed shock scenarios. These include a severe depletion of forest reserves, another Global Financial Crisis and severe currency depreciation.

SIG's debt sustainability and affordability thresholds are debt to GDP (25%) and debt servicing cost to domestically sourced revenue (8%). Debt is deemed to be total central Government debt (i.e. it includes domestic and external debt and all contingent liabilities, both explicit and implicit). The threshold levels are consistent with the IMF/World Bank Debt Sustainability Framework thresholds for Low Income Countries.

Another feature of the Framework is that the DMS requires all borrowing proposals to be assessed by the Debt Management Advisory Committee (DMAC), which facilitates transparency and accountability. The DMAC will provide recommendations to the Minister of Finance on borrowing and debt related matters. The Minister has sole authority for approving borrowing.

The SOE Borrowing Policy was developed and endorsed by cabinet in 2013 (refer to [box 6](#) above). The Policy sets out guidelines for SOE borrowings and outlines how the DMS applies to these

borrowings. SIG plans to enhance the Framework by developing new policy that will seek to govern on-lending arrangements and guarantees that are to be provided by central government.

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 7](#) below for more information about the IMF standby credit facility.)

BOX 7: IMF ASSISTANCE AGREEMENT: PRECAUTIONARY STAND-BY CREDIT FACILITY

Since 2010, the Solomon Islands Government has undergone continued engagement under IMF-supported reform programs. The initial impetus was to access loan financing, given the balance of payments difficulties experienced at the time, and to catalyse development partner budget support under the Core Economic Working Group (CEWG).

After the first Standby Credit Facility (SCF) expired, the Government entered a successor 12-month precautionary SCF to anchor its policy agenda and maintain reform momentum, resulting in a strengthening of the Government's macroeconomic framework and an improvement in the country's financial management systems. Although a stronger fiscal position was attained in the short-run, the medium to longer term economic outlook continues to remain vulnerable, given the economy's strong dependence on export commodities (including a declining logging sector accounting for a major portion of government revenue), and exposure to international price fluctuations.

The Government, in the pursuit of further macroeconomic and fiscal strengthening, entered a three-year Extended Credit Facility (ECF) in June 2013. This successor program provides positive signals to both development partners and the private sector, and is testament to the Government's prolonged commitment to economic reform as a basis of achieving board-based, sustainable, and real growth in Solomon Islands.

5. Conclusion

This 2013 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.