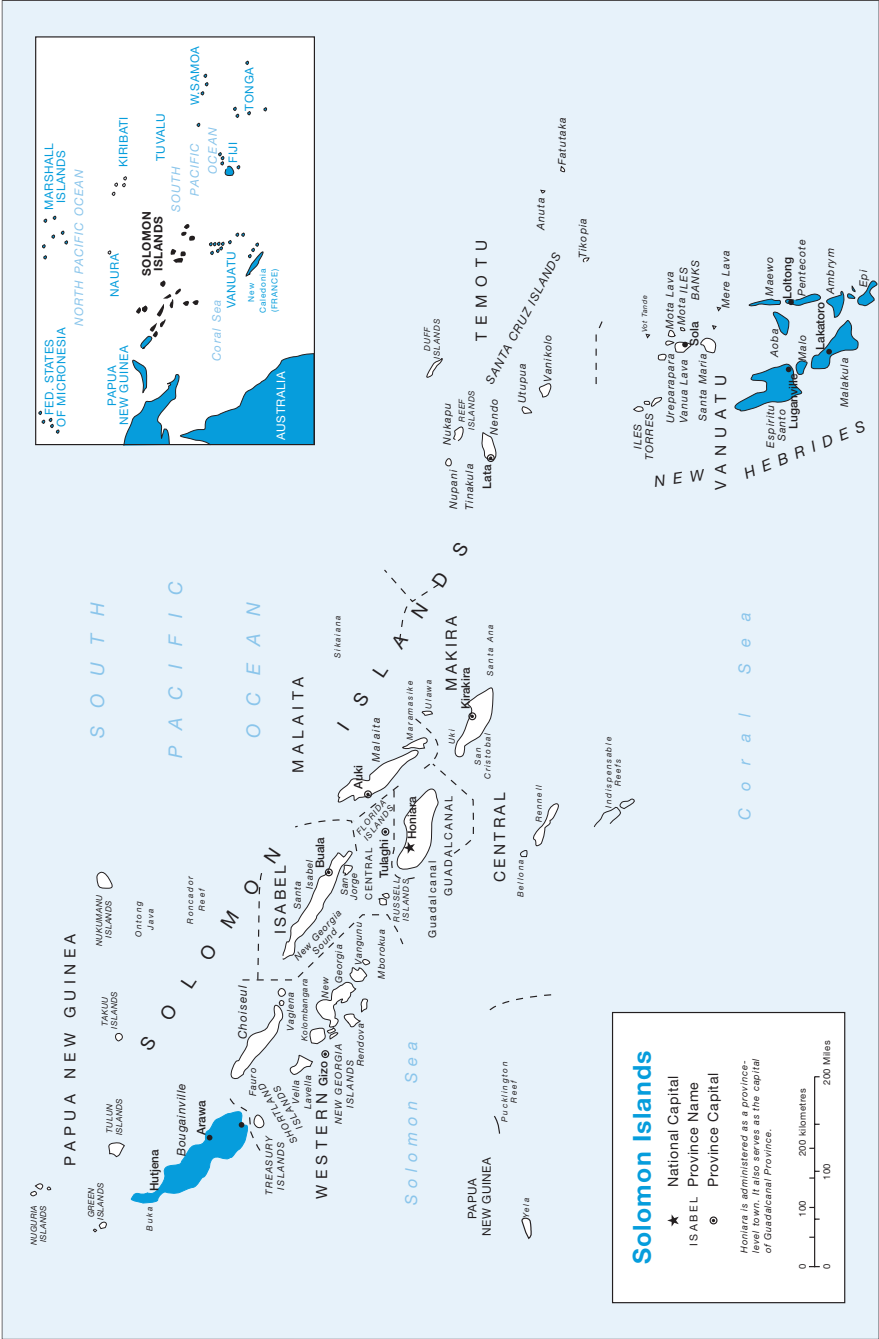


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SOLOMON ISLANDS IN THE SOUTH PACIFIC



Note: Political boundaries as at 1989. Since then, Choiseul became a separate province from Western Province and Rennell and Bellona separated from Central Province to become a separate province.

Source: University of Texas website, http://www.lib.utexas.edu/maps/australia/solomon_islands_pol89.jpg, accessed 11 February 2004.

EXECUTIVE SUMMARY

Solomon Islands is a country endowed with natural resources and attractions yet despite this the economy, which must expand to support a rapidly growing population, is no larger now than it was ten years ago. While ethnic tensions and civil unrest contributed to the severe economic regression of the country around 2000, deeper underlying economic and social problems also have slowly eroded the fundamental stability of Solomon Islands over some years.

The arrival of the Regional Assistance Mission to Solomon Islands (RAMSI) and re-engagement of other donors provide Solomon Islands with an opportunity to rebuild and expand the struggling economy. The Solomon Islands Government must be the driving force of any fundamental reforms for there to be long-term change.

Clearing away the bureaucracy and inefficiencies of the past and providing a stable environment for private business is fundamental to these reforms. Previous government domination of the small economy, both through state businesses and regulation, has hindered the development of a robust private sector.

This report seeks to assist with developing policy to support economic recovery in Solomon Islands.

ECONOMIC CRISIS

Following the outbreak of ethnic tensions in 1999 and the decline in law and order, the Solomon Islands' economy began to collapse. From 1998 through to 2002, gross domestic product decreased by an estimated 24 per cent.

In 2002 alone, the stock of formal government debt increased by over 40 per cent as government lost control of finances. Increasing debt servicing costs, uncontrolled expenditure by government ministries and extortion by militants and police led to fiscal deficits which the Government was not able to finance. The Government defaulted on loan interest payments in 2002 and high levels of government debt increased the vulnerability of financial institutions. High interest rates and limited opportunities for new and viable investments in the domestic market restricted private sector involvement.

As major businesses closed or reduced operations, exports fell. Coupled with falling commodity prices, the value of merchandise exports fell by an average of 19 per cent per year between 1999 and 2002. Falling exports led to substantial trade deficits which, together with capital flight, severely eroded the economy's foreign exchange reserves. This resulted in substantial exchange-rate depreciation by the Central Bank. While depreciation helped stabilise foreign exchange reserves and improved the competitiveness of exports, it had a pronounced effect on the economy's already high external debt levels.

By early 2003, Solomon Islands was arguably becoming a failed state. The Government could not enforce law and order. Corruption and extortion drained government resources and service provision faltered. Domestic production was collapsing and the economy's spiralling debt was becoming unmanageable.

Government Struggles to Provide Services

While the economic and political decline in Solomon Islands saw the withdrawal of government services from many areas of the country, a rapidly growing population placed further demand on already stretched services. Human development indicators including both health and education show that Solomon Islands is falling behind its Pacific neighbours in these measurements of general wellbeing.

Recent Economic Performance

The economy proved surprisingly resilient in 2003 with growth in real gross domestic product estimated at 5.8 per cent. Exports of cocoa were above pre-tension levels and inflation fell. Government finances stabilised and some debt repayment resumed. However, foreign investment remains minimal, much of the population still has difficulty accessing finance facilities and infrastructure remains poor.

STRENGTHENING GOVERNANCE AND THE PUBLIC SECTOR

A unitary style of government in Solomon Islands places power primarily in the hands of the national government, based in Honiara. Provincial governments, headed by elected representatives, operate essentially as administrative arms of the national government. Poor governance has weakened government institutions and been a large obstacle to Solomon Islands development. Pervasive corruption, misappropriation of funds, disregard of the rule of law and government procedures, political favouritism and general inefficiencies have all contributed to a lack of trust in the machinery of government and a deterioration in businesses' operating environment.

Government institutions that promote accountability have suffered from a lack of financial and human resources and political support. Previous attempts to reform the public sector have produced few, if any, benefits.

RAMSI's work to re-establish law and order has provided the basis for both the Solomon Islands Government and donors to strengthen governance. Greater efficiency of government, particularly those involved in the economic arm of government, is necessary and a key focus of support for the public sector. The previous inability of the Government to control expenditure makes strengthening of the Ministry of Finance crucial.

Capacity building in the public sector is a high priority. Technical assistance, short-term training and some targeted long-term training for key personnel, provided in-country where possible, needs to be a key government and donor priority. Re-establishing a local training facility for government staff may be useful.

In the medium term, a public sector restructuring program could introduce efficiencies. While downsizing the public sector is one reform option, it may be more appropriate that a restructure of government operations occurs. This would shift resources towards key areas, reducing government involvement in others. Any attempts to restructure the public service also should take into account the social effects of any reforms. Appropriate training programs that equip retrenched workers to start their own enterprises may be one solution.

Strengthening governance is essential for Solomon Islands to prosper. Solomon Islands has more institutions that deal with accountability than any other South Pacific state, including a Leadership Code Commission, Ombudsman and Auditor General. RAMSI is working with Solomon Islands' authorities to strengthen these Government institutions.

In the long run, accountability is only likely to be sustained if there is transparency in decision-making and the general population understands what should be required from government. The provision of multi-year budgetary frameworks and legislation requiring the public provision of the government's fiscal accounts may assist transparency. Non-government organisations have a role to play in increasing the public's civic education.

Currently, legislation to establish a federal system with more power devolved to the provinces is under consideration. However, experience elsewhere in the Pacific points to the dangers of regarding stronger provincial government as a cure for national failures. This issue needs to be more properly considered and costed before changes are made. New structures may devolve poor governance and further fragment the small Solomon Islands' economy. The fragile economic and political structures of Solomon Islands can ill afford to be exposed to additional and avoidable shocks at this point in time.

MORE EFFICIENT INFRASTRUCTURE PROVISION

Infrastructure supports the economy. It enables the private sector to operate and provides access to health and education services for the workforce. However, in many parts of Solomon Islands, the only services available are limited and costly shipping, postal and radio services. The high cost of many services has made it difficult for businesses to be internationally competitive.

Government provision of basic utilities, infrastructure and commercial services has not worked. Poor management of state-owned enterprises, coupled with the very limited resources of the Government, have been major factors in the enterprises' poor financial performance and limited service coverage. Other factors such as difficulty in setting reasonable price levels, politically motivated board appointments and inadequately funded community service obligations also have hindered the provision of services.

Corporatisation is unlikely to resolve the problems suffered by Solomon Islands state-owned enterprises. Given the limited resources available to the Solomon Islands Government and the previous problems of government management, reforms focused on private sector involvement are more appropriate.

The provision of telecommunications does not require a monopoly supplier. Breaking up the market, or unbundling, and allowing smaller businesses to compete in different parts of the market could decrease costs. Given the geographical isolation of some communities, cost-effective telecommunications through competing businesses is likely to be the best approach.

The promotion of competition in services such as water and electricity may prove difficult in the limited Solomon Islands market. Private sector participation through management contracts is unlikely to provide incentives for new investments. Concession contracts (the provision of long-term leases of assets to a private contractor who buys the right to operate the market) may be the most useful method for involving the private sector in such markets. This method provides incentives for private sector investment and service coverage expansion, while limiting the ability of monopoly suppliers to exploit the Solomon Islands' market.

Unless pressing market failure and national interest reasons exist, government should seek to rationalise its involvement in commercial activities.

Transportation

A population scattered across more than 300 islands makes it difficult to provide an economically viable transport network. Limited, irregular and costly shipping, a poorly functioning air service and a few roads have done little for rural populations.

Inter-island shipping has become increasingly expensive primarily due to fuel prices, but also influenced by a lack of competing services and increasingly costly maintenance. Provincial government authorities operate some of the major inter-island shipping services but many have been unable to meet loan repayments for their vessels. Greater private sector participation and competition are required. Privatising government services and, where necessary, providing limited government subsidisation through a competitive mechanism to private operators in marginal areas may be necessary.

Improvements in port operations, possibly through private sector participation in the major ports, also may assist in providing more efficient services.

Greater competition in the air transport market is required. The introduction of private sector operators into the domestic airline industry through privatisation or a concession for the Government's domestic service could be a first step. Ensuring the market is open and easily accessible to new entrants provide the best operating environment.

STRENGTHENING THE PRIVATE SECTOR

The private sector was severely weakened over the period 1998 to 2003. Businesses faced problems, including weak local demand, rising transport costs, deteriorating infrastructure, lack of business confidence and security problems.

RAMSI has successfully overcome immediate security problems. Many of the other problems that businesses faced still constrain development and need to be addressed quickly.

Access to Finance

High interest rates and lack of suitable collateral (most notably land) restrict access to finance for much of the population. The Development Bank of Solomon Islands has all but collapsed and would require millions of Solomon Islands' dollars before it could operate again. Access to finance for the local population is crucial to private sector development. While rebuilding the Development Bank is one option, the difficulties of ensuring an independent facility that operates efficiently in a small market may require the exploration of other options. Reinvigoration of credit union facilities over the medium term may be more effective and sustainable.

Land Tenure

Land tenure problems remain one of the main impediments to long-term development. Most land is customary, or communally-owned, unregistered land which no one other than a Solomon Islander can own. However, the failure of leasing arrangements for land, as happened with the Gold Ridge Mine and Solomon Islands Plantation Ltd, puts major ventures at risk.

Long-term land tenure solutions are vital for growth. Communal land ownership is closely tied with the values of traditional society and any reform will take a long time and require community participation and government support. Registration of customary land is one step. Improvements in consultations with landowners, a better understanding by landowners of the process and improved use of Landowner Councils and land dispute mechanisms could assist in some longer-term resolutions in this area.

Labour Market

Labour rigidities such as high labour costs and difficult dismissal procedures hinder expansion of the private sector. Employers also are expected to meet other costs including employee transport, housing and clothing costs. Low worker education levels and a shortage of skilled workers also affect labour productivity and employment. More demand-driven and accredited technical training facilities are required within Solomon Islands. Government leadership in simplifying termination procedures could assist labour mobility. A review of minimum wage regulations could assist in much needed formal sector growth.

BUSINESS OPPORTUNITIES WITHIN THE ECONOMY

A few primary product sectors have dominated the Solomon Islands' economy and within these sectors, a few key businesses have dominated. As Solomon Islands is likely to remain competitive in these sectors, their resuscitation is likely to be the quickest path to economic growth.

Plantation Agriculture

Production of the major commodities of palm oil and copra has declined significantly, although high international prices have lifted cocoa production above pre-2000 levels. Copra represents one of the few potential income sources for much of the rural population. Low world prices, coupled with high

transportation costs, contributed to a severe decline in production following ethnic tensions in 1999. Although prices are improving, a lack of investment for working drying facilities continues to be a major impediment to revitalising this industry. Nucleus estate schemes, where outgrowers supply a central estate that assists with organisational, credit, managerial and extension services, have been successful in several developing countries.

Russell Islands Plantation Estate Ltd was the leading producer of copra, coconut oil and cocoa prior to ethnic tension but is currently struggling with limited working capital. New investors in this facility and more efficient transportation services would benefit the industry.

Seafood and Aquaculture

In 2002 and 2003, fish catches were lower primarily as a result of the reduced operations of Soltai and the privately-owned National Fisheries Development Company. Other smaller and often fledgling aquaculture ventures, such as prawns, seaweed and clams, which have shown potential for growth, were disrupted during the ethnic crisis.

Soltai requires new investors to provide funds to reinvigorate the business. Encouragement of foreign investors in other aquaculture ventures also could assist growth. Improvements in the supply chain could provide a basis for further development. The development of a competent authority to accredit seafood exporters also would improve the potential for seafood exports. Institutional strengthening of the Department of Agriculture and Livestock and the Department of Fisheries and Marine Resources to provide effective extension services also would assist the development of both agriculture and aquaculture.

Greater adherence to the current Tuna Management Plan and better monitoring of foreign fishing operations would help ensure a sustainable industry.

Minerals

The closure of the mine, Gold Ridge, is a product of the problems that have faced investments in the country. Disagreements with the customary landowners and destruction and removal of property forced the closure of the mine. Owners of the mine have been unable to reach a new agreement with landowners and the mine remains closed. Better communication between the Government, potential developers and landowners is required. While there is the potential for great economic benefit from mineral extraction, a focus on resource exploitation is not likely to provide a basis for sustainable growth.

Logging

While logging has been the one industry that has prevented the economy from complete collapse, the current rate of harvesting could see the resources depleted by 2015 if not sooner. The industry's importance in terms of export and government revenue may make it difficult to cut back immediate

production. However, the short-term costs must be weighed up against the long-term economic and environmental benefits of a sustainable industry. Strengthening the timber licensing regime, monitoring compliance and improvements to replanting schemes are necessary.

Further work to diversify the timber industry away from direct timber production also may be useful. Strengthening of the Department of Forestry, Environment and Conservation could assist with this.

Tourism

Security concerns have badly affected this small industry. The re-establishment of law and order should assist in the recovery of tourism towards pre-conflict levels. Improvements to infrastructure and a more welcoming foreign investment regime also could assist this potentially valuable industry.

THE NEED FOR REFORM

RAMSI has successfully met the short-term priorities of re-establishing law and order and bringing some control over government finances. Work already underway in the Ministry of Finance to provide greater financial management and introduce a medium-term fiscal strategy is important; this fiscal strategy should include a focus on government's spending priorities in the coming years. The Government is pursuing other short-term goals such as the servicing of some of the Government's arrears with local enterprises.

With stability returning, the Government can begin to tackle a range of medium-term problems that do not require increased expenditure such as removal of inefficient and costly regulations and licensing regimes. This should include regulations which discourage foreign investment. Efficient infrastructure and utilities are vital for economic and social welfare and, over the medium term, need to be improved. Greater government revenues and more targeted expenditure will enable the government to provide better services.

The key longer-term challenge will be that of land tenure. For Solomon Islands to prosper over a long period, the Government must address this divisive and delicate issue.

The size of the Solomon Islands' market and the inherent difficulties and costs due to geography and relative isolation do not mean that Solomon Islands cannot be prosperous. The facilitation of an open and flexible business friendly economy will help the Solomon Islands' economy grow and its businesses to compete in international markets.