**Solomon Islands Government**

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**Medium Term Fiscal Strategy: 2009 – 2014**

**August 2009 Update**

# Foreword by the Minister

In April 2008, the Government released the first Solomon Islands Government Medium Term Fiscal Strategy to outline the state of the Solomon Islands economy, the challenges the Solomon Islands face in future years and the Government’s plans for meeting those challenges.

The Medium Term Fiscal Strategy commits the Government to two objectives to ensure that the Solomon Islands is prepared for the challenges it will face in coming years. These are:

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

To ensure that the Strategy remains current, it is updated at least once a year before Budget time. Each update incorporates recent major changes in the economic environment, and includes a summary overview of one of the productive sectors which can potentially drive growth in our economy. This is the August 2009 edition of these annual updates.

The most significant challenge outlined in the 2008 edition of the Medium Term Fiscal Strategy was the foreseeable decline in the logging sector as our stock of natural logs runs out. However, external shocks, such as the rapid increase in rice and fuel prices in 2008 and the more recent global economic crisis, are making the management of our challenges all the more difficult. The global economic crisis has caused a much steeper decline in log exports in 2009 than was expected.

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

By continuing to plan for the future and updating the Medium Term Fiscal Strategy the CNURA 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 Snyder Rini
Minister for Finance and Treasury**

## Executive Summary

The Medium Term Fiscal Strategy 2009 – 2014 outlines progress towards meeting two basic objectives of the Solomon Islands Government:

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

The Medium Term Fiscal Strategy has two sections. The first section presents the current economic and fiscal conditions and outlook. The second section presents the Government’s economic and fiscal strategy in the context of these conditions and outlook.

In 2007, real GDP growth for the Solomon Islands economy was estimated to be 10.1 per cent while in 2008, it was estimated that the economy grew by 6.7 per cent. The medium term outlook for the economy is concerning, with income per person expected to fall considerably from previous levels in 2009 and 2010. This is caused by both the decline in the availability of logs, slower external demand and reduced capital flows stemming from the global economic downturn.

To maintain fully funded budgets, expenditure growth needs to be reduced from 29 per cent in 2008 to around 8 per cent average annually over the medium term. If this objective is not met, Solomon Islands will have to resort to new debt to fund the shortfall, and this could result in debt climbing from the current 31 per cent of GDP to as high as 90 per cent in five years.

The Government is therefore acting with greater urgency in pursuing the objectives in the Medium Term Fiscal Strategy. The Government is committing to new economic reforms and measures to create a sustainable base for economic development. At the same time, the Government is implementing expenditure and revenue measures to manage the impacts of the Global Economic Crisis. To these ends, the Government is making the following new commitments to meet the challenges of the Global Economic Crisis and the decline of the logging industry.

1. **Remaining committed to the path of economic reform** by:
	* undertaking new infrastructure projects, including the development of a new hydroelectric scheme, the upgrade of Munda Airport, commencement of Gold Ridge Mining project, Fisheries development; and the upgrade of wharves and roads across the country;
	* seeking commitments from donors to use Solomon Islanders and locally sourced materials wherever possible when they undertake construction and infrastructure activities in Solomon Islands;
	* implementing the new Companies Act 2009 and the Companies (Insolvency and Receivership) Act 2009;
	* implementing the new Secured Transactions registry;
	* designing and implementing a new resource tax framework;
	* negotiating with Our Telekom to end the exclusive rights in the licence and introducing new legislation to regulate a competitive telecommunications sector;
	* establishing a tourism taskforce to detail the step-by-step process we must take to build up our tourism industry;
	* commencing reform to local business licences; and
	* commencing reform on Investment Policy, Law and Promotion.
2. **Continuing to pursue an affordable and sustainable budget, which limits debt** by:
	* ensuring expenditure growth falls in line with revenue growth (in 2009, consolidated expenditure growth must fall from 29 per cent in 2008 to around 8 per cent average annually over the medium term).
	* improving revenue collection mechanisms;
	* continuing the process of capacity building in the Ministry of Finance and Treasury, which improves financial management and governance;
	* fully implementing the policy of reducing exemptions on tax and duty;
	* committing 10 per cent of revenue to debt servicing; and
	* not borrowing to fund an underlying deficit in the recurrent budget or to fund the losses of State-owned enterprises.

## Recent Performance and Outlook

# Economic performance

* 1. ***GDP and GDP per capita***

The Solomon Islands economy has been growing strongly in recent years. Real GDP growth increased from 5.1 per cent in 2006 to an estimated 10.1 per cent in 2007 and slightly slowing in 2008 to 6.7 per cent despite stronger growth in sectors like copra, fisheries and palm oil. The fall in GDP growth for 2008 is caused by a slower growth in log outputs and the Global Economic Crisis.

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

**Chart 1: Recent and projected logging output**

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

As projected in the July 2008 edition of the Medium Term Fiscal Strategy (MTFS), log output continues to fall in 2009. Worryingly, this fall has turned out to be much steeper than expected and is expected to be 25 per cent in 2009. The reason for this is twofold. Firstly, on the supply side, larger than expected output in 2008 means there are fewer logs left to export. Secondly, on the demand side, the Global Economic Crisis has stifled demand from our primary export destinations in Asia (see Box 1).

Projecting from the first half of 2009, total log output is now expected to be around 1.1 million cubic metres by the end of the year. Chart 1depicts the Government’s current projection of log exports in the medium term.

**Chart 2:** **Recent and projected Real GDP and GDP per capita**

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

As shown in chart 2, the economy is expected to slow from 2009 to 2014 while GDP per capita is not expected to grow at all over the medium term. The country is therefore facing one of its greatest economic challenges. Employment opportunities will shrink and the ability of Government to provide services will be restrained. The task of fiscal management and undertaking structural reforms will be more difficult under the current condition.

Negative growth in per capita income means that Solomon Islanders will be poorer as the GDP growth for the next 5 years will not be enough to support the growing population. To bring the economy back to safer levels, an annual target of 3 per cent growth must be achieved in the medium term. This base rate of growth target is necessary to ensure that GDP per capita moves back to positive levels.

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| **Box 1. The Global Economic Crisis and Solomon Islands**What began initially as a crisis in credit markets flowing from problems with home mortgages in the United States has lead into a global economic slowdown with rising unemployment, weakening consumer confidence and falling commodity prices in most economies around the world.Developing economies such as Solomon Islands were not directly hurt by the problems on world financial markets, because of their limited direct exposure to the problem mortgages and financial products. However, they are increasingly being affected and it is clear that economic activity in advanced economies has slowed sharply. The global financial crisis has made investors less willing to take risks, and less likely to invest in smaller developing countries like Solomon Islands. The economic slowdown appears to be spreading throughout the world leading to less demand for most commodities, including oil, metals and foods. This is also impacting on the commodities Solomon Islands exports such as logs, copra and cocoa.Lower log export volumes are not the only concern for Solomon Islands. The consequences of lower log output flow into those other sectors of the economy that supply the logging sector (such as transport and trade), leading to lower growth in those sectors too. At the same time, the Global Economic Crisis is also leading to lower demand for other exports, like copra, tuna, and palm oil. Because of this slowdown in Solomon Islands, Government revenue growth is much slower than expected. In the first half of 2009, revenue collections through Customs and the Internal Revenue Division were down collectively by around 9 per cent against the 2009 Budget Estimates. Ministry of Finance and Treasury modelling has indicated that with no policy change by the end of 2009, fiscal balance will be a deficit of about $200 million. The Government responded quickly to this problem by reserving expenditure and reducing waste. Expenditure growth was slowed substantially by implementing a 33 per cent reservation across all expenditure other than payroll and essential services. There was a freeze on new hiring in the public service. Around $100 million of low priority expenditure in the development budget was identified and will be reserved for later years. The Government has also introduced new revenue measures that help to make up the shortfall while improving the fairness of the tax system. In 2009, around $58 million in additional revenue is anticipated from these measures, which range from increased penalties for driving offences to higher tax rates on alcohol.Finally, the Government has established a regular working group with donors to ensure donors are prepared and well placed to assist in any further deepening of the crisis. |

* 1. ***Inflation***

Inflation is the measure of change in prices for goods and services in Solomon Islands. Inflation as measured by a three months moving average receded to around 13.6 per cent in May 2009 after peaking at around 23 per cent in September 2008. The dramatic increase in rice and fuel prices due to global grain and fuel shortages of 2008 was the major cause of this high inflation. Chart 3 illustrates a continuous falling trend due to the slowing global and domestic economy and inflation is expected to fall to below 10 per cent by the end of 2009.

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

The most inflationary of Government spending is spending on goods and services. If the Government continues to spend more while the supply of those goods and services does not increase, the goods and services Solomon Islanders want to buy will become more expensive. Sadly, this has the unintentional effect of hurting the poorest people most severely.

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

Assuming food and fuel price increase as larger economies recover over the medium term period, inflation could become a problem again, and therefore investments in alternative energy sources as well as greater food production and import substitution should also be encouraged. These will relieve pressure in the supply of goods and services, which helps to keep prices stable.

Chart 3: Inflation over 2008 and 2009

*Source: Honiara Consumer Price Index, Statistical Bulletin 05/2009, Ministry of Finance and Treasury*

*1.3* ***Balance of Payments***

In 2008, the Balance of Payments (BoP) fell to a deficit of $210.7m from a surplus of $130m in 2007. The deficit in 2008 was a result of a significant trade imbalance caused by a large increase in fuel and food imports following the global fuel and food price hike in the third quarter of the year. From the end of 2007, foreign reserves fell from $916.5m to $705.7m by the end of 2008.

Income from logging activities makes up around 70 per cent of all of export income for Solomon Islands. This means that the BoP is very sensitive to changes in the sector. The rapid onset of the economic downturn has seen the volume and price of logs from Solomon Islands fall substantially in the first half of 2009. Although this downturn in export receipts has been partly offset by lower fuel prices there is still expected to be a BoP deficit of as much as $190m in 2009.

Reserves are therefore also expected to be depleted significantly in 2009, given the expected large BoP deficit. Ministry of Finance and Treasury modelling anticipates foreign reserves to be around $520 million by the end of 2009, which is equivalent to import cover of about two months.

Beyond 2009, the outlook for 2010 to 2014 is negative and very concerning. As logging output continues to fall, the BoP is likely to come under severe pressure. Foreign reserves are expected to be exhausted sometime in late 2010 or early 2011 unless alternative sources of foreign income can be found. Chart 4 shows the size of the possible financing gap if imports continue to grow and no additional export revenue or foreign investment materialises.

Chart 4: Foreign reserves as months of import cover

*Source: Ministry of Finance and Treasury modelling*

* 1. ***Summary***

Our country has been growing strongly, but there are many big challenges ahead.

Growing our economy by 3 per cent each year will be difficult and will require some difficult economic reforms and sensible investment in productive infrastructure. The CNURA Government is committed to meeting these challenges and is already making progress on crucial economic reforms (summarised in Section 3).

# Recent fiscal performance

* 1. *The Budget*

Funding in the Consolidated Budget has grown strongly over the last few years. Total consolidated funding grew by an annual average of over 26 per cent between 2004 and 2008. This growth has been driven by improvements in compliance by the Inland Revenue Division, strong growth in exports of logs and increased donor support to the Government’s Budget. Domestic revenue collected by the Government has grown at an annual average of around 29 per cent between 2004 and 2008. Export duties from logging grew by an annual average of around 31 per cent and donor funding grew by an annual average of around 8 per cent over this period.

The fiscal position changed towards the end of 2008 as the Global Economic Crisis negatively affected the export of logs from Solomon Islands. Log exports are projected to fall to 1.1 million cubic meters in 2009, and thus expected to contribute far less to Government revenue this year. This coupled with the resultant slower domestic economy growth means that domestic revenue collection growth is expected to slow from 23 per cent in 2008 to around 15 per cent in 2009.

The rapid onset of the Global Economic Crisis has meant that 2009 Government revenue estimates have had to be revised down. Given the Government adopted the policy of using all of its cash reserves to fund expenditure in 2009, this revision in revenue has meant the Government has had to make decisions early in the year to ensure continued expenditure (see Box 1).

The impact of the Global Economic Crisis has also threatened the Government’s cash position. In May, Cabinet sought to combat declining cash reserves by placing a 33% reservation across all expenditure other than payroll, debt service and other essential services against the 2009 budget. Cabinet also approved the implementation of revenue measures to raise up to $58 m in 2009. These measures were a direct response to the Global Economic Crisis to ensure basic services continued to be provided till the end of 2009.

The revised log output projection and slower growth over the next five years means that revenue growth will also slow substantially. Chart 5 shows the projected expenditure growth path for 2009 to 2014 that match projected revenue growth for the same period. Given that Government is unlikely to hold any significant level of cash reserves by the end of 2009, expenditure growth shown in chart 5 also shows the Government’s maximum expenditure growth in the medium term. Notably, this means the excessive expenditure growth of the last five years must slowdown abruptly. To maintain fully funded budgets, **nominal expenditure growth will need to slow from around 29 per cent in 2008 to around 8 per cent average per annum to 2014**

Chart 5: SIG Projected Expenditure Growth for Balanced Budget (2008-2014)

*Source: Ministry of Finance and Treasury calculations*

* 1. ***Debt***

When expenditure exceeds revenue, the difference can be made up by increasing the Government’s level of indebtedness to domestic and international lenders. Used wisely, to invest in a country’s physical and social infrastructure to boost future productive capacity, debt financing can bring improved economic performance and higher living standards. Used unwisely, debt financing can impose a heavy burden on future generations requiring higher taxes and reduced expenditure on services like health, education, and infrastructure.

Solomon Islands have had a difficult history with debt. While the period of civil unrest led to a final blowout in government debt levels (see Chart 6 and Chart 7), many of the underlying causes of what was an unsustainable debt position came from earlier times. In the past, much of the debt incurred by government and the SOE sector was not invested wisely. By 2003 Solomon Islands was in default on all of our debt, which has cost us greatly.

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| Chart 6. Solomon Islands Public Sector Debt Stock (SBD million) | Chart 7. Solomon Islands Public Sector Debt to GDP ratio |

 Source: Ministry of Finance and Treasury calculations

To rebuild our nation’s finances and fix our debt problems, major changes were required. A significant landmark on the path to achieving this was the signing of the Honiara Club Agreement in 2005. [[1]](#footnote-1) The agreement committed the Government to applying a basic set of financial management principles to its fiscal and debt management strategies including balanced recurrent budgets, a freeze on all new borrowing and setting aside a fixed proportion of Government revenue for debt servicing. The principles developed with the Honiara Club Agreement continue to be central to the Government’s approach to managing its debts.

The turnaround achieved in the debt position in the period since the agreement was signed has been significant. The Government is now meeting all its debt repayment obligations compared to not meeting any of them a few years ago. Debt levels have fallen significantly as has debt as a proportion of GDP [[2]](#footnote-2). These gains have been possible because of the improved economic performance of the Solomon Islands; the recommencement of debt repayments; the benefit of debt restructuring and debt relief negotiated with many of our creditors; and the impact of paying down our remaining debt arrears.

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

Some simple projections of debt demonstrate the importance of ensuring balanced budgets. For instance, if expenditure growth were to continue unabated at 2008 levels (29% per annum) and revenue growth were to taper off as is projected, debt levels would more than triple inside five years (see charts 8 and 9). This would clearly be unsustainable and would be an unwelcome legacy to pass on to future generations of Solomon Islanders.

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| Chart 8. Solomon Islands Official Public Sector Debt to GDP Projection | Chart 9. Solomon Islands Official Public Sector Debt Projection |

Source: Ministry of Finance and Treasury calculations

The alternative scenario in Chart 6 and Chart 7is one where budgets are balanced and there is no growth in borrowings. Under this alternative scenario, Solomon Islands could achieve ‘Green Light Status’ under the IMF/World Bank debt distress rating system in the near future[[3]](#footnote-3). Achieving this outcome will improve the Government’s capacity to access finance to fund development activities, like investment in infrastructure, which can drive growth into the future.

# *Strategy*

# Economic strategy

The first objective of the Medium Term Fiscal Strategy is to continue with structural reforms to make the Solomon Islands an easy and reliable place to do business and invest. Structural reform not only helps to make the economy grow, creates jobs and increases income; it also helps to keep inflation low and maintain a sound BoP level.

As highlighted in the earlier sections of this Medium Term Fiscal Strategy, GDP will need to grow by at least 3 per cent per year for the next five years to ensure that incomes do not fall to negative levels and achieving this target requires the implementation of structural reforms.

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| **Box 2. Structural reform can accelerate economic growth**Research from the International Monetary Fund indicates that Solomon Islands can anticipate a higher growth rate, but only if economic reform is pursued. Indeed, the IMF projections indicate that economic reform in Solomon Islands could deliver an additional 3 percentage points per annum. However, as Chart 10 also highlights, if economic reform is not pursued, then GDP growth will be below 3 per cent, which could mean a fall in the wealth of all Solomon Islanders as indicated by a fall in GDP per capita (as discussed in Section ).Chart 10. IMF projections for Real GDP growth 2008-2013Source: International Monetary Fund Article IV Consultations 2008 |

Over the coming months and years, the Government will start new economic development activities and economic reforms, all aimed at ensuring economic growth continues through the difficult years ahead. This section of the Medium Term Fiscal Strategy outlines the Government’s commitments to implementing structural reforms to help grow the economy.

* 1. *Implementation of Business Laws*

The CNURA Government has remained committed to the path of economic reform. From August 2008 to date, the Government has passed 3 new pieces of important legislation; the Secured Transaction Act 2008, the Companies Act 2009 and the Companies (Insolvency and Receivership) Act 2009. The implementation of these Acts will make it easier to start and operate businesses in the Solomon Islands. These new business laws form part of the foundation for growth that the CNURA Government is building for Solomon Islanders.

The Government is implementing these Acts and plan to enforce them by the first quarter of 2010. The commencement of these laws will create a robust and appropriate legal framework for businesses to start and operate in Solomon Islands. The new legal framework also allows people and businesses to make investments quickly and easily and to shift their investments as market conditions change. This is especially important in Solomon Islands, where global market volatility means that we have to be very flexible if we want the economy to grow and new jobs to be created.

* 1. *Infrastructure*

Infrastructure refers to all of the roads, wharves, marketplaces, buildings which are used in Solomon Islands to facilitate the trade and provision of goods and services. Infrastructure development can assist economic growth in Solomon Islands in two ways.

Firstly, infrastructure makes it easier for people to do a lot of things that are the basis of economic growth. For instance, infrastructure makes it easier for people to take goods and services to markets, where they can trade with others. And, when they are at the market, they can also gather information and invest in equipment that can help make them become more productive. Other types of infrastructure, like schools and hospitals, can lift our productivity through education and by keeping people healthy. All of this makes infrastructure a basic driver of economic growth in any country.

Secondly, the building of infrastructure has a more immediate effect on the economy. This is through the construction activity itself. As our country continues to rebuild after our difficult years, a lot of money is being spent on building roads, wharves, schools, marketplaces and so forth. This is creating jobs and income for people working on these projects. In turn, these people use their incomes at shops and markets, which creates more jobs and incomes and begins a cycle of growth in the economy, or they re‑invest their incomes in education or equipment, which makes them even more productive.

This second effect is actually made even stronger by the presence of infrastructure. For example, when people earn money from building a new road to a town, they can then travel to that town and spend money on things they may not have been able to buy before. Infrastructure not only boosts the economy through its construction, but then helps boost flows of economic activity around the country, which creates new jobs and income for Solomon Islanders.

Infrastructure development can be very expensive. However, infrastructure development is one of the few areas where finance can be raised and where the growth from expenditure creates a return that exceeds the cost of that finance. The World Bank and the Asian Development Bank both provide facilities for countries like ours to invest in these types of works. Great care and diligence must be taken on this path. As the Debt Strategy (Section 4.2) highlights, a poor investment decision could easily undermine growth for generations to come. This is why this Government is committing to a set of basic principles on debt in this edition of the Medium Term Fiscal Strategy.

The CNURA Government will be working with donors and International Financial Institutions to design and build infrastructure that is both a pillar and driver of economic growth. The Government is committed to the following tasks:

* Undertaking new infrastructure projects, including the development of the Tina River Hydroelectric scheme; the upgrade of Munda airport; the building of Bina Harbour and Suava Harbour; and the upgrade of wharves across our country. Further a new franchise shipping scheme which increase access to trading and passenger routes will shortly begin operations;
* Working with development partners to coordinate transport expenditure through working towards a sector wide approach; and
* Engaging with donors and IFIs and seeking their commitment to use Solomon Islanders and locally sourced materials wherever possible when they undertake infrastructure construction and maintenance activities. This is critical if investment in our country is to create jobs and incomes for Solomon Islanders.
	1. *Telecommunications*

The telecommunications sector is constraining the economic and social development of Solomon Islands.

Solomon Islands are blighted with limited coverage, limited services, poor quality and amongst the highest prices in the world. To overcome these obstacles, the Government is acting strongly and quickly to reform the sector.

The Government has negotiated and signed an agreement with Our Telekom to end their exclusive licence, and will be gazetting a new legislation in August 2009 to regulate a competitive telecommunications sector. The Government also expects a second competitor to begin ground work in late 2009 and launch services by April 2010. With the introduction of competition, the Government expects greater investment in telecommunication infrastructure leading to greater coverage, improved technology, a wider range of services and lower prices. This reform could be instrumental in helping our country and our people get through the challenging economic adjustment as the logs run out.

### Box 3. Fisheries and Marine Resources Sectors

The fisheries and marine resources sector (the sector) is a very important part of the Solomon Islands cultural, social and economic wellbeing. This sector offers real potential to generate domestic revenue, expand formal employment, and improve livelihoods and food security. By 2010, the population of the Solomon Islands will be over 550 000 and the national need for fish for food is estimated to be 15,000 mt per annum. An estimated 20,000 people are also expected to be seeking some level of income from the sale of fisheries products by 2010.

The sector consists of industrial fisheries (predominantly off-shore fishery) and subsistence fisheries (predominantly inshore). The industrial sector depends heavily on the abundant tuna resources found within the Solomon Islands’ Exclusive Economic Zone (EEZ) and in 2006 accounted for approximately 14% of the nations GDP. The subsistence rural economy is heavily based on inshore resources, which are mostly in the coastal region where approximately 85% of the population lives. The data for coastal subsistence catches is unreliable and varied but estimates of its value in 2007 where around $84 million SBD.

However, the sector faces major management and development challenges. The Solomon Islands does not currently have the resources or infrastructure to protect its EEZ from illegal fishing, the resources to actively participate in international and regional negotiations, or a private sector that can sustainably exploit its resources and provide employment. In rural areas some species are under threat and a high population growth rate is putting greater pressure on marine resources that are basic to the subsistence and semi-subsistence economy.

The Government has recognised the importance of the sector and put more emphasis on developing policies and strategies for achieving effective and sustainable development. With assistance from a variety of donors and non-Government organisations, new legislation is being drafted and the Ministry of Fisheries and Marine Resources (MFMR) is being strengthened to play a leadership role in the sector. An important component of this strengthening work is the development of a robust and transparent policy and regulatory framework which includes an emphasis on staff capacity building. This is a long process and will be undertaken over a number of years through the coordination of efforts by MFMR, non-governmental and community based organisations, the private sector and external agencies.

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 **2002 Solomon Islands Government Aquaculture Plan 2002 – 2006**

 **Government estimate from DEVFISH 2006 (Fishing Association and Fishing Industry Data)**

 **ADB Publication February 2008: The Contribution of Fisheries to the Economies of the Pacific Island Countries and Territories, pg 146.**

* 1. *Tax reform*

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

The Ministry of Finance within the Solomon Islands Government is working with regional and international organisations, such as the Pacific Financial Technical Assistance Centre, to design major reforms to strengthen the tax system.

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

In addition, the Government is also committed to ensuring that the mistakes that have been made in the past with logging are not repeated with new resource sectors in Solomon Islands. The Government is designing a resource tax framework, which it will implement in time to ensure that Solomon Islanders receive their fair share from the future profits made from our natural resources.

### Box 4. Mining or Mineral Sector

The development of the mineral sector is a Government priority. In the medium term, the rehabilitation and commencement of the Gold Ridge Mine will be crucial in helping to replace the export earnings from the declining log volumes and prices experienced after the onset of the global economic crisis.

The reactivation of the Gold Ridge Mine is very important to the Solomon Islands economy. Before its closure the Mine produced over 30% of Solomon Islands GDP. The reopening of the mine could improve growth by as much as 5 percentage points by 2012. The Gold Ridge Mine will directly employ up to 500 people and a lot more in other sectors as the economy grows due to the income generated by the mine.

The commencement of Gold Ridge will be an important signal to foreign investors that Solomon Islands are a viable and attractive investment location especially in the mineral resource development.

A special task force has been established by the Government to link negotiation activities between the mining company, landowners and the Government; the taskforce adds value to the efforts to restart operations in the medium term.

Gold Ridge Mine is one of a number of potential mineral projects the Government is welcoming to Solomon Islands.

* 1. *State Owned Enterprises*

The CNURA Government is absolutely committed to ensuring state owned enterprises in Solomon Islands deliver real benefits to Solomon Islanders. A key part of reform in this area has been the move to ensure state owned enterprises meet their obligations under the new State Owned Enterprises Act 2007 (SOE Act). This Act obliges SOEs to provide clear business plans for their operations and to sustain theses businesses in the increasingly competitive Solomon Island economy.

Over the coming years, the Government will monitor closely the state owned enterprises, particularly because they provide key services for the public and business, and have been the source of significant fiscal risk to the Government. To this end, the Government has established a State Owned Enterprises Monitoring Unit in the Ministry of Finance and Treasury. The unit is working with SOEs sort their operations to ensure they are prepared to comply with the SOE Act. Any sign of fiscal pressure from State Owned Enterprises will be dealt with swiftly and responsibly by the Government.

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| **Box 5. The Solomon Islands Tourism Industry**Tourism could potentially contribute significantly to our economy. However, in 2006 and 2007, tourism only contributed around 2 per cent of GDP to our economy. Between 2006 and 2007, the total number of tourists was only around 4,600.This is a very small number of tourists, particularly when compared to the role tourism plays for many of our neighbouring economies with similar economic challenges. Figures from the UN Statistical Yearbook for Asia and the South Pacific show that in 2005 tourism contributed 67 per cent of GDP in Palau, 50 per cent of GDP in Cook Islands, 18 per cent of GDP in Samoa, 15 per cent of GDP in Fiji, and 5 per cent of GDP in Tonga. The economic contribution of tourism in Solomon Islands is far below that of other similar Pacific nations.The smallness of our tourism sector and the obvious potential of our country in this area are the reasons why the CNURA Government has committed to an ambitious target of doubling tourist numbers by 2010.Tourism has a number of important benefits. Firstly, it creates income generating opportunities across the Solomon Islands, not just in Honiara. Secondly, it is a sustainable industry, unlike logging or mining which will decline along with the resources. Thirdly, a variety of jobs are created, with spin offs such as handicrafts, and these jobs can be filled by Solomon Islanders, rather than foreigners. And fourthly, many tourist ventures, such as eco-lodges or tour guide businesses, can be established with relatively small amounts of capital.The Government recognises that in order to achieve the goal of doubling tourist numbers by 2010, steps will need to be taken to reduce the barriers that have so far prevented the Solomon Islands from becoming a popular tourist destination.The main barriers to tourism are:* The high cost and unreliability of transport. For example, there is currently no competition for domestic air services.
* The difficulties and uncertainties regarding customary land. There are no major hotel chains operating in the Solomon Islands.
* A lack of information for tourists and promotion in the key markets in Australia and New Zealand.

The Solomon Islands Government plans to establish a Tourism Taskforce to advise the Government on the best ways of reducing these and other barriers to tourism. The taskforce will includes key industry stakeholders, the Economic Reform Unit and the Ministry for Tourism. This taskforce is to provide a plan to achieve the Government’s goal of doubling tourist numbers by 2010. This plan is to be provided in the last half of 2009 and will include:1. An analysis of the tourist market in the Solomon Islands2. An assessment of the potential economic benefits of different growth scenarios for the tourism industry in the Solomon Islands. 3. An analysis of the current barriers to growth in the tourism sector of the Solomon Islands economy. 4. Recommendations on how to reduce these barriers and achieve the Government’s goal of doubling tourist numbers. These recommendations will include clear **implementation steps** that the Government must take to overcome the barriers to growth of the tourism sector. The potential and importance of growth in the tourism sector is clear. That is why the Government is committed to creating an environment conducive to the growth of our tourism sector and why the Government intends to consider carefully and act on the measures recommended by this taskforce.  |

* 1. *Summary*

This Government is committed to ongoing economic reform. The Economic Reform Unit in the Ministry of Finance and Treasury has identified development work and reforms that will grow the country’s economy and is implementing these reforms quickly. At the same time, the Economic Reform Unit is also examining each industry in the Solomon Islands. Their task is to find the impediments to growth in our important industries and to design and implement reforms that will remove these impediments. This will help those industries grow quickly in order to replace logging.

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

# Fiscal strategy

The second objective of the Medium Term Fiscal Strategy 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, minimise the inflationary effect of our expenditure, and maintain sound levels of foreign reserves.

This section of the Medium Term Fiscal Strategy outlines what the Government is doing to manage the challenges outlined earlier. In particular, this section outlines the policies 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.

* 1. ***The Budget***

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

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

In the first part of 2008, Customs and Excise Division also implemented new software for the management and monitoring of collections. With this reform, it is now be possible for this Division to undertake audits and significantly improve collection of customs and excise duties.

Finally, the tax reform that is being undertaken as part of the broader structural reform program (see Section 3) will be carried out in a way that ensures the revenue base is broadened. This reform will continue and includes building the administrative and resource capacity of the Inland Revenue Division to enforce compliance. The Solomon Island Government has provided funding for Inland Revenue Division to increase its staff numbers and thereby continue this important work, and this is paying dividends in improved collections.

Timber and mineral resources are a valuable commodity in the Solomon Islands. It is therefore important that the Government ensure that these are priced at the international market prices so that Solomon Islanders receive fair value for their resources. The Government introduced an increase in the determined value for export round logs in May 2008, which is the first step towards ensuring all Solomon Islanders benefit from the export of our natural resources. The Government has reduced the export price by 6% to match the deteriorating market value for logs in the international markets; the determined value will be reviewed every 3 months.

Government revenue collection has been very low and since January 2009 has continues to pressure the Government cash position. The Government is monitoring this and will adopt appropriate action as required over the year. The Government has approved the implementation of a 10 per cent expenditure warrant on the 2009 budget as well as various revenue policies. These measures have been taken to ensure the cash position is maintained, to ensure services continues to be provided and key structural and development reforms for future growth continue to be implemented.

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

* 1. ***Debt***

The CNURA Government is committed to reducing the burden of public debt on the nation’s finances and future prosperity. To this end, the Government’s will continue to be guided by the principles established under the Honiara Club Agreement (see Box 4*)* in the management of our debts with the only departure being the already announced reduction in the percentage of revenue allocated for debt servicing from 15 to 10 per cent. This minor change reflects the improvements in our debt position and the expansion in Government revenue since the signing of the Agreement in 2005 and does not have any impact on our ability to meet future debt repayment obligations as they fall due.

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| **Box 6. The Honiara Club Agreement**The Honiara Club is a multilateral forum that was convened by the Government in October 2005 to discuss our debt problems. The forum provided the basis for the Government to negotiate with its creditors concerning the provision of relief on its external debt obligations. In return for this, the Government gave undertakings to the creditors that it will observe good budget practices and proceed with implementing reforms to the economy and improve government services. Specific undertakings in the agreement include commitments to: * no further borrowing or sovereign guarantees until the Solomon Islands achieves “green light status” under the IMF and World Bank’s Debt Distress Rating system;
* maintaining a fully funded recurrent budget;
* allocating 15 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
 |

While the Government has no current plans to recommence borrowings, and intends to fully fund its budget priorities from its own resources, preparations for the responsible use of debt financing in the future are underway. When borrowing does recommence, the CNURA Government will ensure that our debts remain affordable and sustainable for the long term and do not put our country’s reputation at risk again.

The core principal the Government will apply to future borrowing is that it will not borrow to fund an underlying deficit in the recurrent budget or the losses of State owned enterprises. Borrowed resources need to be channelled to productive uses that build the foundations for sustainable long term economic progress in the Solomon Islands. Good examples of this are the types of infrastructure programs outlined in Section 3.1.2.

The Government will also take measures to improve transparency and accountability around debt management. This will include the formation of a Debt Management Advisory committee to review and make recommendations on borrowing proposals and expanded reporting on Government debt and related debt management activities.

# Conclusion

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

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

In the next release of the Medium Term Fiscal Strategy, the Government will outline its approach to ensuring donor investment in infrastructure and technical support is well-targeted and appropriately balanced. In particular, the Government will focus on the integration of the Medium Term Fiscal Strategy with the objectives contained in the Medium Term Development Strategy and outline our forward agenda for ensuring that the Government and donors work together to confront the challenges of the next five years.

But without a concerted reform effort that begins today, it is likely that income per capita will fall and our budget and debt position will become unmanageable. Solomon Islands cannot afford for this to happen. That is why the Government is absolutely committed to reform. By taking all necessary steps to ensure Solomon Islands sees off this challenge, we will build a better country for everyone.

1. Box 4 on page 14 summarises the key elements of the Honiara Club Agreement. [↑](#footnote-ref-1)
2. Debt levels stood at an estimated $2.2 billion just prior to the sighing of the agreement (comprised of official external/domestic debt and informal debts arising from loan guarantees, contingent liabilities and trade creditor arrears). At end June 2009, debt levels have fallen to around $1.6 billion. [↑](#footnote-ref-2)
3. The system is part of a unified effort by the world’s largest multilateral financial institutions to ensure that financial assistance does not cause undue financial hardship to recipients. The Solomon Islands is currently assessed as being ‘at-risk’ of debt distress and is effectively ineligible for debt funding (assistance must be grant based). [↑](#footnote-ref-3)