# SOLOMON ISLANDS

## Rebuilding an Island Economy

Australian Government
Department of Foreign Affairs and Trade
Economic Analytical Unit

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AusAID

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# ECONOMIC ANALYTICAL UNIT

Initially called the East Asia Analytical Unit, the Economic Analytical Unit was established in 1990 as the main agency within the Australian Government responsible for publishing analyses of major economic and political issues in Asia and other emerging markets. In 1999, the Unit's research scope was expanded to include important emerging market issues outside East Asia, so in November 2001, it was renamed the Economic Analytical Unit. Part of the Department of Foreign Affairs and Trade, to date the EAU has released 35 reports on major issues related to Australia's trade and investment policy interests.

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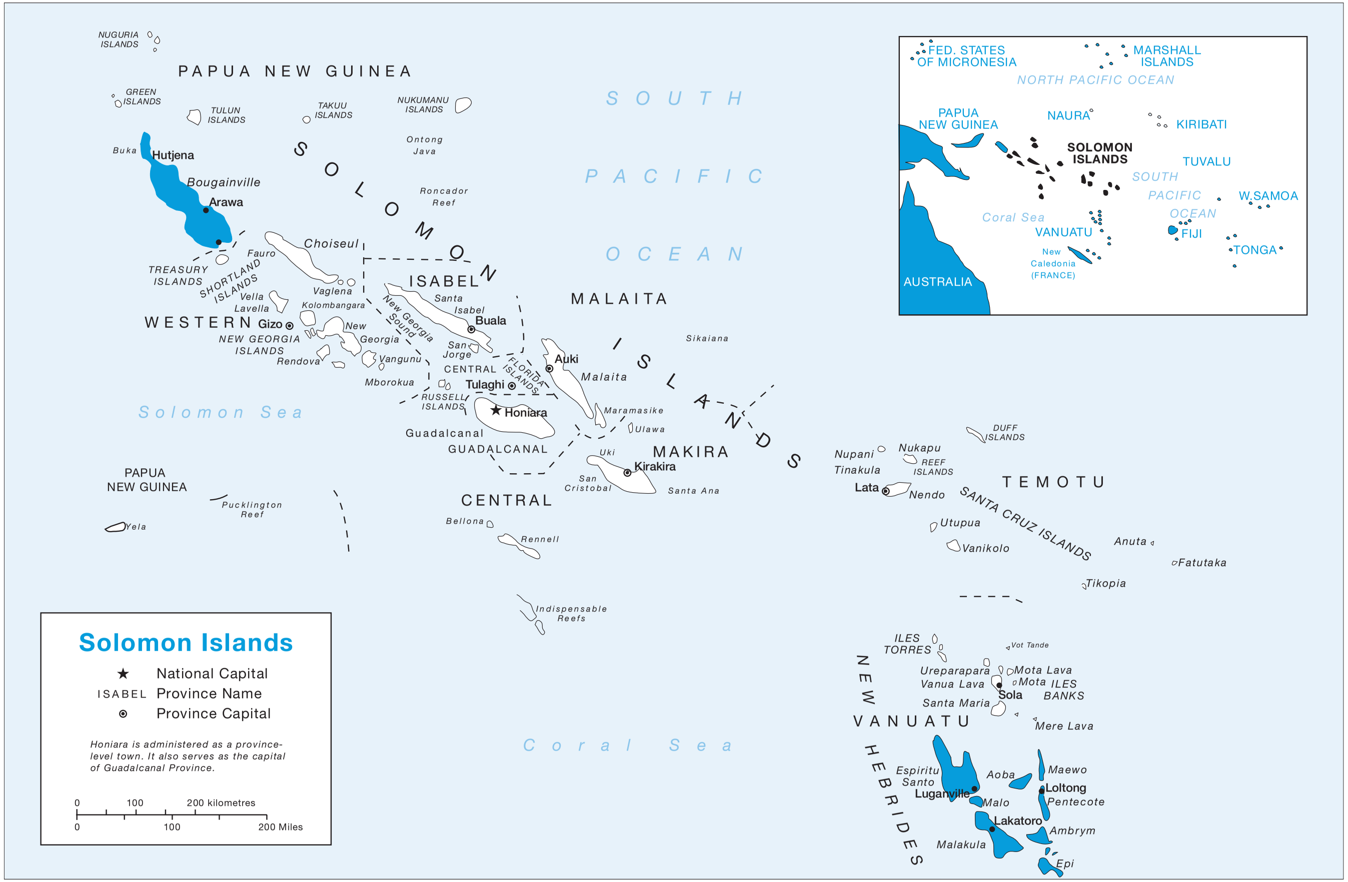



Note: Political boundaries as at 1989. Since then, Choiseul became a separate province from Western Province and Rennell and Bellona separated from Central Province to become a separate province.

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.

# ECONOMIC OVERVIEW

## KEY POINTS

- In 1999 in Solomon Islands, a mixture of economic stagnation, social tensions and political decay erupted into ethnic conflict. This caused extensive damage to personal property, infrastructure, core government operations and social services delivery, and the closure of a significant number of businesses.
- Real Gross Domestic Product (GDP) fell by around 24 per cent from 1998 to 2002, reversing the growth of the preceding decade. Exports of many products collapsed and external debt levels soared.
- With the country at risk of descending into chaos, the Solomon Islands Government sought external assistance.
- The Regional Assistance Mission to Solomon Islands arrived in mid-2003 and quickly restored law and order. Community and business confidence has picked up, but there is still a long way to go in addressing fundamental problems facing the country. The movement from a poorly functioning state to a prosperous economy will take some years.
- The economy is showing signs of a rebound with estimates for 2003 indicating some GDP growth, export growth and an expansion of credit to the private sector.
- Policies aimed at reinvigorating infrastructure, providing suitable land tenure arrangements, reforming the foreign investment regime and strengthening governance and fiscal accountability will assist in attracting new investors and reopening closed businesses.
- The private sector has a significant role to play in driving economic growth and can efficiently service markets previously dominated by government enterprises.
- The economy remains highly dependent on agricultural production, both subsistence agriculture and direct production for markets. Economic policies aimed at reinvigorating the agricultural sector and providing support and access to credit and markets for small producers are likely to provide the greatest benefit for the rural population.

In 1999, ethnic conflict broke out in Solomon Islands causing extensive damage to personal property, infrastructure, core government operations and social services delivery. The economic progress that had occurred in the preceding decade was quickly reversed and a significant number of both small and large-scale businesses closed. Outside attention focused on the tiny nation. With the country at risk of descending into chaos, the Prime Minister of Solomon Islands, Sir Allan Kemakeza, formally approached Australia for assistance in April 2003. The Australian-led Regional Assistance Mission to Solomon Islands arrived in July 2003, and has included personnel from New Zealand and many Pacific Island countries, as well as Australia.

The rapidly growing population and many islands and languages of Solomon Islands represent a challenge to government. Pacific regional indicators show that human development remains low and poverty levels relatively high. Unstable and inefficient government operations have hindered private sector development and contributed to the withdrawal of foreign investment.

With law and order now restored, the attention of the Solomon Islands Government and others involved in Solomon Islands is turning to the medium and longer-term problems confronting the nation. There is evidence that this is having a positive effect on the economy with interest rates falling, some growth of GDP and some interest shown by foreign investors. However, sustainable growth will require an ongoing effort from a government committed to tackling medium and long-term issues. The commitment of donors provides an opportunity to rebuild the economy and implement policies which could see the economy prosper beyond the levels it previously experienced.

## SOLOMON ISLANDS – LEAD UP TO A CRISIS

Solomon Islands has struggled to achieve effective governance since its independence in 1978. British control of the nation had lasted 85 years and a heavy dependence on British grants and institutions had formed (Bennett, 2002). The withdrawal of the British saw control handed to a government for whom the task of managing a country – so long dependent on aid and a few key commodity exports – was always going to be difficult. In addition, the structures and institutions in place to govern were hastily established with shallow foundations (see Chapter 2 – *Public Sector Reform and Recovery*).

The ethnic and geographic diversity of the nation had always presented a challenge to its government. The tensions of the past between differing ethnic groups, particularly between the Guadalcanal population and Malaitans, grew after independence. Many Malaitans moved to Guadalcanal to work in business and government. Inevitably, the relative affluence of these workers drew their immediate family, then other relatives and friends, to the area, causing resentment among the Guadalcanal population.

Additionally, resentment grew among the population in the more remote provinces. They considered themselves forgotten by central government and felt that Honiara monopolised government resources. The population outside of Honiara saw little benefit from government other than spending by politicians seeking re-election.

## SOCIAL CONTEXT

Solomon Islands comprises 992 islands spread over 28 450 square kilometres (Central Intelligence Agency, 2003). The population of between 450 000 and 500 000 is made up of five major ethnic groups with Melanesians accounting for 93 per cent of the population. While there is great diversity within the population with over 70 distinct languages spoken, Solomons pidgin is the common language; only 1 to 2 per cent of the population speak English (CIA, 2003). The economy is rich in natural resources such as fish, forests, gold, bauxite, phosphates, lead, zinc and nickel. The nation has nine provinces: Central; Choiseul (Lauru); Guadalcanal; Isabel; Makira; Malaita; Rennell and Bellona; Temotu; and Western; and the separate administrative centre of Honiara.

In each of these societies, kinship is the traditional and continuing cement, binding the individual to the group (Bennett, 2002). The ownership of land and maritime resources is based on customary use which can often be traced back to the original settlers of an area. Traditionally, Solomon Islanders were not highly mobile and the movement of people to Honiara is a relatively recent development. Leaders mostly are self-made who, because of their skills, have attracted kin and others; this is sometimes called the 'big man' system. They are conduits for the distribution of wealth and prestige (Bennett, 2002). The Melanesian islands have not traditionally had an overarching leadership class. The various ethnic groups have widely differing cultural traditions for inheriting political authority and land. For example, people on Guadalcanal pass land on through matriarchal lines while Malaitans pass theirs on through patriarchal lines (Australian Strategic Policy Institute, 2003). The idea of a Solomon Islands nation is a relatively new concept.

While customary land ownership, which covers around 87 per cent of the land, provides most Solomon Islanders with a social safety net ensuring they can meet their basic needs for food and shelter, it creates problems for developing large-scale infrastructure and private sector projects (Kabutaulaka, 1998). Tensions between the traditional owners and the requirements of modern businesses for adequate land tenure rights escalated during the ethnic conflict period, closing such large-scale operations as Gold Ridge mine and Solomon Islands Plantation Estate Ltd.

Eventually, the imposed structures of the modern state began to unravel (Australian Strategic Policy Institute, 2003). Leadership changes were common. Despite various attempts by government and donors to reform government and build a stable economy, government revenue was insufficient to meet expenditure and, with the debilitating effects of corruption, cronyism and mismanagement, the economy became increasingly reliant on resource exploitation and foreign aid.

### ETHNIC FLASHPOINT AND ECONOMIC AND POLITICAL CRISIS

In 1999, the mix of economic stagnation, social tensions and political decay began to erupt into conflict between people from the islands of Malaita and Guadalcanal. The conflict's origins date back to the relocation of the capital to Honiara on Guadalcanal which attracted many people from the former capital on Malaita. Malaitans had a history of working for Europeans; they became the main labour force in Honiara and began to lease land nearby for agriculture. Rivalry and jealousy between Malaitans and the local people of Guadalcanal grew over time, often taking the form of disputes over inheritance, use of leased land and divergent social customs.

These tensions erupted into open confrontations in 1998. Alleged Malaitan crimes and land occupation resulted in demands for compensation by the people of Guadalcanal. This precipitated a wave of attacks on Malaitans and the formation of the Guadalcanal Revolutionary Army. In response, disgruntled Malaitans formed the Malaitan Eagle Force. The resulting conflict caused over 200 deaths, and 20 000 Malaitans and people from other islands fled Guadalcanal. Personal property, transport and communications infrastructure, schools, water supply and sanitation systems, government buildings and the health sector all suffered extensive damage. In June 2000, the Malaitan Eagle Force took control of Honiara and forced the largely pro-reform government of Prime Minister Bart Ulufa'alu to resign.

The situation stabilised after an interim government formed. In October 2000, the Government signed an agreement with the two militias in Townsville. Under the Townsville Peace Agreement, the militias agreed to surrender their weapons in return for compensation for loss of property and promises of development aid. In December 2001, elections resulted in the formation of the current government under Prime Minister Sir Allan Kemakeza. Open conflict ended, but large numbers of weapons were not surrendered. The police force was weak and divided, effective government collapsed and the Government was unable to enforce its rule and maintain security.

Source: Sherlock, 2003; Houenipwela, 2002.

## ECONOMIC CRISIS, 1999 TO EARLY 2003

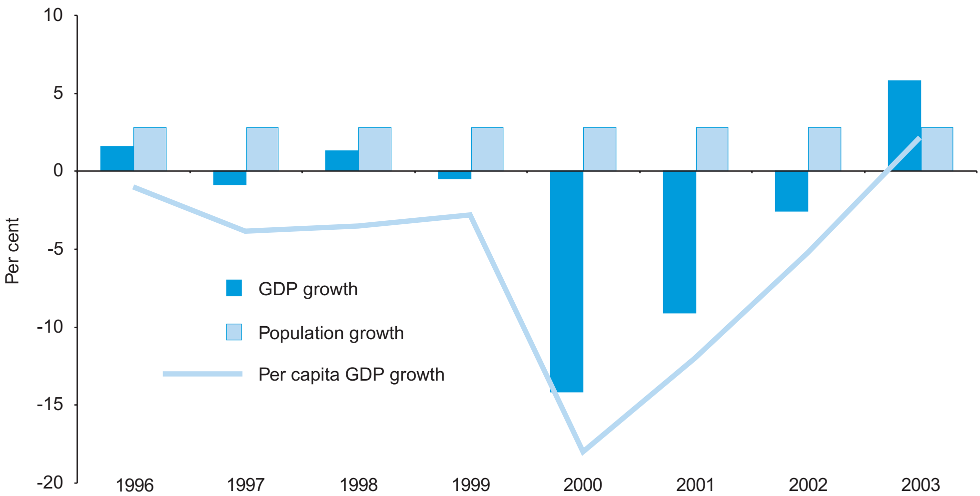
Ethnic tensions sparked economic collapse in an already fragile economy. Economic growth had been relatively stagnant from around 1996, and in 1999 the economy began contracting; by 2002, the economy had contracted by around 24 per cent from its level in 1998 (Table 1.1). Government lost control of expenditure and revenue, resulting in defaults on debt repayments to foreign and local institutions, and further weakening the local financial market. Domestic production levels fell and, coupled with falling commodity prices, export levels plummeted.

Economic decline slashed per capita GDP levels by around 18 per cent in 2000 alone (Figure 1.1). Coupled with high population growth rates, per capita nominal GDP fell to around US$660 in 2002, down from a high of US$989 in 1996 (International Monetary Fund, 2004).

Figure 1.1

**GDP and per capita income contracted sharply**

**Solomon Islands' real GDP, population and real per capita GDP growth, 1996–2003, per cent**




Note: Population estimates based on population growth from 1986 to 1999.

Source: Central Bank of Solomon Islands, 2000, 2002, 2003a; Houenipwela, 2004; International Monetary Fund, 2004; Solomon Islands Census Office, 1999.

Table 1.1

## Major economic indicators decline

**Summary of key economic indicators, 1993–2003**

| | 1993 | 1995 | 1997 | 1999 | 2000 | 2001 | 2002 | 2003 |
|---|---|---|---|---|---|---|---|---|
| GDP (US$ millions, current prices)[a] | 283 | 357 | 390 | 336 | 319 | 303 | 322[b] | 365 |
| GDP (SBD millions, current prices) | 901.0 | 1217.0 | 1452.0 | 1605.0 | 1529.0 | 1447.0 | 1532.0 | 1739.0 |
| GDP per capita (US$, current prices) | 798.2 | 928.9 | 962.6 | 773.1 | 701.1 | 644.0 | 660.8 | 724.0 |
| Inflation (average per cent change in Honiara Retail Price Index )[c] | 9.2 | 9.6 | 8.1 | 8.0 | 6.8 | 6.8 | 7.3 | 10.1 |
| **Demand structure of GDP (per cent)[d]** | | | | | | | | |
| Government consumption | 37.8 | 28.8 | 29.6 | 29.8 | 27.6 | 32.3 | 43.9 | 39.3 |
| Exports: goods and services | - | - | 58.1 | 62.1 | 39.6 | 36.0 | 32.4 | 42.9 |
| Imports: goods and services | - | - | 70.1 | 64.7 | 55.1 | 52.0 | 39.4 | 52.5 |
| **Sectoral structure of GDP (per cent)** | | | | | | | | |
| Agriculture | 19.7 | 18.3 | 20.0 | 15.1 | 14.7 | 14.2 | 16.1 | - |
| Forestry and fisheries | 18.9 | 24.2 | 19.7 | 18.3 | 14.8 | 15.7 | 17.0 | - |
| Mining | 0.2 | 0.1 | -0.7 | 6.8 | 4.0 | -0.3 | -0.3 | - |
| Manufacturing | 4.4 | 4.5 | 6.0 | 6.2 | 6.0 | 5.5 | 5.4 | - |
| Services and other | 56.7 | 53.0 | 54.9 | 53.7 | 60.5 | 64.9 | 61.8 | - |
| **External account** | | | | | | | | |
| Exports: goods and services (SBD million) | - | - | 843.9 | 997.4 | 603.6 | 521.1 | 497.8 | 746.7 |
| Imports: goods and services (SBD million) | - | - | 1018.2 | 1037.7 | 839.8 | 752.1 | 604.6 | 913.4 |
| Current account balance (SBD million) | -24.4 | 28.4 | -54.3 | 120.0 | -223.8 | -172.3 | -41.0 | 204.0 |
| External debt (SBD million) | 639.6 | 519.3 | 756.0 | 833.8 | 851.7 | 957.3 | 1307.4 | 1379.9 |
| External debt (per cent of GDP) | 71.0 | 42.7 | 52.1 | 52.0 | 55.9 | 67.8 | 84.1 | 79.4 |
| Foreign direct investment flows (US$ million) | 23 | 2 | 9 | -19 | 1 | -12 | -7 | - |

Table 1.1 (cont.)

| | 1993 | 1995 | 1997 | 1999 | 2000 | 2001 | 2002 | 2003 |
|---|---|---|---|---|---|---|---|---|
| Exchange rate (SBD to US$, year average) | 3.18 | 3.41 | 3.73 | 4.93 | 5.11 | 5.3 | 6.78 | 7.51 |
| **Growth rates (per cent)** | | | | | | | | |
| Real GDP | 1.3 | 10.1 | -0.9 | -0.5 | -14.2 | -9.2 | -2.6 | 5.8 |
| Merchandise exports | 36.6 | 22.5 | 0.8 | 6.1 | -51.4 | -29.5 | 56.9 | 42.8 |
| Population[e] | 2.8 | 2.8 | 2.8 | 2.8 | 2.8 | 2.8 | 2.8 | 2.8 |

Notes: Data represented indicates best available statistics primarily based on Central Bank of Solomon Islands data. However, table should only be read as indicative as comprehensive statistics are not available. All data shown in per cent GDP terms has been calculated using the International Monetary Fund (2004) estimates of GDP in SBD.

a. GDP in US$ based upon GDP in national currency and the exchange rate projections provided by country economists within the International Monetary Fund for the group of other emerging market and developing countries as reported in the World Economic Outlook (International Monetary Fund, 2004). As a result, GDP in $US presented in this table is not convertible with GDP in SBD using the year average exchange rates as shown in the table.

b. The World Bank (2003) estimate a significantly lower figure of $239.6 million for 2002.

c. Inflation in years not shown is variable. For example, inflation in 1994 was 13.1 per cent; in 1998 it was 12.4 per cent.

d. Indicative composition only. Statistics derived using Central Bank of Solomon Islands data for government expenditure, exports and imports, as a proportion of GDP in SBD as reported by the International Monetary Fund (2004).

e. Estimates only. Population growth estimates based on Solomon Islands 1999 census data indicating annual average growth of 2.8 per cent from the last census in 1986. Some other sources, such as the Asian Development Bank (2003b) indicate growth rates of well over three per cent.

Sources: GDP, current prices (US$ and SBD) and per capita statistics, International Monetary Fund, 2004.

Inflation and real GDP growth statistics: for 1990–95, Solomon Islands Government, 2002; for 1997–2002, Central Bank of Solomon Islands, 2000, 2001, 2002, 2003a, 2004d; for 2003, Houenipwela, 2004.

Government Consumption Data: for 1990–95, Asian Development Bank, 2003; for 1997 onwards, Economic Analytical Unit calculations based on government expenditure data from Central Bank of Solomon Islands, 2000, 2001, 2002, 2003a, 2004d, as a proportion of GDP in SBD reported by the International Monetary Fund, 2004.

Sectoral Structure of GDP: for 1993 and 1995, International Monetary Fund, 1998; for 1997 onwards, based on data from Central Bank of Solomon Islands, 2000, 2001, 2002, 2003a, 2003b.

External account statistics: Foreign Direct Investment, United Nations Conference on Trade and Development, 1999, 2003; current account, external debt and exchange rate statistics from 1990–95, Solomon Islands Government, 2002; all statistics, excluding Foreign Direct Investment, from 1997 onwards based on data from Central Bank of Solomon Islands 2000, 2001, 2002, 2003a, 2004d.

Merchandise export growth rates; for 1990–95, Asian Development Bank, 2003; for 1997 onwards, Central Bank of Solomon Islands, 2000, 2001, 2002, 2003a, 2004d.

Population data, based on Solomon Islands Census Office, 1999.

### SOLOMON ISLANDS LACKS MEANINGFUL STATISTICS

With the notable exception of some series produced by the Central Bank of Solomon Islands and more recently the Ministry of Finance, Solomon Islands has not released comprehensive statistics since the first half of the 1990s. Only a very limited range of up-to-date statistics is currently available, making it difficult to assess the true state of the economy. The available statistics have primarily been provided by the Central Bank and the independent Census Office. They include monetary statistics (monthly), balance of payments (annual) and external transactions (monthly), partial unpublished prices data (monthly), partial government finance statistics (monthly), census of population (1999) and GDP at constant prices (annual). RAMSI's work in the Ministry of Finance has resulted in the publication of government budget statistics. Despite having 16 staff, the Statistics Office has produced only very limited statistics since the end of 2000, due in large part to lack of support, direction and resources.

Statistics on monthly trade figures, more reliable and comprehensive annual GDP estimates, quarterly arrivals and departures, expanded national accounts, a more comprehensive monthly consumer price index, employment and wages, full balance of payments and full government finance statistics are necessary for determining the state of the economy. The development of the statistical authority will require technical assistance and financial support from the Solomon Islands Government and donors.

Source: Pacific Financial Technical Assistance Centre, 2003.

## Services and Primary Production Dominant

During the period 1999 to 2003, the services sector, predominately government, continued to play a major role in the economy. Services share of output was almost 59 per cent in 2002, down slightly on 2001 but up significantly from 49 per cent in 1996.

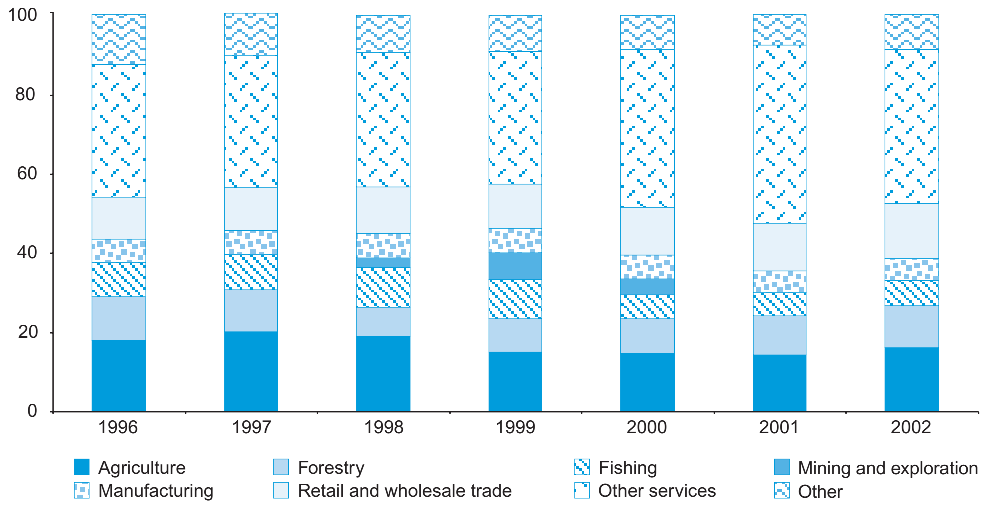
Solomon Islands' economy also remained highly dependent on primary production through direct production for markets and subsistence agriculture, on which over 75 per cent of the population relied (CIA, 2003). In 2003, marketed agricultural output accounted for almost 16 per cent of GDP, forestry around 9 per cent and fishing over 6 per cent (Central Bank of Solomon Islands, 2004d). Primary production's GDP share of 33 per cent in 2002 was down from 40 per cent in 1997 (Figure 1.2). The main agricultural products have been cocoa beans, coconuts and copra, palm kernels, potatoes, vegetables, fruit, pigs, timber and fish.

Although overall GDP fell in 2002, some sectors grew. Construction grew a strong 23 per cent in 2002. Similarly, transport and communications, retail and wholesale trade and hotels, agriculture, fishing and forestry all grew in 2002. The mining and exploration sector began to have a positive effect on growth between 1998 and 2000 until the closure of the Gold Ridge mine due to ethnic tension. The mine's infrastructure was badly damaged.

Figure 1.2

**Services dominate output**

**Sectoral share of GDP, 1996–2002, per cent**




Note: Other includes electricity and water, transport and communication and construction.

Source: Central Bank of Solomon Islands, 2000, 2001 and 2003a.

## External Sector Weakens

From 2000 to 2003, Solomon Islands experienced a sharp decline in trade and capital inflows, a weakening balance of payments, critically low gross international reserves and significantly increasing external debt.

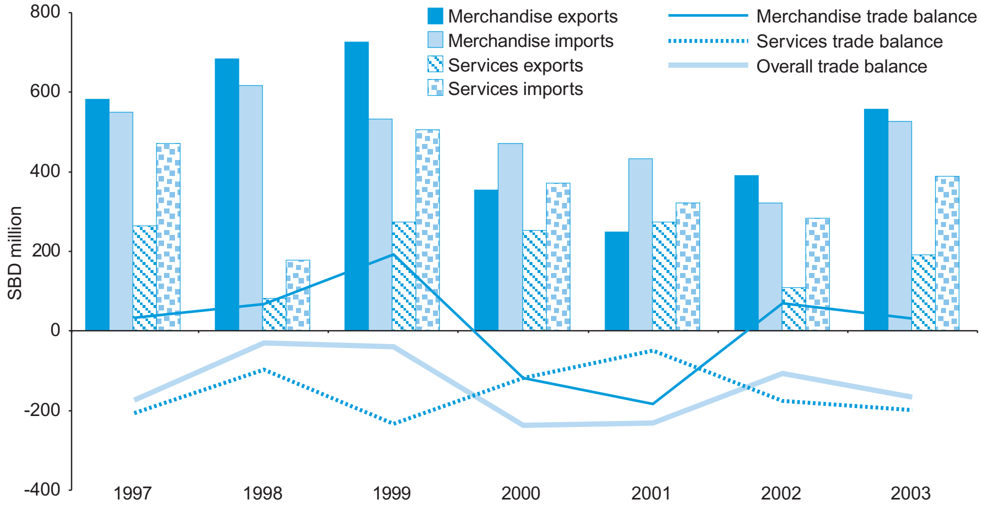
The ethnic conflict and violence significantly reduced trade flows. Between 1999 and 2002, merchandise and services exports declined by an average of around 19 and 27 per cent per year, while merchandise and services imports fell by an average of around 16 and 18 per cent each year (Figure 1.3). In 2002, merchandise exports grew 57 per cent and imports fell by just under 26 per cent. These trends created a merchandise trade surplus for the first time in three years.

Solomon Islands reliance on timber increased with the collapse of other commodity exports. Even with this collapse, foreign revenue was primarily derived from commodity exports (Figure 1.4).

Figure 1.3

## Trade performed poorly

### Exports, imports and merchandise trade balance, 1997–2003, SBD million

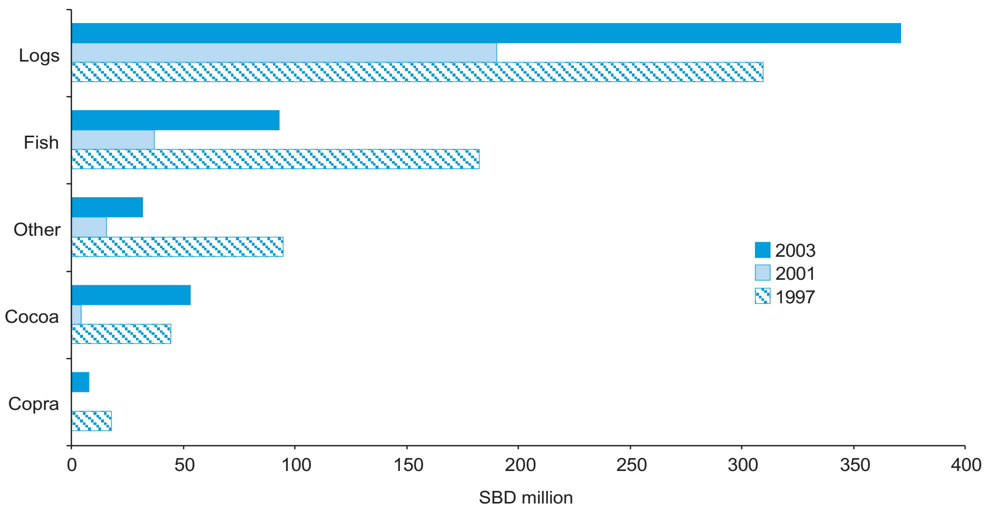



Source: Central Bank of Solomon Islands, 2001, 2003a, 2004d.

Figure 1.4

## Logs and fish dominate exports

### Top five commodities, foreign exchange receipts, 1997–2003, SBD million




Note: Other covers minerals, palm oil and kernels, and exports other than those in the above figure.

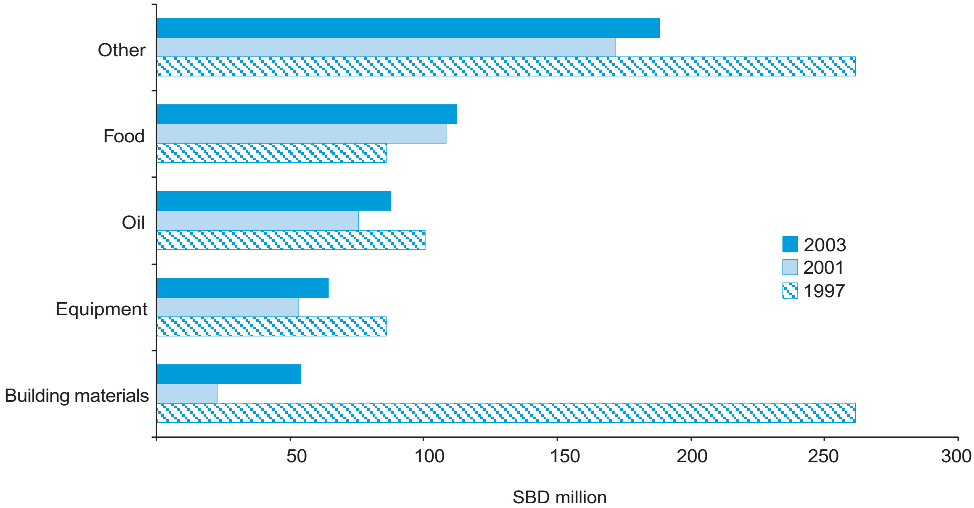
Source: Central Bank of Solomon Islands, 2000, 2001, 2002, 2003a, 2004d.

The shrinking economy caused a sharp decline in construction, resulting in the large decline in building material imports. By 2003, the main import items were food and oil (Figure 1.5).

Figure 1.5

**Food and oil major imports**

**Top five imports, foreign exchange payments, 1997–2003, SBD million**




Note: Other covers chemicals, beverages, tobacco, government payments and imports other than those in the above figure. Equipment covers plant, vehicles and transport equipment.

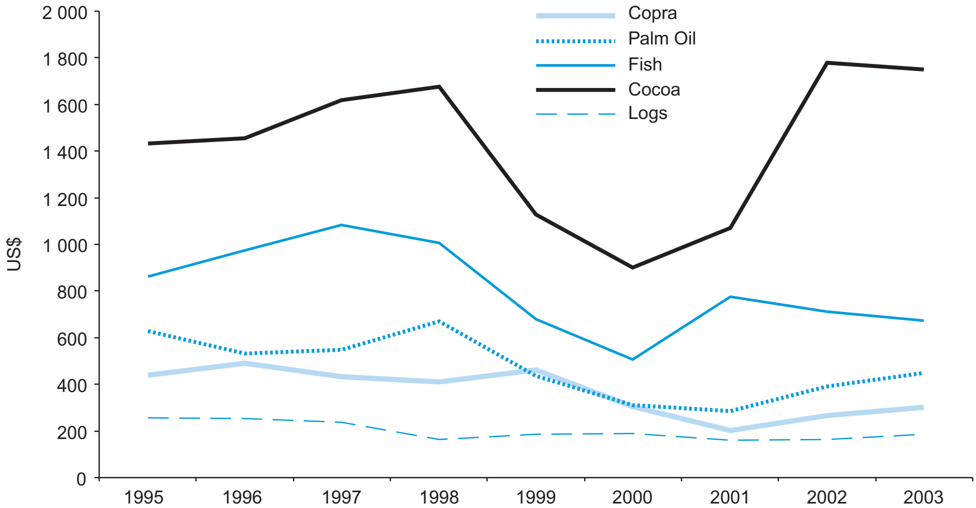
Source: Central Bank of Solomon Islands, 2000, 2001, 2002, 2003a, 2004d.

Due to its heavy reliance on commodity exports, the economy is highly sensitive to commodity price fluctuations. Between 1998 and 2002, palm oil prices fell by 42 per cent, copra prices by 35 per cent and fish prices by 29 per cent, aggravating the existing economic problems (Figure 1.6). However, cocoa prices increased by 6 per cent over the same period and log prices remained approximately constant. Overall, the terms of trade moved unfavourably, declining from 1997 until 2003 (Figure 1.7).

Figure 1.6

## Low commodity prices after 1998

### Commodity prices, 1995–2003, end of period, US$



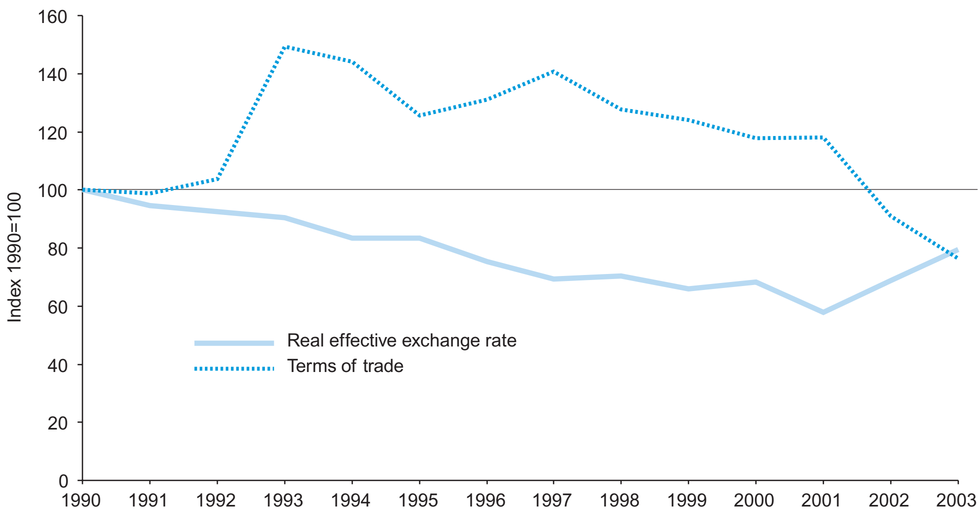

Note: Copra, palm oil, fish and cocoa prices are in US$ per tonne and log prices are US$ per cubic metre.

Source: Central Bank of Solomon Islands, 2003a, 2004d.

Figure 1.7

## Solomon Islands' competitiveness and terms of trade decline

### Real effective exchange rate and terms of trade, 1990–2003, index 1990=100




Notes: A rise in the terms of trade indicates Solomon Islands' retail prices increased relative to those countries from which it imports. The real effective exchange rate is based on relative domestic retail prices and foreign export prices; a rise indicates depreciation, that is, average foreign export prices increased faster than Solomon Islands' consumer prices when all are expressed in a common currency.

Source: Central Bank of Solomon Islands, 2003a, 2004d.

## Exchange Rate Depreciates Sharply

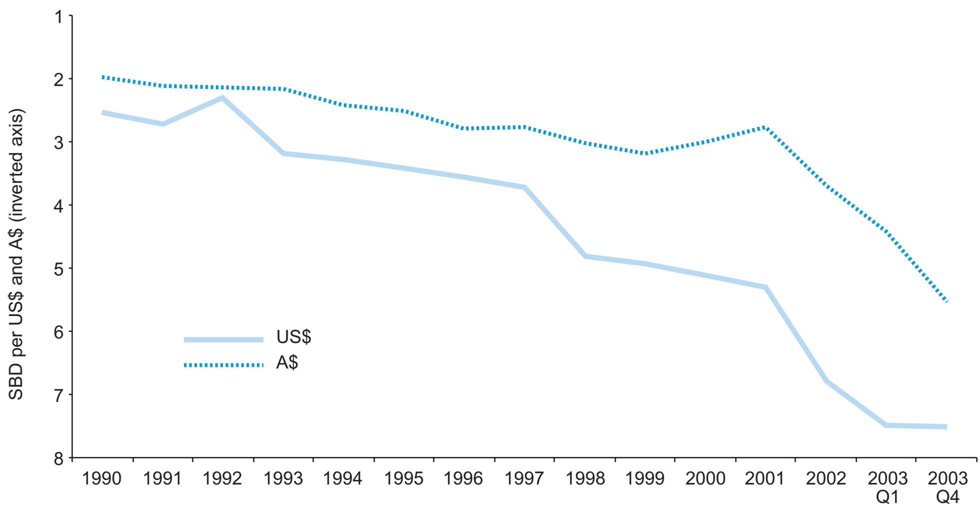
The exchange rate system is a crawling peg with the US dollar, based on changes in the trade-weighted value of a basket of foreign currencies; the basket comprises the Japanese yen, the Australian dollar, the UK pound and the US dollar. The weights of the foreign currencies are based on a three-year moving average using the latest annual trade statistics.

In an effort to protect dwindling international reserves, the authorities depreciated the exchange rate sharply in 2002 and tightened exchange restrictions (Figure 1.8). By 2003, the Solomon Islands dollar was valued 50 per cent below its level in 1997 against the US dollar, while its value against the Australian dollar during the same period fell by around 38 per cent.

Figure 1.8

**Solomon Islands' dollar depreciates significantly**

**Solomon Islands' dollar against the US dollar and the Australian dollar, 1990–2003, period averages**




Source: Central Bank of Solomon Islands, 2003a, 2004c.

## Current Account Deficit Rose Sharply in 2000

Declining exports generated large current account deficits in 2000 and 2001, equal to around 15 and 12 per cent of GDP respectively. Improving export levels and commodity prices and rising donor payments reduced the current account deficit from SBD172.3 million in 2001 to SBD41.0 million in 2002, or around 2.7 per cent of GDP.

## External Debt Soars

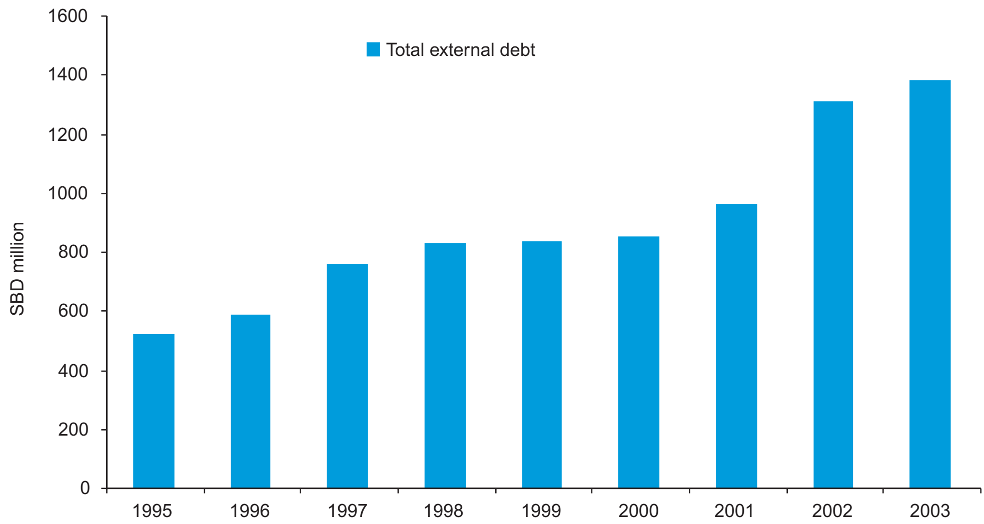
External debt levels grew significantly after the outbreak of civil ethnic conflict in mid-1999 and the associated exchange rate depreciation. By 2003, the national external debt stock rose to SBD1.4 billion, over 80 per cent of GDP, up from around 52 per cent in 1999 (Figure 1.9). A rise in public sector debt drove this increase in external debt given the slight decline in private sector debt over this period.

Capital inflows fell substantially over 1999 to 2002, due in large part to the law-and-order situation. Multilateral institutions ceased loan disbursements in 2002, further decreasing capital inflows.

Figure 1.9

**Foreign debt rising sharply**

**Level of Solomon Islands' external debt, 1995–2003, SBD million**




Source: Central Bank of Solomon Islands 2000, 2001, 2002, 2004d.

## Control Lost over Public Finances

The troubles in Solomon Islands caused revenue to decline in 2000 and expenditure to rise sharply in 2002, resulting in a sharp deterioration in the Government's fiscal position. The budget moved from a small surplus in 1999, largely generated by external assistance, to a deficit of around 11 per cent of GDP in 2002.[1] However, because of inadequate public accounting procedures on both the revenue and expenditure sides, the actual situation could have been worse than these data indicate.

Poor fiscal control resulted in fiscal deficits for most of the 1990s. Towards the end of the decade there was some success in containing expenditure. However, this was short lived and the Government's fiscal control soon deteriorated to crisis levels. In 2002, Ministry of Finance staff came under threat

[1] Large arrears are included in these deficit calculations.

when armed gunmen entered Ministry of Finance buildings to coerce staff at gunpoint. Expenditure became uncontrolled and, compounded by lack of political will, misguided policy directions and a substantially increased debt burden, government finances deteriorated (Central Bank of Solomon Islands, 2003a). In 2002, total expenditure was 50 per cent more than budgeted (Figure 1.10). Non-tax revenue and grants and borrowings were 50 per cent and 35 per cent below budget expectations. As a result, the domestically financed fiscal deficit was more than 11 times worse than forecast.

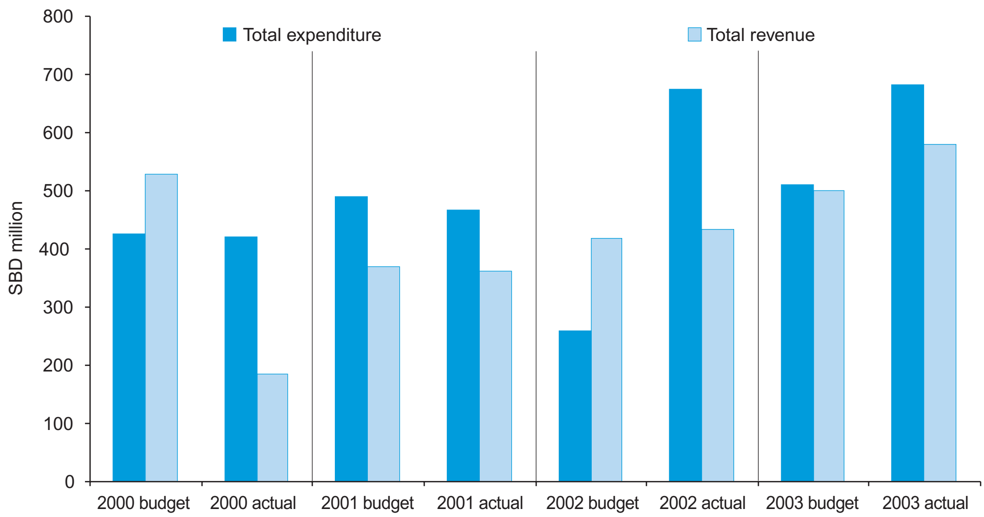
Total recurrent expenditures in 2002 were SBD547.3 million compared with the revised budget level of SBD250 million. The Government was unable to pay all obligations during the year and most expenditure was financed through increased arrears (Central Bank of Solomon Islands, 2003a). At the end of 2002, expenditure arrears were estimated at 19 per cent of GDP, an increase of 6 percentage points during the year.

In 2002, total recurrent revenues were SBD6.4 million higher than the budget and SBD36.5 million more than the previous year (Central Bank of Solomon Islands, 2003a). Due to a gradual improvement in economic activity in 2002, revenues from the Inland Revenue Division rose by over 6 per cent in 2002 after the large decline in 2001. Total revenues from international trade rose by almost 40 per cent, underpinned by increases in the value of imports and log export tax receipts (Central Bank of Solomon Islands, 2003a). In 2002, import duty receipts increased significantly by 30 per cent on 2001. This was due to the small rise in import payments and better collection.

Figure 1.10

**Public expenditure blew out in 2002**

**Total expenditure and total revenue, Government annual accounts and budget forecasts, 2000–2003, SBD million**




Note: Total revenue includes grants.
Total expenditure both recurrent and development expenditure. Expenditure is total accrued expenditure, including estimated arrears.

Source: Central Bank of Solomon Islands, 2003a, 2004d.

In August 2002, the Government announced it would cut the public sector workforce by 1300, reduce the number of ministries from 20 to 10 and start to pay down arrears by funding development expenditure wholly by external grants. In mid-2002, the Government started to set aside 15 per cent of non-grant revenue to help service government debts, and in October 2002, the Central Bank of Solomon Islands issued regulations to tighten export and import duty collections. However, in December 2002, these restructuring plans were thrown into disarray. The Government, under threat of violence including the firing of shots into the Prime Minister's residence, was forced to authorise the use of the debt service fund account for large unbudgeted payments to 'special constables', most of whom were former members of armed militias.

In the first eight months of 2003, some ministries, most notably the Ministry of Police, National Security and Justice, grossly overspent their budgets. Extorted and unscheduled payments to the 'special constables' blew out expenditure by SBD57.3 million in this period.

## Budget Reliance on Donor Funding

The budget has continued to function through the support of donors; total official development assistance in 2001 was US$58.8 million, or US$130.7 per capita, declining in 2002 to US$26.3 million, or US$59.3 per capita. In per capita terms for 2002, assistance to Solomon Islands was less than to Samoa (US$213.3) or to Vanuatu (US$133.5), but more than to Papua New Guinea (US$37.8) and far above the average received by Least Developed Countries (US$25.09) (Development Assistance Committee, 2004).

## Government Debt Soars

The succession of budget deficits resulted in an increase in the Government's formal debt to around 110 per cent of GDP, over two thirds of which was external debt. In 2002, the total stock of formal government debt increased by almost 42 per cent to SBD1635.9 million. The rise in the external component was due primarily to the inflow of Taiwanese Exim Bank loan proceeds and exchange rate effects (Central Bank of Solomon Islands, 2003a).[2] The Asian Development Bank accounted for around 32 per cent of the external debt and the World Bank 28 per cent (Central Bank of Solomon Islands, 2003a). Between 2000 and 2002, loans increased by just over 70 per cent. In particular, in 2001 and 2002, Taiwanese bodies advanced significant loans to Solomon Islands, totalling SBD194 million at the end of 2002; significant amounts of these loans were used to pay compensation claims to various groups.

The domestic component of the debt was split almost equally between government securities and government advances from the Central Bank. Of the securities, 78 per cent were restructured bonds.

In 2002, the Government could not pay the amount budgeted for debt servicing, managing only SBD19.7 million or 70 per cent. Of this, SBD7.7 million was for external debts, with SBD5.4 million for interest repayments. The SBD12 million for domestic debt was all interest repayments and no principal repayment.

2 The Exim Bank is Taiwan's 100 per cent Government-owned export and import bank. This facility provided commercial loans to the Solomon Islands Government across 2001 and 2002.

The Government began to default on its external debt when the domestic banking system became unwilling to hold government securities and the Central Bank would not give further credit. Between 2000 and 2002, arrears on public external debt increased by 159 per cent. The Government's continuing financial difficulties also meant that it had difficultly in meeting domestic costs.

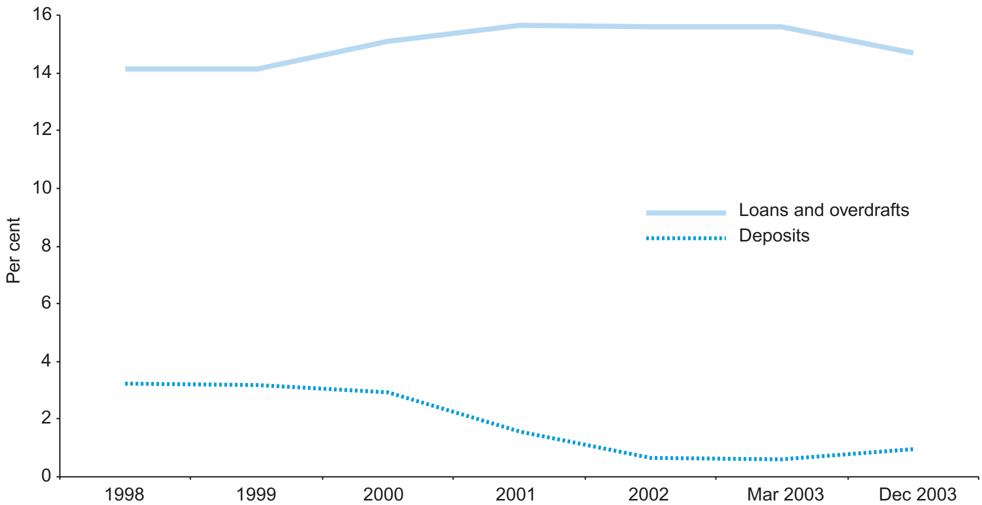
## Banks' Lending Rates Increase

High lending rates, lack of acceptably low-risk borrowers and a shortage of collateral due to the communal land ownership system impeded bank lending. Interest rates on loans and overdrafts increased to a nominal weighted average of 15.6 per cent in early 2003 (Figure 1.11). In comparison, due to poor earning opportunities on government securities and excess liquidity in the banking system, deposit rates fell to a nominal weighted average of 0.6 per cent, resulting in highly negative real returns (that is, after the impact of inflation is taken into account). This resulted in a large interest rate spread (the difference between the interest rate for loans and that for deposits); between 1998 and March 2003, the interest rate spread increased by just over 4 percentage points.

Figure 1.11

**Large spreads on bank lending**

**Interest rates on loans and overdrafts and on deposits, weighted averages, 1998–2003**




Source: Central Bank of Solomon Islands, 2003b, 2004a.

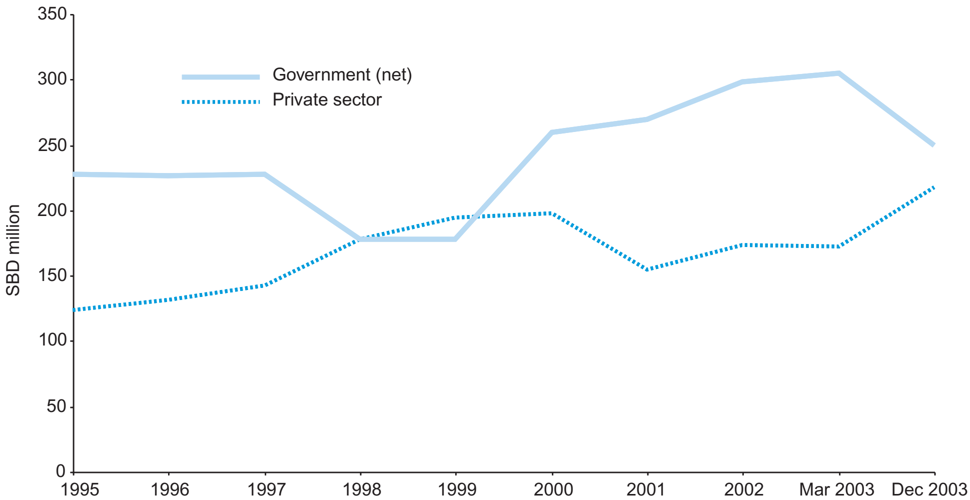
## Credit Growth Contracted

Due to high interest rates on loans and the vulnerability of the financial system, there was a saving-investment mismatch, with relatively low levels of private lending occurring. Most credit, around 64 per cent in the first quarter of 2003, was to the Government. The Government's huge demand for credit was the main reason for high interest rates and this crowded out private sector borrowing. Between 2000 and the first quarter of 2003, domestic credit increased by 28 per cent. In that period, domestic credit to the private sector fell by 11 per cent while domestic credit to government rose by 71 per cent (Figure 1.12). This reflected the private sector's difficulty in accessing credit.[3]

Figure 1.12

**Government borrowing crowded out lending to private sector**

**Domestic credit, 1990–2003, SBD million**




Source: Central Bank of Solomon Islands, 2000, 2003a and 2003c, 2004c.

[3] It should be noted that the increase in credit in 2002 was more a consequence of declines in government deposits than any appetite of the banking system to provide further credit to the Government (Central Bank of Solomon Islands, 2003a).

## Financial System Vulnerable

All financial institutions had a high exposure to government debt which made them vulnerable when the Government began to default on interest repayments.[4] In 2001, the Government defaulted on interest payments on its bonds and restructured them only to default again in 2002. Since August 2002, government debt holders have been forced to roll over maturing securities at an administrative interest rate of 3 per cent.[5]

Solomon Islands has three commercial banks, Australia and New Zealand Banking Group Ltd (ANZ), Westpac Banking Corporation and the National Bank of Solomon Islands, which is partly owned by the Solomon Islands National Provident Fund. In 2001, commercial banks' profits fell considerably reflecting their reduced lending (Houenipwela, 2002). The issue of greatest concern to banks became their holding of government securities which were under-performing and technically in default. At the end of March 2003, of the total amount of outstanding bonds, 52 per cent were held by commercial banks, representing around 30 per cent of total banking system assets. The uncertain status of these bonds undermined the stability of the financial system. If banks were forced to provision for these under performing assets, some could confront solvency risks (Houenipwela, 2002).

In particular, the largest commercial bank, the National Bank of Solomon Islands, which holds more than half of total banking sector assets, came under financial pressure. The bank held high levels of government debt and its major shareholder, the Solomon Islands National Provident Fund, faced financial difficulties. From mid-2002, the National Bank of Solomon Islands lost its foreign shareholder.[6] Since then, the new shareholding of the National Bank of Solomon Islands has remained formally unresolved. However, the current owners remain unlikely to be able to meet any new capital requirements should the bank require them. In 2003, the National Bank of Solomon Islands made a SBD13 million balance sheet loss provision on its outstanding government bonds.

The Development Bank of Solomon Islands also began to face serious difficulties (see Chapter 4 – *Creating the Right Environment for Business*). It has been plagued by management problems and politically driven lending. Its loan portfolio was heavily tilted towards sectors producing marginal returns (Houenipwela, 2002). In 2002, the Development Bank was unable to make new loans and it effectively ceased operating.

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4 Solomon Islands' financial system comprises four tiers. In the first tier is the Central Bank of Solomon Islands, responsible for monetary policy; the second tier comprises the three commercial banks, the National Bank of Solomon Islands and two branches of Australian banks, the Australia and New Zealand Banking Group Ltd and Westpac Banking Corporation; the third tier is made up of the National Provident Fund, the Development Bank of Solomon Islands, Home Finance Corporation and credit unions; and the fourth tier comprises insurance companies, Investment Corporation of Solomon Islands and micro-saving and credit organisations (Central Bank of Solomon Islands, 2003a).

5 In April 2001, the Government defaulted on the first tranche (SBD54 million) of the Restructured Bonds. Although interest was being serviced, in April 2002, the Government also defaulted on the second tranche (SBD54 million). Attempts to agree on a scheme of repayment and interest servicing were unsuccessful until the Government ultimately prescribed terms for repaying and servicing the debt; from 1 August 2002, it put in place a three-year moratorium on principal and a 3 per cent interest rate. Where individual contractual arrangements with creditors put the interest rate above 3 per cent, the excess will accrue monthly. Repayment will span 20 years (Houenipwela, 2002).

6 In mid-2002, the Bank of Hawaii gave its 51 per cent stake in the National Bank of Solomon Islands to three local charities established by the Bank of Hawaii to benefit the education and health sectors and the bank's employees.

The Solomon Islands National Provident Fund, which collects and invests compulsory social security contributions, also began to face financial difficulties (see Chapter 4 – *Creating the Right Environment for Business*). More than half of its investments, many of which are treasury bills, were yielding negative real rates of return; the Government did not pay its share of members' contributions from September 2000 to May 2002; and its asset portfolio was heavy in poorly performing state-owned enterprises. The fund survived on the cash reserves of past years and would have become insolvent except for delays in deciding on members' applications for withdrawal of contributions (Houenipwela, 2002).

Of the other main financial institutions, many credit unions ceased to function during the ethnic crisis and the remainder faced problems due to mismanagement. The umbrella body, Solomon Islands Credit Union League, suffered from management problems.

### FINANCIAL SCAMS IN SOLOMON ISLANDS

There has been a history of financial scams in Solomon Islands. Most recently, a scam involved a pyramid scheme where people who paid SBD250 (around A$50) were promised they would be repaid SBD1.2 million a month later. In May 2003, hundreds of people besieged the Central Bank of Solomon Islands and one of the commercial banks in the belief the banks would make the payouts. In early May 2003, people linked to the trust demanded to open a bank account which the commercial bank refused to do on the basis that it believed the accounts would be used for money laundering. The trust then threatened to blow up the bank and kill expatriate staff. The Central Bank of Solomon Islands and other banks closed for a period after the threats. The Government ordered police to mount a security operation. In February 2004, the organisers of the scam were found guilty and jailed.

Source: www.news.com.au, 'Solomon Islands' banks close', May 2003, accessed 11 August 2003.

## RAPID POPULATION GROWTH STRAINS SERVICE DELIVERY

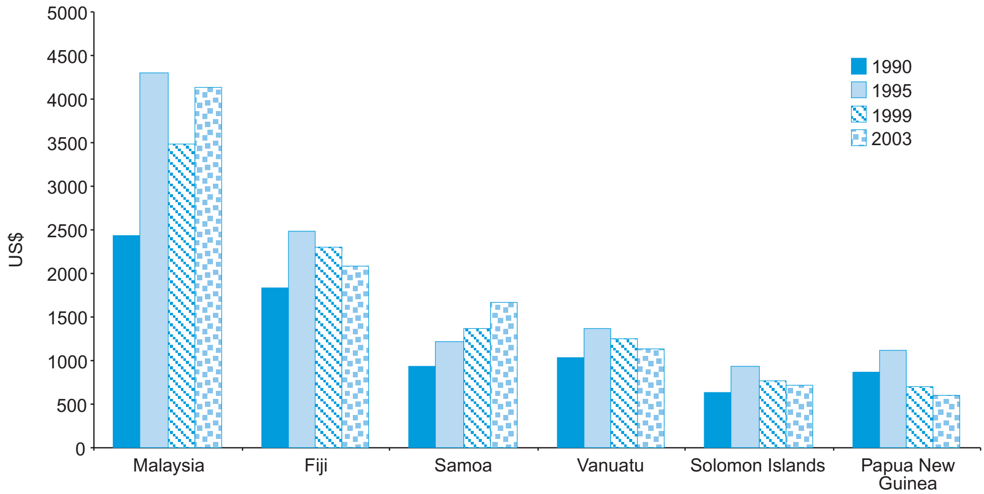
Solomon Islands has struggled to improve economic outcomes for a rapidly growing population. People continue to drift to urban centres, particularly to the island of Guadalcanal.

Solomon Islands' annual population increase over recent years is one of the world's highest at almost 3 per cent; if this continues it would double the population around every 25 years. GDP growth of a similar rate would be required just to keep GDP per capita at current levels, while much higher levels of growth would be required to improve the standard of living. Rapid population growth has placed great strain on the traditional subsistence economy, encouraged a drift to urban areas, contributed to high youth unemployment, and created huge burdens for the health and education systems and physical infrastructure (Sherlock, 2003). Even before 1999, Solomon Islands was relatively poor in comparison with many other Asia-Pacific economies (Figure 1.13).

Figure 1.13

**Solomon Islands a low income economy**

**Per capita Gross Domestic Product, current prices, selected Asia-Pacific economies**




Source: International Monetary Fund, 2004.

Only a very small proportion of the population, about 23 per cent of the population aged 14 and above, is involved in any paid work (Solomon Islands Census Office, 1999). Cash from these workers supports many people linked to the employee through family or ethnic ties. However, the largest section of the community remains involved in semi-subsistence agriculture with cash crops meeting basic cash needs such as schooling and medicine.

In 2001, the share of the population living in urban areas was around 20 per cent, up from 9 per cent in 1975. With most economic activity and spending centred on Guadalcanal, other regional and clan groups moved to Guadalcanal to take advantage of opportunities there. This increased conflicts over land use and access to jobs, and contributed to the violence and law and order problems.

## Poverty a Problem for Health and Education

With a strong communal system and access to subsistence agriculture, Solomon Islanders are less likely to suffer from hunger and starvation because of poverty than is the case in other developing economies. However, poverty remains high and has effects in other areas such as access to health and education.

Solomon Islands suffers from low health and education levels. Standards have declined further since the start of ethnic violence. Ethnic tensions disrupted the delivery of these services, while the Government's financial problems have hindered effective service delivery. The United Nations

Development Programme (1999), using a poverty index measuring general health and education and access to health services, records the Solomon Islands as having the second highest poverty levels in the Pacific.[7]

The number of students enrolled in primary and secondary education increased through the 1990s, raising literacy levels from around 62 per cent in 1991 to 76 per cent in 1999 (Solomon Islands Government, 2002).[8] However, the quality of education is an issue as about 35 per cent of teachers in primary and junior secondary schools in 2001 were untrained and most schools had inadequate materials and facilities (Solomon Islands Government, 2003). Schooling is neither free nor compulsory, so participation rates are low (Table 1.2).

Significant health problems exist, particularly malaria. In 2000, public health expenditure as a share of GDP was 5.5 per cent and private health expenditure was 0.3 per cent of GDP. Per capita spending on health was around US$97 on a purchasing power parity basis. Solomon Islands suffers 15 malaria cases per 100 people per year, approximately nine times the incidence in Papua New Guinea and 16 times that in Indonesia.

Table 1.2

**Solomon Islands has health and education problems**

**Selected social indicators, various regional economies and years**

| | Fiji | Papua New Guinea | Samoa | Solomon Islands | Indonesia | Thailand | Australia |
|---|---|---|---|---|---|---|---|
| **Major indicators** | | | | | | | |
| Human Development Index, 2001 | 0.754 | 0.548 | 0.775 | 0.632 | 0.682 | 0.768 | 0.939 |
| GDP per capita, PPP[a], US$, 2001 | 4 850 | 2 570 | 6 180 | 1 910 | 2 940 | 6 400 | 25 370 |
| Average annual population growth, 1992–2002 | 1.2 | 2.6 | 0.8 | 3.2 | 1.4 | 1.1 | 1.2 |
| Life expectancy at birth, 2002 | 67.3 | 59.8 | 68.2 | 65.4 | 66.4 | 69.3 | 80.4 |

7 The Human Poverty Index allowed some comparison between countries. Papua New Guinea recorded the highest poverty index of 52.2, followed by Solomon Islands (49.1), Vanuatu (46.4), Federated States of Micronesia (26.7) and then other Pacific Island Countries (United Nations Development Programme, 1999).

8 The 1991 and 1999 statistics are not strictly comparable due to differing methodologies. The 1991 figure is from literacy surveys and tests and includes those classed as semi-literate, while the 1999 figure is from the census and based on self-reporting in response to a census question. The United Nations (2002) reports that the 1991 census shows literacy rates of only 30 per cent of the adult population, the lowest in the Pacific Region, and questions the method of literacy measurement used which provide the1999 literacy rates (United Nations, 2002).

Table 1.2 (cont.)

| | Fiji | Papua New Guinea | Samoa | Solomon Islands | Indonesia | Thailand | Australia |
|---|---|---|---|---|---|---|---|
| **Education indicators** | | | | | | | |
| Adult literacy rate, per cent of people aged 15 and above, 2001 | 93.2 | 64.6 | 98.7 | 76.6 | 87.3 | 95.7 | |
| Primary, secondary and tertiary gross enrolment ratio, per cent, 2000–01 | 76 | 41 | 71 | 50 | 64 | 72 | 114 |
| Public expenditure on education as a per cent of GDP, 1998-2000 | 5.2 | 2.3 | 4.2 | 3.6 | | 5.4 | 4.7 |
| Public expenditure on education as a per cent of Government expenditure, 1998-2000 | 17 | 17.5 | 13.3 | 15.4 | | 31 | |
| **Health indicators** | | | | | | | |
| Infant mortality, per 1 000 live births, 2001 | 18 | 70 | 20 | 20 | 33 | 24 | 6 |
| Maternal mortality per 100 000 live births, 1985–2001 | 38 | 370 | | 553 | 380 | 44 | |
| Malaria cases per 100 000 people, 2000 | | 1 688 | | 15 172 | 920 | 130 | |
| Public expenditure on health as a per cent of GDP, 2000 | 2.6 | 3.8 | 5 | 5.5 | 0.6 | 2.1 | 6 |
| Health expenditure per capita, PPP[a], US$, 2000 | 194 | 145 | 227 | 97 | 84 | 237 | 3161 |

Notes: a. Under purchasing power parity the exchange rate between two economies equals the ratio of the two economies' relative price levels.

Sources: World Health Organization, 2003; United Nations Development Programme, 2003.

## WAS SOLOMON ISLANDS A FAILED STATE?

By early 2003, Solomon Islands was in a desperate situation. Rogue police who were often former militants freely extorted money from a government unable to reimpose law and order. The lack of law and order directly affected the operations of businesses on Guadalcanal, causing a number to close. By the end of 2002, GDP had fallen for the fourth year in a row.

Corruption further eroded government finances, contributing to a lack of services such as schools and medical facilities. Government debt had escalated to unserviceable levels and avenues for further loans had dried up. Many government institutions lacked funds to operate and public servants often were not being paid. Infrastructure, including telecommunications and electricity, was already limited in its service coverage and damage to this infrastructure through the crisis further restrained service delivery.

By April 2003, when the Prime Minister of Solomon Islands, Sir Allan Kemakeza, acknowledged that outside assistance would be required to halt the decline of Solomon Islands, it arguably was fast approaching failed state status.

### WHAT IS A FAILED OR FAILING STATE?

Failed or failing states have certain characteristics including:

- a lack of governance, particularly a significant failure of law and order and an inability to provide nationwide security or assert any kind of power beyond a capital city
- deteriorating economic performance, contracting year-on-year GDP and per capita income, increasing income inequality, declining investment or disinvestment, low or negative savings, often an excessive public sector, a shrunken and declining private sector, rising inflation, falling exports, unsustainably high and increasing government debt, a continually depreciating currency and capital flight
- decaying or destroyed infrastructure
- educational and health systems that largely cease to function, falling literacy, rising infant mortality, falling life expectancy and AIDS or other public health epidemics overwhelming health infrastructure
- weak and flawed institutions where only the executive institution functions; the legislature, if it exists at all, is a rubber-stamp or is totally ineffective in providing leadership; the judiciary may not be independent; and the bureaucracy has lost its sense of professional responsibility
- corruption flourishing on an unusually destructive scale
- a state that has lost its basic legitimacy within its nominal borders, become irrelevant and has one or more groups seek autonomous control within the national territory or across borders.

A collapsed state is an extreme version of a failed state. It has a total vacuum of authority.

Source: Rotberg. 2002.

## RAMSI INVOLVEMENT

As general lawlessness replaced ethnic tension, the Prime Minister of Solomon Islands, Sir Allan Kemakeza, formally approached Australia for assistance. With the support of Solomon Islands Parliament, the Australian-led Regional Assistance Mission to Solomon Islands (RAMSI) was formed and dispatched in July 2003.

The assistance began with a police-led operation designed to introduce law and order. Over 300 police officers from Australia and the Pacific, supported by around 1700 military personnel, were sent to Solomon Islands. The operation removed weapons from communities, dealt with former militants and began work to clean up and strengthen the Royal Solomon Islands Police. Law and order was re-established within a year.

RAMSI also contained a Budget Stabilisation Team tasked with regaining budgetary discipline and fiscal control. Providing security for the Ministry of Finance buildings stopped the most excessive instances of government extortion. A number of other measures were implemented to regain fiscal control. RAMSI staff worked in government departments to ensure the last quarter 2003 and 2004 budgets were more realistic and to ensure fiscal controls were implemented. They began assessing the size of government debt and developed a debt management strategy (see Chapter 2 – *Public Sector Reform and Recovery* for more information on the Budget Stabilisation Team).

With stability returning, the focus of RAMSI has shifted to capacity building of police and government, and reforms necessary for future economic growth (See Chapter 2 – *Public Sector Reform and Recovery*).

## RECENT ECONOMIC DEVELOPMENTS

Economic growth in 2003 was positive for the first time since tensions began in 1998 but this rebound has been from a low base. Houenipwela (2004) highlights the 'Great Effort at the Grassroots', or the significant role of Solomon Islands' producers and other small economic players, in contributing to real GDP growth estimated to be around 5.8 per cent.

Average inflation for 2003 remained high at around 10 per cent. However, by December 2003, the three-month moving average had fallen to 4.1 per cent, down from the 2002 high of over 15 per cent (Central Bank of Solomon Islands, 2004a). Solomon Islands has kept the exchange rate stable since early 2003 at around SBD7.50 to one US dollar, although that has meant further depreciation against the Australian dollar.

Commodity price increases have assisted domestic producers. In 2003, all commodity prices except for cocoa, which had experienced high prices throughout early 2003, and fish, the price of which fluctuated throughout the year, were above 2002 prices.

This rebound of the productive sector has strengthened the external accounts. The value of exports for 2003 was 43 per cent above that in 2002. This resulted in a trade surplus of SBD31.6 million. However, exports for 2003 remain below 1999 levels. Driven primarily by transfer receipts, the current account moved to a SBD204 million surplus in 2003 (Central Bank of Solomon Islands, 2004d). The balance of payments in 2003 registered its highest overall surplus since independence (Central Bank of Solomon Islands, 2004d).

Solomon Islands relies heavily on primary commodity exports, particularly timber, for foreign revenue. While 2003 saw a notable turnaround in economic performance, timber production is at record levels. Current production is unsustainable (See Chapter 5 – *Business Opportunities*). Development strategies which focus primarily on exploiting gold, unprocessed timber or fishing rights, bias the economy against labour intensive employment (Hughes, 2003).

Government finances are back under control, but further work remains to be done. Although total expenditure for 2003 was almost 30 per cent above the budgeted amount, this was more than matched by revenue returns almost 50 per cent above budgeted levels (Ministry of Finance, 2004). In late 2003, the Inland Revenue Division strengthened taxation collection; taxation revenue for December 2003 was some 40 per cent higher than the previous best month of the year. Similarly, expenditure controls assisted in producing a SBD30 million budget surplus for the month of December 2003 (Ministry of Finance, 2004). The final budget balance for 2003 showed a cash surplus, taking into account debt servicing funds, of SBD37.5 million. However, the Government built up significant arrears not included in this surplus figure.

Solomon Islands' development budget continues to be wholly funded through donor payments, while around 25 per cent of the recurrent budget is funded through donors. Donor funding comprises an estimated 24 per cent of recurrent health expenditure and around 33 per cent of recurrent education expenditure (Ministry of Finance, 2003).

RAMSI has been assisting the Government to establish the exact level and nature of its debt and to develop a debt management strategy. For its part, the Government has committed to meeting all current payments and is not currently entering into any further debt. While Australian repayments of Solomon Islands' outstanding multilateral institution debts allow loan disbursements to restart, the Government's heavy indebtedness and availability of significant grant aid has reduced the rationale for additional borrowing. By the end of 2003, formal government debt had risen slightly from 2002 to around SBD1680 million (Central Bank of Solomon Islands, 2004d). Total informal debt, including debt to trade creditors and liabilities of state-owned enterprises, was estimated at around SBD495 million.

There have been improvements in the monetary sector. In the last quarter of 2003, reduced risk premiums allowed banks to start to offer lower lending interest rates. Interest rates on loans and overdrafts decreased in December 2003 to a weighted average of 14.7 per cent, down from earlier averages of over 15 per cent. Deposit rates for 2003 increased slightly to a weighted average of 0.9 per cent (Central Bank of Solomon Islands, 2004c). Lending, including for mortgages, is increasing again, although communal land ownership and lack of individual titles still prevent most potential Solomon Islands borrowers from accessing bank lending.

In late 2003, the fall in loan interest rates and the stability in law and order began to have some effect on credit to the private sector. In the 12 weeks leading up to February 2004, credit to the private sector grew by around 12 per cent (Central Bank of Solomon Islands, 2004b). The growth of credit to the private sector in 2003 is almost entirely in the form of overdraft facilities for businesses to sustain existing operations (Central Bank of Solomon Islands, 2004d).

Although the economy performed positively in 2003, a number of impediments remain. Government is hindered by high debt levels and service provision remains poor and generally reliant on donor funding. Infrastructure fails to support the community or business and foreign investment is very limited. Additionally, a number of institutions in the financial sector are in financial difficulties and much of the population has difficulty accessing credit. Sustainable economic growth beyond the immediate economic rebound will require a focus on these issues.

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# PUBLIC SECTOR REFORM AND RECOVERY

## KEY POINTS

- Poor governance has been a major obstacle to development. Many public institutions need strengthening and capacity building.

- RAMSI assistance, through the Budget Stabilisation Program, is focusing increasingly on medium-term issues including medium-term budget plans, ongoing budget stability, and more intensive and structured capacity building for Ministry of Finance employees.

- Re-establishing formal vocational public service training on governance, as well as operational courses on fiscal control, management and core public service functions, is an important priority. Where possible, training should be conducted in-country to avoid the removal of key personnel.

- The urgency of providing access to basic services at the village level, combined with budgetary pressures, necessitates public sector consolidation. Restructuring the public service to focus on key areas is necessary to improve service delivery. This may also increase equity between urban and rural areas and reduce urban and inter-island migration pressures.

- Accountability institutions in Solomon Islands have been under-resourced for several years. Protecting and strengthening key accountability institutions is essential to restoring governance standards.

## GOVERNANCE AND ECONOMIC DEVELOPMENT

Failing governance in Solomon Islands played a large role in ethnic conflict and economic contraction. International development partners and particularly RAMSI are helping Solomon Islanders to restore and sustain good governance to promote economic growth and social stability. This will be a lengthy and resource-intensive process.

### The Decline in Governance

At independence in 1978, Solomon Islands inherited a functioning public service, a respected judiciary and a disciplined police force and prison services; the latter two both had reputations for 'honest authority'. In the first decade of independence, Solomon Islands was able to fund its recurrent budget domestically, though it continued to depend on donors for its development budget. In spite of relatively low average-per-capita incomes, most Solomon Islanders enjoyed a reasonably high level of social services delivery and the economy achieved modest economic growth. Although during this period, the governance systems developed under colonial rule continued to function, the ability of Solomon Islands to sustain these operations was limited. The country's first Governor General, Baddley Devesi, said that at independence, the structures, institutions and players in the hastily established political system had developed only short-lived and shallow foundations (*The Australian*, 7 July 2003).[1]

Over time, inefficiency, mismanagement and corruption began to undermine much of the public service, the law-and order system and, ultimately, the political system. The debilitation of these institutions made them less relevant to, and less respected by, the public.

In the 1990s, the decline in governance accelerated, although for a time unsustainably high logging levels masked their impact, producing high revenues and a false impression of broader economic growth. The decline of growth and governance contributed to the underlying tensions and resulted, by the end of the 1990s, in an outbreak of violence.

Lower standards of fiscal discipline, poor budgeting and weak recurrent budget administration also contributed to unsustainable budget deficits. The domestic deficit blew out as expenditure – particularly on the public service payroll – was left uncontrolled. This, in turn, undermined delivery of services. Combined with one of the world's highest population growth rates, the excessive public spending on salaries seriously reduced per-capita spending on forming human capital and public infrastructure. This, in turn, constrained private sector development and employment growth. The decline in good governance directly undermined the major drivers of economic growth.

[1] Many Solomon Islanders believe they were ill-prepared for independence and some vocally protested against Britain's independence timetable. Training of local police and junior judiciary began before World War II but in all other areas of administration localisation came much later, if at all. At the time of independence less than 5 per cent of the population had received primary education and a much smaller fraction had secondary or tertiary education. Little preparation was undertaken in terms of nation building.

By early 2003, poor governance and budgetary policy had severely eroded the Government's service delivery. Many essential services, including health clinics and schools, were able to operate only with donor assistance and local community support, but were often critically short of basic supplies and resources. Public servants, teachers, police and health workers had not been paid in full or on time for many months before budget stability was restored in late 2003. Few had access to telephones, computers, cars and even basic equipment, and government offices were often without electricity.

Lack of financial and human resources and political support have also weakened government institutions designed to strengthen good governance. Such institutions as the Public Service Commission, Auditor General's Office and Leadership Code Commission have been unable to uphold the procedures, rules and regulations which ensure the transparent performance of general administration and the implementation of government polices.

By 2003, Cabinet procedures had also become ineffective with ministers often not being briefed prior to Cabinet meetings on issues to be discussed. This reduced the quality of debate and decision-making.

## Good Governance, Fiscal Discipline and Infrastructure Promote Growth

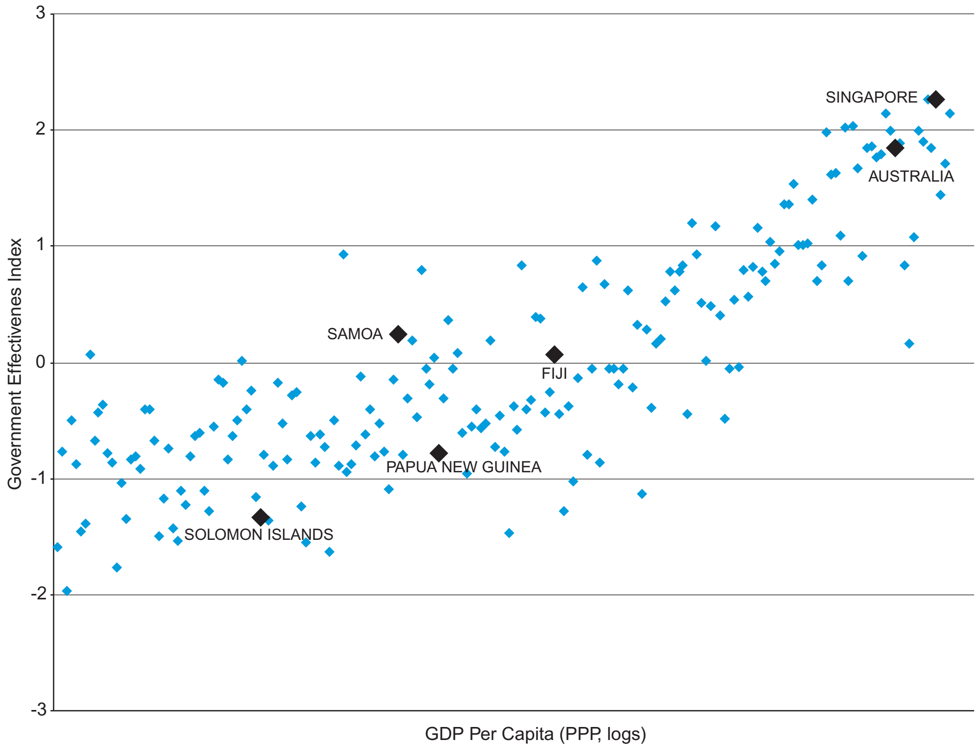
The fundamental relationship between good governance and economic growth is now widely recognised in both developed and developing economies. Ethical, accountable and efficient governance that appropriately regulates and nurtures competitive markets helps ensure resources are used efficiently to maximise public welfare.

The relationship between the strength of an individual country's economic institutions and its economic development is clearly demonstrated in Figure 2.1. Previous studies have found that the quality of institutions assists growth, but that the reverse is not always true. That is, higher incomes cannot buy better institutions, but better institutions can generate higher growth and GDP per capita (Economic Analytical Unit, 2003). Secure property and contractual rights increase the speed at which developing countries grow, nearly doubling the rate at which developing countries catch up with developed countries (Knack et al., 1995).

Figure 2.1

## Close correlation between governance and economic development

### Scatter plot of economies' national income (per-capita purchasing power parity basis) and the quality of governance




Notes: Government effectiveness refers to the quality of public service provision, the quality of the bureaucracy, the competence of civil servants, the independence of the civil service from political pressures and the credibility of the government's commitment to policies. Dots represent the estimates of governance for each country for which data is available. Selected countries are labelled. See Kaufmann et al., 2003 for more details.

The purchasing power parity (PPP) approach to calculating real GDP values the total bundle of goods and services a population consumes each year at the price they would cost in the United States. Hence PPP per-capita income adjusts ordinary US dollar measures of per-capita income to take account of the fact that goods and services sold in developing and even other developed economies and not traded internationally may be cheaper than in the US.

Source: Kaufmann et al., 2003.

### FISCAL POLICY AND INFRASTRUCTURE STIMULATE GROWTH

An empirical study covering around 100 countries over a period of 18 years found a direct relationship between fiscal policy settings, the level of development and the rate of economic growth (Easterly and Rebelo, 1994). Four findings have direct relevance to Solomon Islands' current situation:

- the share of public investment in transport and communications is strongly correlated with income growth
- a government's budget surplus is consistently correlated with growth in income and private sector investment
- government revenues in developing countries rise as a proportion of GDP with a rise in per-capita income for the period examined
- a rise in income is associated with a fall in the share of international trade taxes in total government revenues, with related increases in domestic taxes making up the shortfall.

The above study suggests budget deficits and deteriorating transport and communications infrastructure over the period of ethnic conflict may have constrained Solomon Islands growth. Importantly, a rise in growth has the potential to provide resources for expansion of infrastructure, thus there is a positive feedback loop between the two. Development partners' investment in essential infrastructure can assist in hastening growth and the recovery process.

Source: Easterly and Rebelo, 1994.

## STRENGTHENING FISCAL CONTROL

Beyond the re-establishment of law and order, the first priority of the Solomon Islands Government, with the assistance of RAMSI, has been to provide greater fiscal and economic management through the Budget Stabilisation Program.

### REHABILITATING MAJOR ECONOMIC INSTITUTIONS

In the first phase of RAMSI, Australia provided 17 advisers and in-line personnel to work with the Solomon Islands Government to stabilise government finances. The Australian Treasury and Department of Finance and Administration provided some of these professionals. The short-term objective of the Budget Stabilisation Program was to assist the Solomon Islands Government to:

- control expenditure and work towards stabilising the budget (Table 2.1)
- prepare a realistic 2004 budget that directs resources to meet basic social service and infrastructure maintenance needs

- produce a comprehensive debt management strategy to prioritise and find solutions to the large public debt and related arrears
- clean up the public sector payroll
- strengthen revenue collection through Customs and Inland Revenue.

The Budget Stabilisation Program has achieved considerable progress in these areas; an expenditure plan for the December quarter 2003 was produced and Parliament passed the 2004 budget in December 2003. Led by lower than forecast payroll costs and debt servicing, total government expenditure for the December quarter 2003 was SBD85.9 million, some 14.4 per cent lower than the original forecast (Ministry of Finance, 2004). Overall, there has been a broad stabilisation in the spending of ministries.

A major focus of the assistance program in the short to medium term is the strengthening of core functions of government through intensive, tailored training programs; partnership between relevant Solomon Island and Australian Government agencies; and on-the-job training and mentoring of government officials. Public sector and economic reforms are a key priority in 2004.

Table 2.1

## Restoring budget stability

**Summary of revenue and expenditure, recurrent budget**

| | 2002 Actuals ($m) | 2003 Budget ($m) | 2003 Actuals ($m) | 2004 Budget Estimates ($m) |
|---|---|---|---|---|
| **Revenue** | | | | |
| Inland Revenue | 136.5 | 130.0 | 198.7 | 193.9 |
| Customs and excise | 107.7 | 105.0 | 140.1 | 142.5 |
| Other ministries | 14.1 | 24.0 | 33.0 | 25.7 |
| Domestically sourced revenue | 258.2 | 259.0 | 371.8 | 362.1 |
| Budget support | 0.0 | 0.0 | 14.3 | 117.6 |
| TOTAL REVENUE | 258.2 | 259.0 | 386.1 | 479.6 |
| **Expenditure** | | | | |
| Payroll charges | 158.2 | 123.0 | 153.3 | 188.8 |
| Other charges | 115.8 | 136.0 | 163.2 | 173.3 |
| Budget support (including for debt servicing) | 0.0 | 0.0 | 16.5 | 117.6 |
| TOTAL EXPENDITURE | 274.0 | 259.0 | 333.0 | 479.6 |
| Accumulated debt servicing funds | - | - | 15.6 | - |
| **Gross cash surplus/deficit** | -15.8 | 0.0 | 37.5[a] | 0.0 |

Note: a. This surplus figure does not include substantial arrears and debt accrued by the Government in 2003.

Source: Ministry of Finance, 2003, 2004.

## STRENGTHENING THE PUBLIC SECTOR

Restoring law and order and fiscal discipline have been important first steps, but further assistance will be required to develop a sustainable public sector. For Solomon Islands, winding back public sector activity to core functions to match available fiscal capacity will be a key to improved delivery of basic services and the macroeconomic environment. Australian assistance has also now moved beyond immediate budget stabilisation to broader public sector capacity and economic reform issues.

### Capacity Building a Priority

Given prevailing capacity constraints and the need to ensure policymaking remains in local hands, public service capacity building is a high priority within the economic reform program. Capacity building is aimed at improving the effectiveness of government organisations, including the development of core skills and capabilities, to enable them to perform their responsibilities.

Where possible, training should be conducted within Solomon Islands. This is to avoid removal of key personnel from fragile systems for prolonged periods of time. In-country advisers, from appropriate government institutions abroad, who can identify and mentor counterparts, together with twinning arrangements with mature public service institutions abroad, also can be useful in creating long-term relationships. Australian assistance has included support in several Government ministries and some of these, such as those involving finance, taxation, statistics and central banking, could benefit from stronger long-term relationships with Australia (see Appendix 2.1 for information on current Australian assistance and suggestions for stronger linkages between specific Solomon Islands and Australian economic institutions). Coupled with the broader strengthening of parliamentary and government processes and management, such arrangements can assist in long-term sustainability of capacity building in the public service.

Short-term training for the bulk of the workforce can be undertaken cost effectively in Solomon Islands by re-establishing formal vocational public sector training in governance as well as operational courses in fiscal control, management and core public service functions. However, recognising the urgent need for trained staff and the limited capacity of public service training in Solomon Islands, AusAID, in consultation with the Australian Department of the Treasury, has commissioned the Australian National University to provide limited short-term training in Australia. The identification of appropriate candidates who can be removed from the domestic system is important, as will be periodic evaluation of each candidate's performance upon their return. The economic training course for staff working on economic and fiscal policy issues seeks to build their capacity to provide sound economic and fiscal policy advice and analysis that will support sustainable long-term economic and fiscal reform.

### Restructuring the Public Sector

Given the major share of government resources the public payroll absorbs, many analysts believe that certain areas of the public service are too large for an economy the size of Solomon Islands.[2] In

[2] See the Solomon Islands Government (2003) and the Multi-Donor Economic Governance Mission (2002).

late 2002, the Solomon Islands Government attempted to reduce the number of ministries from 20 to 10. However, as the new super ministries still have separate permanent secretaries and ministers, the Government has made few if any financial, coordination or efficiency gains.

The first priority is to cleanse the Government payroll of non-workers or ‘ghost-workers’. This can have positive effects on government expenditure without the need for difficult restructuring efforts. Once successfully completed, the Government will be better informed on the size and structure of the public sector.

In the medium term, a well-managed, public sector restructuring program could save vital resources to fund development. However, as public servants and their union constitute a significant lobby, they have the potential to stall public sector reform. A similar initiative in Vanuatu as part of a comprehensive reform program had minimal success. Retrenched workers were hired on more expensive contracts, actually increasing the salaries and wages bill in the aftermath of ‘right-sizing’. To be effective in producing savings, downsizing efforts need to be driven by changes in the function of government. While downsizing is one option, restructuring the public sector to strengthen performance in key areas may be a better option. Re-allocating personnel and financial resources to departments focused on the provision of key services and streamlining other areas is critical to the success of public sector reform. This report contains some suggestions for priority areas to which, following a review of Government functions, resources could be better directed.

Appropriate training programs that equip retrenched workers to move into the private sector or enable them to start their own enterprises also could ease labour mobility. Vanuatu had some success with its Transitional Services Unit created to serve this purpose. Moreover, any restructuring must ensure that redundancies do not adversely affect key services like revenue collection, fiscal control and basic service delivery.

## STRENGTHENING POLITICAL GOVERNANCE

Improving governance extends beyond capacity building of the public sector to issues including accountability and transparency. Ensuring the government is accountable for its actions strengthens governance which, in turn, assists economic growth.

### Dealing with Corruption

Strengthening systems and accountability in government departments helps prevent corruption. It also is important to have independent institutions dedicated to dealing with corruption and bringing to justice those accused of improper behaviour. Solomon Islands has more institutions that deal with accountability than any other South Pacific state, including a Leadership Code Commission, Ombudsman and Auditor General. For several years, these institutions have been under-resourced. Building strong institutions to deal with present and future corrupt conduct is essential for effective government and economic growth in the country. Australian officials are currently working with Solomon Islands’ authorities on a program to strengthen existing government institutions that deal with accountability.

## Increasing Awareness of Governance Issues

The public in Solomon Islands has a poor understanding of government and has limited expectations of what can be expected from political leaders in terms of both public conduct and access to goods and services. Increasing the public's civic education is important as expectations of accountability enforce good governance. Civil society and non-government organisations, with the support of donors, can play a useful role in increasing the public's civic education.

## Greater Transparency Promotes Good Governance

Transparency in decision-making with targets and evaluations readily understood and available to the wider community is essential to promote and sustain government accountability. Transparency and public accountability in relation to all financial matters is particularly important. Since the RAMSI Budget Stabilisation Program commenced work, the Solomon Islands Government has released expenditure and revenue data and has said it will continue to do so. Vanuatu has enshrined in legislation requirements relating to the provision of government financial information and estimates through the Public Finance and Economic Management Act. This has had some success in improving transparency and Solomon Islands would benefit from similar legislation.

A multi-year budgetary framework with national priorities driving public investment and donor activities in annual budgets which provides transparency in the collection and allocation of scarce resources is important. The Budget Stabilisation Program has helped the Ministry of Finance develop a medium-term budget strategy which could include this.

The Parliamentary Public Accounts Committee plays an active and positive role in enquiring into fiscal transparency and accountability but its effectiveness is limited. The committee needs to be improved through changes in its governing orders.

## Federalism – a Looming Challenge

Solomon Islands has a decentralised unitary system of government. The national government, based in the capital, has sole powers to pass legislation and set policies for the nation as a whole. Under this system, the provincial governments, which are in effect administrative arms of the national government headed by elected representatives, are responsible for implementing some policies and delivering most services in the nine provinces. Local councils and chiefly structures operate at lower levels. Under the unitary system, political and economic power and activity remains largely centred in the national capital. The unitary system has long had its critics and the recent troubles have encouraged those favouring federalism as an alternative system of government.

In the first three months of 2003, a United Nations Development Project consulted an estimated 20 000 people, or approximately 10 per cent of the adult population in all nine provinces. This survey revealed strong support for increased autonomy and better service delivery at the local level. Most equated this with federalism, but the survey was conducted with little understanding of the social, political and financial implications of a federal structure.

While decentralisation exists to some extent, with responsibility for service provision notionally resting with the provinces, progress in achieving efficient service delivery at the local level has been slow due to lack of human and financial resources available to local authorities. Many now equate federalism and further decentralisation as a solution to the lack of service provision. The current proposal for a new federal constitution would grant autonomous powers to the provinces or states.[3] Proponents of federalism believe establishing autonomous states would provide a new base for economic planning and development. Each state could raise revenue for its recurrent budget for education, health and general administration.

To be successful, this would require revamping provincial and local government delivery mechanisms, ensuring that provincial institutions are robust and able to provide services at local levels. While provincial governments do have an important role in ensuring the needs of constituents are met, a lack of skilled and experienced personnel in the poor and remote parts of provinces is a significant constraint on their capacity to deliver services. The experience of Papua New Guinea suggests that capacity constraints at the local level can be a major obstacle to successful decentralisation. Devolving further resources and responsibilities to lower levels of government offers no guarantee that irregular practices will be controlled or service delivery improved. Any new structure would come under the same pressures as the existing structure.

In the short term, it is likely that such reform would be too costly for the fragile economy, contributing to a further decline in the state's capacity to provide services. Federalism may thus become a major obstacle to the restoration of good governance, political stability and ultimately economic growth. Changing incentives of service providers would be less costly than changing the structure of government.

3 Under the centralised system of government, all the powers are vested in the national or central government, while the nine provincial governments act merely as its agents. All revenues are collected by the national treasury and are then distributed to the nine provinces through the national budget.

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# APPENDIX 2.1 – AUSTRALIAN ASSISTANCE FOR REHABILITATING AND STRENGTHENING CORE INSTITUTIONS

Aid flows to Solomon Islands have increased markedly in recent years. In 1998–99 Australian aid to Solomon Islands totalled A$12.2 million, by 2002–03 total aid was A$35.3 million and Australia expects to provide up to around A$37 million in 2003–04. This is in addition to the expenditure associated with RAMSI that was launched in July 2003, the Economic Assistance Package of A$25 million announced in August 2003 and a Criminal Justice Package of A$25 million.

In the medium to long term, technical assistance and long-term capacity building in core economic, legal and public accountability ministries and institutions are a high priority for aid.

## Major Economic Institutions

Strengthening the capacity, efficiency and effectiveness of core economic institutions such as the Ministry of Finance, including Taxation and Customs Divisions, Central Bank of Solomon Islands and the Statistics Office is imperative if Solomon Islands is to achieve sustained economic growth and prosperity.

### Ministry of Finance

Australian assistance associated with RAMSI in the short to medium term includes assigning advisers and in-line personnel to the Ministry of Finance to undertake on-the-job training and mentoring of officials, working with staff to develop and monitor the budget and government expenditure, improving revenue collection, cleaning up the payroll and assisting with debt management.

Australian technical assistance of A$3 million also was provided to the Customs and Excise Division of the Ministry of Finance from 1999–2002. Despite significant disruptions to the project as a result of the events of June 2000, it has successfully implemented a simple but effective computerised system for tracking and processing customs entries which has improved revenue collection.

Long-term assistance might usefully include a partnership commitment between the Ministry of Finance and the Australian Treasury, Department of Finance and Administration and Australian Taxation Office. Assistance could include on-the-job training and mentoring of finance officials, local and some Australia-based intensive training for more junior and middle level officials, and seminars for more senior officials.

### Central Bank of Solomon Islands

Australia currently provides assistance (short-term technical assistance) to the Central Bank of Solomon Islands. The Central Bank has been a sound institution in terms of its leadership, strategic development and the independence of its operations. The World Bank also plans to provide some technical assistance to the Central Bank.

The Central Bank of Solomon Islands has the capacity to take a leadership role in future reform of the financial system. The potential for a stronger partnership with the Reserve Bank of Australia might be explored to provide ongoing mentoring and training.

### Statistics Office

As the National Economic Recovery and Development Plan highlights 'it is necessary and important that up-to-date and accurate data is available for planning and monitoring of economic and social development in the country… The statistical information produced by the Statistics Office is important for assessing performance in economic management and therefore accountability for economic management policies and their implementation… The Statistics Office has not been able to carry out its functions effectively and efficiently. The problems faced by the Statistics Office need to be resolved' (Solomon Islands Government, 2003).

There is a need to rebuild completely the bureau, as a stand-alone unit or as part of the operations of the Central Bank of Solomon Islands. There is no current assistance from Australia, though the placement of officials in the Ministry of Finance including Customs and Treasury areas has assisted in increasing the availability and reliability of statistics. Leadership and management strengthening in the short term are urgently required, possibly assisted by the potential benefits of a partnership with the Australian Bureau of Statistics.

## Law and Justice Institutions

For sustainable improvements to occur, training and mentoring programs will need to be established for the medium to long term for court personnel, magistrates, officers and lawyers with the Department of Public Prosecutions, police prosecutors, the Attorney General's and the Public Solicitor's Office.

Solomon Islands Law and Justice Institutional Strengthening Program, a three-and-a-half year, $A17.2 million project, was started in December 2000. It focused on rebuilding basic police services, reforming the courts and prison system, and improving police–community relations. This program concluded in mid-2004.

Australia's more recent assistance to this sector, the A$25 million Criminal Justice Package, builds on the existing aid program to improve the existing courts and justice systems to provide support to the RAMSI operation.

### Justice System

Law and order advisers and support staff have been provided to the courts, offices of Public Prosecutions, Public Solicitors and Attorney General. This includes approximately 25 expatriates filling positions including Magistrate, Public Solicitor, Solicitor General and Legal Drafter.

### Prisons

The completion of a maximum security prison at Rove in Honiara as well as the re-opening of the Tetere prison farm on the outskirts of Honiara have significantly boosted the capacity of the prison service. Over 30 Australian prison advisers have been provided to improve the capacity of the prison service to deal with increased prisoner numbers, including through introducing high security management procedures at the new prison.

### Royal Solomon Islands Police

A strategic review of the Royal Solomon Islands Police Force has been launched. The review focuses on strengthening the Royal Solomon Islands Police so that it can operate as a trustworthy and effective service. The review's terms of reference include developing a strategic policy direction, examining the resources required to meet the community's policing needs, and determining disciplinary arrangements, training regimes and terms and conditions of employment.

In addition to policing assistance, Australian assistance is focusing on improving the capacity of the police service through training assistance, career planning and institutional and leadership development. Australia's Law and Justice Institutional Strengthening Program assisted in rebuilding basic police services and training new recruits prior to RAMSI. Further assistance to the Royal Solomon Island Police from the Australian Federal Police, including in-line officers, training and mentoring, is being handled under the auspices of RAMSI. The sustainability of the improvements in the Royal Solomon Islands Police also will depend on the effectiveness of the broader economic and governance reforms and the capacity this generates in the national government to provide an adequate level of funding for the police force.

## Social Service Delivery Institutions

Non-payment of salaries, lack of operational funds, training requirements and a lack of facilities (partially due to destruction of facilities in the recent conflict) have all played a role in destroying the health and education systems in Solomon Islands. As a result the role of donors in basic social service delivery has grown greatly in the past few years reflecting an attempt by the international community to avert a complete collapse of the health and education systems.

Both sectors need to be prioritised for early attention and rebuilding. This must include fiscal consolidation, improving provision of electricity, transport and communications links in rural areas, regular supplies of drugs, and basic education materials and personnel.

The European Union and New Zealand are providing substantial assistance to the education sector. As a result, current Australian assistance is limited to provision of A$1.1 million worth of scholarship funding annually. These assist Solomon Islanders to attain qualifications in a range of fields in Australia and regional higher education institutions such as the Fiji School of Medicine and various campuses of the University of the South Pacific.

### Health

Current Australian assistance to the health sector is aimed at assisting the Solomon Islands Government to address the deterioration in health services by providing support both at the grassroots level and by strengthening health sector management. This has been done chiefly through funding for essential basic health services at a total cost of $A20.8 million since 2001 and a further A$9 million for strengthening health sector management.

## Other Assistance

### Forestry

Since 1999 more than A$6 million has been provided by Australia to assist forestry management. The forestry sector remains under extreme pressure to deliver export revenue to the Government because other commodity exports have declined or ceased and other revenue sources have contracted. This project is assisting the Department of Forestry, Environment and Conservation to strengthen organisational development and industry monitoring, and improve forest management infrastructure. In addition to these ongoing activities, future work will focus on policy and legislative reform to improve ministry operations and industry practices, and to support community reforestation. Project achievements include increased log export duties due to improved log shipment monitoring, the construction and refurbishment of operational infrastructure in four provinces, the provision of operational and logistical support to office and field activities, and new customary reforestation. Assistance to the sector, which at the time of writing, also is assisting in the parliamentary passage of a rigorous new Forestry Act, will be critical in ensuring sustainability of a key foreign exchange earning resource and in controlling the improper practices currently associated with the industry.

### Land Administration

A project aimed at strengthening land administration has seen around A$5 million in assistance provided since 2000 in a project focused on strengthening the Department of Lands and Survey. The project was designed to improve access to critical land records and land information for government agencies and the public, laying the groundwork for future economic development. It also improved revenue collection procedures and land administration functions in the provinces. This project was completed in January 2004.

A new program, expected to cost A$7 million over three years, commenced in March 2004. It continues with institutional strengthening and capacity building for the Department of Lands and Survey and also cautiously addresses the issue of customary land registration through a pilot registration scheme. Other areas this program will address include the security of temporary occupation licences in urban centres and an inventory of land owned and controlled by Solomon Islands Government and Honiara City Council.

## Machinery of Government

RAMSI is also reviewing the machinery of government and prioritising assistance across all the institutions and functions that ensure a country is responsibly governed. This includes the executive (Cabinet), the legislature (Parliament) and the public service, shaped by the established political system and culture.

Further assistance in this area (still to be finalised) will focus on two phases. The first phase will target improved human resource management and capacity development, workforce planning, business planning, policy development and implementation. The second phase will involve more comprehensive reforms, including consideration of restructuring the public service to remove duplication, improve accountability and resource allocation, and improve service delivery.

In the case of electoral assistance, this will build on previous assistance which Australia provided around the 2001 elections and seek to strengthen democratic processes in Solomon Islands.

# POLICIES TO REJUVENATE UTILITIES, INFRASTRUCTURE AND STATE-OWNED ENTERPRISES

## KEY POINTS

- **Infrastructure provision in Solomon Islands is inadequate. Key infrastructure services that provide a basis for economic development (electricity, water and sanitation, telecommunications and transport) are erratic and generally provided only in Honiara.**

- **Government provision of economic infrastructure has not worked. Key options for reform are to corporatise public utilities or to involve the private sector in service delivery.**

- **Private sector involvement in water, electricity and domestic airline service provision through the auction of long-term concessions to use government-owned assets provides a good model for improving service delivery. Concession contracts and privatisation of basic infrastructure provision requires transparency and effective regulation.**

- **Telecommunications and transport markets need to be opened to allow greater competition.**

- **The Solomon Islands Government cannot afford to be involved in largely loss-making enterprises. Many government businesses should be in the private sector. While some smaller enterprises may attract local interest, larger enterprises and utilities might require appropriately resourced foreign investors.**

- **The Government will need to engage in a concerted campaign to moderate unrealistic demands of some landowners which make commercial provision of some basic community services untenable.**

- **The Solomon Islands Government's economic reform program provides an opportunity to secure new investment, strengthen management and provide better service delivery.**

## INFRASTRUCTURE – CRUCIAL FOR DEVELOPMENT

Cost effective, efficient transport and communications infrastructure is crucial to Solomon Islands' economic and social development and political sustainability. However, with Solomon Islands' population of less than half a million people scattered across more than 300 inhabited islands, in most parts of the country the only infrastructure services available are the limited and often costly shipping, postal and radio transmissions services (Table 3.1). Without access to reasonable transport, electricity, water and communications infrastructure, investment in new productive activities that drive growth is unlikely to occur. Weak economic infrastructure lowers the productivity of all employed capital, labour and land, and reduces returns on new and existing investments.

Table 3.1

### Lack of basic utilities in Solomon Islands

**Access to basic utilities and infrastructure, urban and rural sectors, per cent of population**

| Access to utilities (per cent population) | Solomon Islands[a] | | | East Asia and Pacific | Low income countries |
|---|---|---|---|---|---|
| | 1980-89 | 1990-99 | 2000-02 | 2001 | 2001 |
| Improved water source | | | | | |
| Total | 63 | 64 | 71 | 75 | 76 |
| Urban | 91 | 80 | 94 | 93 | 88 |
| Rural | 60 | 62 | 65 | 66 | 70 |
| Electricity | | | | | |
| Total | - | 15.7 | - | - | - |
| In largest city | - | 72.5 | - | - | - |
| Telephone (mainlines) | | | | | |
| Total | 1.2 | 1.9 | 1.7 | 11.0 | 2.6 |
| In largest city | - | - | 13.2 | 50.2 | 13.0 |

Notes: - data not available.
a. Data presented is latest single year available.

Source: United Nations Development Programme,2000, 2003a, 2003b; World Bank, 2002; World Bank, 2003a, 2003b; Government of Solomon Islands, 2002; International Telecommunication Union, 2003.

While reforms in the provision of infrastructure will not be easy, the Government's inability to provide cost-efficient infrastructure indicates a need for alternative approaches to providing infrastructure services. Even in well-resourced economies like Australia, governments have moved out of many areas of infrastructure service provision, leaving this activity to the private sector. The Solomon Islands Government's limited financial and human resources and the poor state of infrastructure make exploring creative solutions, which seek to improve service delivery and maximise benefits to consumers, a high priority. Poor governance and management and lack of accountability in state-owned enterprises reinforce this requirement. Large government businesses dominating markets also limit the avenues for private entrepreneurs to go into business and prosper.

In recent years, resource constraints have forced the Solomon Islands Government to review its traditional role as the primary infrastructure supplier and recognise the need for greater private sector involvement.[1] This chapter builds on these policies by providing options for alternative service provision. Where possible, it draws on the infrastructure privatisation experiences of other economies in the Pacific.

### IMPORTANCE OF INFRASTRUCTURE

Infrastructure plays a crucial role in stimulating economic growth and raising living standards by:

- reducing production costs. Reliable, reasonably priced power, water, telecommunications and transport infrastructure must be available to develop competitive industrial production, increase output, improve profitability, increase income and employment, and provide greater export competitiveness
- diversifying production into more productive and higher-return activities by facilitating growth of alternative employment and consumption possibilities. For example, inter-island shipping gives cash-crop farmers access to more distant and lucrative markets, enabling them to access income-earning opportunities outside subsistence farming
- raising the population's standard of living and welfare. Appropriate transport, power and water supply infrastructure reduces time spent on non-productive activities like travel and procuring energy and water, thereby increasing time available for income-earning activities. Providing sanitation and clean water also improves people's health status.

Source: East Asia Analytical Unit, 1998.

## PROBLEMS OF INFRASTRUCTURE PROVISION

In Solomon Islands, the state-owned enterprises that provide basic services have had little accountability for the provision of their services or for their level of financial performance. Weak management of these enterprises has resulted in poor performance and gradually eroded their financial position. Some enterprises, such as the water and electricity authorities, have not produced audited financial statements in recent years, while reporting against performance measures has been very limited. Much of the rural population has come to accept the lack of government service delivery which has further eroded any sense of accountability.

1 For example, the Ministry of Economic Reform and Structural Adjustment (2002) and the Solomon Islands Government (2003) both examined privatisation, while the Asian Development Bank (1998) Public Sector Reform Program also had a focus on public enterprises.

Many of the state-owned enterprises operate at significant losses and their debts place further pressure on the already overstretched financial position of the Government. The large debts accrued by state-owned enterprises are one of the causes of the high levels of government debt. The interest burden and repayment obligations have reduced the Government's ability to provide decent services to the people.

The Investment Corporation of Solomon Islands, the body responsible for managing the Government's commercial interests in many of the state-owned enterprises, is itself in a poor financial position with funds barely sufficient to continue operations. The corporation has summarised a range of factors that have affected the performance of state-owned enterprises including:

- weak capital structure
- lack of clear policy direction, strategies and planning
- weak management team
- weak human resources development
- poor governance and accountability
- weak market research and development
- weak financial planning and control
- lack of understanding and response to reform and structural changes
- political interference in day-to-day management and operations
- little monitoring of performance and outputs by management or shareholders (Investment Corporation of Solomon Islands, 2003).

A lack of effective control of customer indebtedness, together with crippling rent-seeking behaviour by some landowner groups, also has undermined efforts to make some key state-owned enterprises profitable. These problems may also impact on the viability of private sector investment.

## Investment

One of the major problems facing state-owned enterprises, particularly those supplying basic services such as water and electricity, has been their inability to secure funds to invest efficiently in the upgrade and maintenance of assets. Several public enterprises have considerable levels of debt and are owed substantial amounts, particularly by the Government. As at September 2003, Solomon Islands Electricity Authority's two largest debtors were the Government with unpaid arrears of around SBD12 million and the Government-owned water authority with outstanding arrears of SBD10.2 million (Nation, 2003).

Similarly, the Electricity Authority itself had unpaid arrears of around SBD17.5 million with Solomon Islands National Provident Fund as at July 2003 (Solomon Islands National Provident Fund, 2003).

This circular problem of non-payment leaves little room for effective financial management and investment planning.

With high levels of debt, negative profits and a poorly working private capital market, public enterprises have often had limited recourse to investment funds, leading to little maintenance and replacement and the further running down of assets.[2]

### Government Involvement

In small economies, the government often has developed ahead of the private sector and the pool of skilled managers is limited. In many of these economies, there often is a blurring between government and business, and a few individuals are involved in many of the major enterprises. However, state-owned enterprises operate more effectively when their day-to-day operating decisions are separate from government. High levels of government involvement in choosing boards and decision-making has hindered the ability of enterprises in Solomon Islands to act as separate commercial entities.

The ability of state-owned enterprises to drive reforms, such as major restructuring or privatisation, currently is limited as the incentives for board members to carry out reform are lacking. Board members, who receive both formal and informal remuneration through representation on boards, have an interest in maintaining the status quo.

### Tendering

Previous privatisation and the sale of assets from state-owned enterprises have consistently occurred outside the Government's proper tender processes. This has damaged the Government's credibility.

## BASIC PRINCIPLES OF INFRASTRUCTURE PROVISION

Several basic economic issues underpin the efficient provision of utilities and services in economies including:

- understanding the monopolistic nature of most infrastructure networks and facilities
- recognising the importance of introducing competition, where possible, and providing appropriate government regulation to prevent infrastructure providers exploiting monopoly power
- recognising the 'public good' aspects created by some infrastructure services (East Asia Analytical Unit, 1998).[3]

[2] As an example, the Solomon Islands Electricity Authority has relied on donor funding to carry out the minimal amount of maintenance undertaken on its transmission network over the three years to September 2003.

[3] The essential feature of a 'public good' is that one person's use of the good or service, such as that of a lighthouse, generally does not reduce another's ability to use the good or services. The result is that pricing for these goods is often difficult and private sector providers may be less willing to provide the service.

## Natural Monopolies?

Infrastructure and utilities, such as water and electricity, often require networks with high set-up costs; as a result, these networks are often regarded as 'natural monopolies'. This is because a new investor is unlikely to be willing to duplicate, for example, a national fixed-line telephone system or the water pipes in a city water supply. Because of these natural monopoly characteristics, governments often provide infrastructure services to ensure both urban and rural populations receive services at a reasonable cost. In the case of Solomon Islands, the relatively small size and isolation of the market, in addition to the dispersed population, reinforce the monopolistic nature of basic infrastructure networks.

However, in recent decades many developing and developed-economy governments have recognised that much public infrastructure provision is inefficient and have sought more creative models. Governments with limited budgets have realised that they alone cannot meet all their future infrastructure needs without sacrificing essential government spending in other areas. Governments increasingly accept the need to implement policies to mobilise private resources efficiently to meet infrastructure shortfalls (East Asia Analytical Unit, 1998).

### Unbundling

Governments increasingly understand that although the network facilities associated with utilities may be monopoly markets, it may be possible to introduce competition into other parts of the market. For instance, while electricity distribution requires a large network, smaller firms can competitively generate electricity. Similarly, while telephone cabling may be a monopoly service, opening up the network to use by different phone companies can create competition. Separating the natural monopoly aspects of infrastructure provision from those where competition can be efficiently introduced is generally referred to as 'unbundling' and is a key part of efficiently introducing private sector funding and competition into the provision of infrastructure.

## Infrastructure and Essential Services

Some types of infrastructure may be considered essential. Provision of clean water is the best example of this. Communities need access to at least a minimum lifeline amount of clean water at a zero or minimum price, with effective regulatory controls on water quality. However, once this essential need is satisfied, additional water supplies should not be zero priced. If subsidies are provided, they should be clearly identified.

## OPTIONS FOR REFORM

Reforms need to be styled to account for differing economies and markets. Appropriate reforms in large economies will differ from those possible in much smaller markets. For smaller markets, such problems as monopoly providers exploiting the market will influence the types of appropriate reforms. Reform policies also need to take into account the governments' ability to operate independent entities without interference.

## Corporatisation

Corporatising infrastructure industries can secure significant benefits, separating government's political interests and the enterprise's commercial and operational interests. The corporatised public enterprise can be reconstituted along commercial lines, with a professionally qualified board of directors responsible for achieving more transparent and focused objectives. Political directives should be explicit and open to public scrutiny and if they impose a commercial cost on the corporatised operator, transparent subsidies should compensate for this. Managerial rewards should be closely related to achieving stated objectives. Corporatised public enterprises should not have any role in regulation. A clear separation should be established between the regulatory role of government and the commercial objectives of the enterprise to prevent any conflict of interest between commercial interests of the enterprise and community welfare interests.

Where properly executed, the introduction of new, professionally qualified boards of directors, the removal of any regulatory role from the enterprise and the greater commercial focus of the enterprise can assist in improving the performance of the enterprise.

However, corporatisation still leaves an enterprise in public hands. Public sector managers may have less incentive to serve customers and minimise costs than private operators who are driven by a profit motive. Government ownership of these firms also gives the government an incentive to restrict competition to protect its own enterprises and allows them to interfere in the efficient running of the infrastructure enterprise. Such interference can include refusing to allow tariff increases even when they are commercially justified, making political appointments to enterprise boards, and requiring the installation of uneconomic and socially unjustified services to serve narrow political ends. In addition, state-owned enterprises often operate under the expectation government will provide them financial assistance if they are in distress. To be effective, corporatisation requires strong resolve from governments to maintain an arm's-length relationship between politicians and the operation of the enterprise.

## Privatisation Can Introduce Efficiencies

In many countries, private operators are now permitted to operate within previously government-dominated industries because they have been found to be more efficient than publicly owned enterprises at producing these goods and services. Government's role is increasingly becoming one of regulator, thereby separating the role of regulator from service provider.

Private providers can ensure service provision becomes accountable. Firms' income and profits are closely linked to their performance and, as a result, they have an incentive to respond quickly to price signals and customer demands. They tend to minimise costs and innovate in technology more than state-owned enterprises, which lack these incentives. As a result, public providers often undertake inefficient or few investments, overstaff facilities, allow long delays in providing service connections and facility maintenance, and can charge high service costs. Given the strong link between private enterprises' income and performance, many efficiency problems that plague state-owned enterprises are potentially addressed by private sector profit incentives. For example, water concession holders have incentives to fix leakages in their water-pipe networks and ensure 24-hour-a-day water supply because they receive the revenue for water sales. The result being better services for consumers at reasonable costs, maximising the welfare gains for the population.

## Privatisation Should Aim to Benefit Consumers, Not Government Revenue

Reform of state-owned enterprises should aim to benefit consumers through improved services and potentially lower prices. If governments focus on maximising revenue from sales of state-owned enterprises rather than optimising efficiency and cost benefits for consumers, they will undermine successful infrastructure reform. Assets should not be sold merely to retire government debt or, even worse, to finance current expenditure. A low market value for public assets can indicate the government has not established a transparent and stable regulatory process or an efficient industry structure. However, a very high sale price can indicate the new private owners expect to reap monopoly profits. Certainly, government could maximise the sales revenue of assets by maximising the monopoly power of the privatised entity, but this could significantly raise prices for consumers (East Asia Analytical Unit, 1998). Given the crucial nature of most infrastructure services in economic activity, such short-sighted policies would undermine growth.

Privatisation which does not address the underlying inefficiencies in the enterprise, focusing instead on government revenue, for example through the partial share sale of government enterprises without private sector involvement in management, also is unlikely to benefit consumers or the enterprise in question.

While the small size and relative isolation of many Pacific Island markets could impact on the viability of private infrastructure provision, recent experience indicates that where the commercial and regulatory risks are favourable, experienced private infrastructure firms are interested in supplying these markets (Zieroth, 2001). In per-capita terms, private investment in infrastructure projects in Fiji is the fifth highest within East Asia and the Pacific (World Bank et al., 2003). Evidence from a range of other privatisation experiences shows that, provided it is undertaken in an appropriate market and regulatory environment, privatisation can improve service delivery, reduce costs to consumers, and free governments from commercial risks and fiscal drain.

### EMPIRICAL STUDIES ON PRIVATISATION

A 1994 study of privatisation found that privatisation increased capital investment spending, employment and operating efficiency, increasing performance and profitability without sacrificing employment security. The study also found that nine of 14 firms privatised into non-competitive markets increased returns on their sales. The study analysed the operating performance of 61 fully or partly privatised firms from 18 countries across 32 industries from 1961 to 1990 (Megginson et al., 1994).

The World Bank (1995) also has pointed out that the best empirical work on privatisation finds that private sector firms perform more efficiently in competitive markets. Another study cited by the World Bank (1995), found that if monopoly regulation allowed private firms to function efficiently and protected consumers, privatisation in both competitive and monopoly markets improved welfare in 11 out of the 12 cases examined. Gains came primarily from improved productivity, increased investment and better pricing.

Source: Megginson et al., 1994; World Bank 1995; East Asia Analytical Unit, 1998.

## The Need for Regulation

The key to unlocking the benefits from privatising state-owned enterprises with natural monopolies is to ensure their monopoly power is effectively regulated. Poorly regulated private monopolies can be just as inefficient as government monopolies. While larger economies have been able to privatise utilities and establish effective regulatory bodies to oversee these industries, smaller economies' limited financial and human resources could reduce their ability to regulate industries. Appropriate regard must be given to this limitation in designing and supporting any privatisation policies.

Government regulation needs to be able to ensure tariff and service quality standards are at acceptable levels, network access to other suppliers is enabled and monopoly power, including cross ownership, is controlled. Government must ensure appropriate regulation and regulatory bodies are in place before any privatisation occurs. If a government cannot enforce necessary regulation to control privatised monopoly infrastructure industries, firms are likely to exploit their monopoly status.

## Methods of Privatisation

A number of options exist for methods of privatising state-owned enterprises. Typically these range from minimalist approaches, where the government retains ownership and has some minimal private sector input, to 100 per cent sales of public companies. Apart from divestments, typical privatisation methods may include:

- **Management contracts.** This involves contracting out, or outsourcing, the day-to-day running and management of the enterprise. The involvement of the private sector in these enterprises, where contract fees are linked to performance, can provide incentives for better performance and draw on private sector expertise. However, there is little incentive for the contractor to make long-term investments in new infrastructure and assets.
- **Build, operate, transfer (BOT).** These typically involve the private sector designing, constructing and operating new facilities and providing services to government utilities or directly to customers. While BOTs have been used extensively in Asia, little use of these schemes has occurred in the Pacific. The small size of the markets leaves little room for competition so a BOT may be the only supplier to the government. Tonga provides one of the few Pacific Island examples where a BOT arrangement has been adopted. Tonga's electricity is supplied by a private BOT contractor to the Tongan Government authority. However, the lack of open tendering for this contract or competition in electricity supply to the authority leaves the authority with little negotiating power, often increasing the cost of this option (Zieroth, 2001).
- **Concession contracts.** These typically involve long-term leases of government-owned infrastructure assets and the rights to supply specified markets. The concessionaire, in leasing the assets and getting access to the market, also takes on the debt-servicing obligations of the authority.

### CONCESSION CONTRACTS

Under concession contracts, a private operator bids to obtain the right to use the existing infrastructure and assets to provide services directly to consumers. The operator then retains all revenue from sales. The operator is provided a long-term concession contract and is responsible for all upgrades, extensions and maintenance of the network. This allows the operator the flexibility to determine new investments to meet supply obligations and provides incentives for the investor to minimise leakage in the system, thereby maximising revenue. The long-term nature of these contracts, usually 20 to 30 years, gives the operators the necessary time to recover capital and financing costs invested in the operation.

The scope for monopoly exploitation through concession contracts is reduced through a competitive bidding process for the industry.

A concession contract should be selected on a combination of:

- price of supplied service and escalator clauses
- size of the licence fee paid to the government
- assessment of the tenderers' capacity to comply with the terms of the contract including service levels.

Contracts also often include obligations to expand the service coverage by a set amount each year.

Source: East Asia Analytical Unit, 1998.

## Benefits of Concession Contracts

Concession contracts have many benefits over more traditional privatisation methods, particularly for markets where little scope exists for creating competition within the market. Specifically, the use of concession contracts:

- is long term – there are incentives for operators to make substantial investments in the industry, minimising leakages and improving efficiency and services where they can recoup costs
- can potentially provide lower prices – the use of competitive bidding for the concession based, among other things, on tariff charges provides incentive to keep the tendered tariff levels low. In designing any contracts, careful consideration should be given to ensuring that improvements in service are achieved without severe tariff hikes after the concession is let
- can expand service coverage – contractual obligations stipulating expansion of service coverage can increase the number of people connected to the service, while direct revenue from customers provides further incentive to expand the service coverage
- places clear obligations on private operators – contractual obligations for the level of service provision and tariffs allow the regulator to monitor contract compliance with some certainty without

becoming involved in deciding what represents, for example, fair tariff increases. Tariff escalation clauses, based on unavoidable supply costs, form part of the concession contract. This should reduce or remove the ability of the concessionaire to exploit the monopoly market. Failure to comply with this contract can result in termination of the concession.

## REFORM FOR SOLOMON ISLANDS

The limited resources of the Government, the size of Solomon Islands' markets, the level of government involvement in state-owned enterprises and the current state of these enterprises all affect the available options for reform.

The Solomon Islands Government previously explored options for reforming state-owned enterprises, including the restructure and divestment of enterprises, the establishment of strategic alliances with the private sector to facilitate private sector investment and encouragement of the private sector to buy shares in public enterprises (Ministry of Economic Reform and Structural Adjustments, 2002). Unfortunately, although resource constraints have forced the Government to examine these options, there has been little action to date.

Solomon Islands' state-owned enterprises have encountered problems which corporatisation may not resolve. Past governments have been reluctant to allow infrastructure utilities to raise tariff levels to commercially viable levels, undermining service efficiency. Political considerations and social group allegiances also have motivated utility and state-owned enterprise board appointments, further reducing operational capacity. Such problems can also occur for corporatised entities.

Additionally, the Government alone does not have the resources to expand and construct infrastructure across the region. While the current infrastructure networks often have been maintained and expanded using donor funds, these funds are often provided through long-term loans.[4] These loans may carry a low interest rate; however, the addition of more debt needs to be heavily weighed against the individual benefit of any new infrastructure projects.

Assisted by working capital markets, private sector institutions can play a clear role in bringing in new capital and ensuring this capital is efficiently utilised. Privatised enterprises rely on the viability of new investments rather than on government decisions and have better mechanisms and incentives for determining the highest return investment projects.[5] With access to both domestic and international capital sources, private enterprises can potentially fill the role of investor which government is unable to fill.

Attracting competition into different segments of some industries, such as power and water, through unbundling may be difficult given the small market. However, changing technologies do offer new

4 The Government's development budget has been almost solely reliant on donor funding.

5 Solomon Islands currently suffers from an inadequate capital market. Mechanisms to revitalise this vital sector are required (see Chapter Four – *Creating the Right Environment for Business*).

opportunities to introduce competition into markets. The rapidly changing information and communications sector could benefit from an unbundling of the market. The introduction of competition into Samoa's Internet service market has made its Internet facilities among the cheapest in the Pacific.

While it is optimal that privatised industries operate in competitive industries, the small size of many Solomon Islands infrastructure markets may make this difficult to achieve. As a result, options for privatisation aimed at divesting monopoly suppliers should aim at creating competition for the market when competition in the market is not possible.

For Solomon Islands, employing appropriate concession arrangements could enable efficient infrastructure investment and operation, while helping overcome potential problems associated with monopoly suppliers. Hence, concession contracts may offer a best-practice model for considering private sector involvement in majority government-owned infrastructure industries such as water and electricity.

Given the high levels of debt most Solomon Islands' state-owned enterprises currently have, introducing a credible private enterprise which can service these debts through more efficient operation and billing practices also could alleviate much strain from the Government. Where these debts are so high that they deter potential investors, it may be necessary to consider carving out all or part of the debt component from some deals.

To facilitate private sector involvement in the provision of infrastructure, the Government may need to assist in the moderation of the demands of landowners, particularly when groups may regard private enterprise as more capable of meeting ambitious demands.

## Open and Transparent Processes Provide Optimal Results

Without transparent tender procedures, privatisation is unlikely to yield maximum benefits for either government or consumers. Before the Solomon Islands Government pursues privatisation policies, it must ensure the framework in place is sufficient to protect the policies which it pursues. The use of the public tender board process for disposal of government assets needs to be strictly followed. Strictly enforced legislation can assist in providing open, competitive sales procedures. For larger sales, including privatisation of state-owned enterprises, donors can assist by ensuring the sales process is open and transparent. Their involvement can deter interference in privatisation processes.

## Reforming Government Management of State-Owned Enterprises

Although the best option to improve management and operation of state-owned enterprises is to increase private sector involvement, some other reform options may improve the operation of enterprises that remain under government ownership and control.

### Board Membership

The potential for board appointments based on political considerations and social allegiances could be avoided by reform of the current system of board appointment. It is a prerequisite for good governance that all state-owned enterprises have independent boards that are neither too large nor too small. To lock-in good governance, the Government should consider legislation governing board membership and limiting the size of boards. Legislation should exclude all Members of Parliament from board membership. Further reform needs to be aimed at ensuring qualified candidates are appointed to boards according to merit and not political connections. Board members could potentially be nominated by relevant professional associations or interest groups, or by the Public Service Commission on the basis of merit. Such measures would increase transparency in appointments and provide some arm's-length distance between board members and the Government. The pool of professionally qualified people in Solomon Islands available for such positions is small and this is another reason for limiting, by legislation, the size of boards for state-owned enterprises.

### Government Mandated Service Delivery

The Government has attempted to use statutory authorities to service a broad section of the population. However, it has not acknowledged, through direct payments or subsidy, the cost implications of meeting community service obligations. Directing enterprises to perform costly tasks without providing clear payments for these services disassociates the enterprise's performance from its financial position and directly adds to the financial difficulties of many of the state-owned enterprises. For example, Solomon Airlines flies several non-economical routes at government direction, while the Electricity Authority provides services to rural populations at below-cost levels often without being paid the agreed level of offsetting government subsidy. If the delivery of essential services to some areas is not viable without a subsidy, clear and transparent policy directions from the Government to the enterprise are required, accompanied by transparent payments for these services.

## SECTOR SPECIFIC PLANS

The Solomon Islands Government has limited financial resources to maintain infrastructure networks, let alone expand existing networks. This is likely to make private sector involvement a necessity. The efficiencies which the private sector can introduce are necessary to support economic growth.

## Electricity

Plagued by customers' non-payment of bills, particularly by the Government and other state-owned enterprises, large debts, poor management and the Government's refusal to allow tariff increases, Solomon Islands Electricity Authority has had few resources to devote to maintenance and asset replacement.[6] Inadequate maintenance and occasional difficulties in obtaining necessary fuel have resulted in frequent disruptions to the supply of electricity.

6 As an example, the Solomon Islands Electricity Authority carried out little network maintenance for the three years to September 2003 (Nation, 2003).

From 1999 through to 2001, electricity production fell by 14 per cent. There was little expansion in electricity production from 2001 to the end of 2003 despite some improvement in electricity sales in 2003 (Central Bank of Solomon Islands, 2004). The Solomon Islands Electricity Authority faced severe financial difficulties in the three years to 2002, including a loss of SBD19 million in 2002.

Major investments in electricity infrastructure are needed to provide a reliable service to both urban and rural areas. Only 16 per cent of the total population have access to electricity, though 73 per cent of Honiara residents have access. Many residents and businesses in Honiara bear high costs for back-up generators due to the unreliability of the current service.

Donor assistance aimed at restoring some of the assets of Solomon Islands Electricity Authority, while helpful for current operations, is likely to be a short-term repair to what are more fundamental problems. These include inefficient management and the inability of the Government to fund new investments.

In 2000, the Cabinet approved outsourcing the management of Solomon Islands Electricity Authority to a private supplier, but this has not happened. While outsourcing of the authority via a management contract may be a useful short-term mechanism to bring private sector expertise into the sector, it will not assist in delivering urgently needed new capital investment for electricity infrastructure. An outsourced management team also may have little incentive to ensure the authority operates on a commercial footing or that it has sufficient funds for maintenance and expansion. To promote private sector investment in this sector, other options will need to be explored.

## Private Sector Participation in the Electricity Market

In global terms, the electricity sector attracted the second largest level of private sector investment among infrastructure sectors in the developing world in 1990 to 2001 (World Bank et al., 2003). Many Asian countries have opened electricity generation to private sector operators as the first stage of electricity reform. Often, several private sector generators compete to sell electricity into a government-controlled market, for purchase by private sector distributors. This unbundling and privatisation model was used to privatise the electricity sector in Australia's state of Victoria.

## Power Supply in the Pacific

Other Pacific Island nations use different options to supply electricity.

Samoa's electricity company, Electric Power Corporation, is wholly owned by the Government but has been corporatised and provides a high level of service coverage, including to rural areas. However, its high level of coverage, which was largely funded from multilateral loans, grants and public sector borrowing, has resulted in substantial financial losses for the enterprise (Zieroth, 2001).

Vanuatu has largely privatised its electricity supply through the use of long-term concessions, with the Government retaining a 16 per cent share of the company. This successfully transferred management to the private sector and raised the quality of service. However, the absence of open competition in tendering for the concession and the lack of legal and regulatory basis for monitoring and constraining the monopoly power of the company have resulted in relatively high power tariffs for consumers, and electricity supply is focused primarily in the urban centres (Zieroth, 2001). Domestic electricity costs in Vanuatu are around US$0.24/kWh compared to US$0.18/kWh in Samoa and US$0.15/kWh in Solomon Islands (Solomon Islands Electricity Authority, 2003).

While Samoa and Vanuatu show different approaches to electricity supply in the Pacific, neither experience has resulted in reliable, cost-effective supply of electricity to a broad percentage of the population without substantial costs to the relevant government. However, the experience of Vanuatu does provide evidence of private sector interest in providing infrastructure services in the Pacific.

### Concession Contracts for Electricity Generation and Distribution System

The very small size of Solomon Islands' electricity market means that competition for energy generation is unlikely to occur in the short to medium term. A single concession for the integrated electricity generation and distribution system is a more appropriate model for private sector involvement.

Care must be taken to ensure that the utility privatisation or concessions are carried out in a competitive manner, with a focus on minimising consumer charges and maximising service coverage. Appropriate government regulation in the industry prior to privatisation also is critical. If done properly, private sector involvement through concessions can potentially deliver a high quality service at an affordable cost to consumers.

### Rural Electrification

Privatisation of Solomon Islands Electricity Authority alone will not result in power being supplied to rural populations. Rather, it should be seen as part of a broader reform to refocus the Government's resources on the more critically required areas where there is a need for government involvement.

Once Solomon Islands Electricity Authority is operating on a sound commercial and technical footing, it will have an increased capacity to expand its network. Soft-loan borrowing and grant aid also could potentially be used to extend services to rural areas on an agreed time schedule.

Prior to the ethnic tensions, the Government, with donor assistance, began work on rural electrification schemes. However, ethnic tensions and the associated law-and-order breakdown resulted in the withdrawal of financial support and eventually brought a halt to this scheme in 2001. There has been little progress in rural electrification since, although some villages have successfully implemented micro-electrification schemes with donor assistance. The broader improvements in government finances could allow limited resources to be carefully redirected to rural electrification schemes.

## Water

In the urban centres (Honiara, Auki, Noro and Tulagi), water is supplied by the Government through Solomon Islands Water Authority. Apart from poor water quality, a major problem with water delivery is the large volume of water for which revenue is not being collected, estimated to be anywhere up to 80 per cent of all water going into the network. The authority is in a poor financial state; as at September 2003 the authority owed around SBD10 million to Solomon Islands Electricity Authority alone and, as a result, has had little ability to invest in infrastructure (Nation, 2003). A multi-donor mission to Solomon

Islands in November 2002 reported that donor officials were agreed that the authority should be outsourced via a management contract (Multi-Donor Economic Governance Mission, 2002). While this option might be useful in bringing in private sector expertise to improve efficiency, it will not bring new capital investment to the sector and is unlikely to provide the private sector incentives necessary to improve service delivery significantly.

### Concession Contracts for Water

Throughout the world, concession contracts are increasingly being used as a model for private sector involvement in the water industry. Between 1990 and 2001, concessions accounted for 69 per cent of cumulative investment in water projects with private sector participation in developing countries (World Bank et al., 2003). Concession holders have the right to collect revenue from water consumers for all water delivered. This right provides the incentive for the concession holder to invest to ensure a constant supply of water and to repair damaged water pipes.

The privatised service, UNELCO Vanuatu Ltd in Vanuatu, is the only water-sector utility among Pacific Island economies which is known as a profitable enterprise. This utility, operated on a concession contract, provides a relatively high quality service to urban areas and has achieved a significant increase in connections over the last 10 years. Service expansions are funded through internally generated reserves. However, the service charges to the public have been high at around US$0.40 per cubic metre compared to about US$0.05 in Samoa, US$0.13 in Fiji and US$0.18 in Solomon Islands based on 1999–2000 data (Zieroth, 2001). The tariff rates in some of these countries have been insufficient to recoup costs, and government subsidies for the water utilities have been necessary.

Solomon Islands' urban water supply could be concessioned out with contract clauses for extension of the network over time. With a contract awarded on criteria including tariff charges and specified service quality standards, the ability of a private sector entrant to exploit the monopoly market should be largely removed.[7] The result should be a better service to urban residents and a gradual extension of services to outlying areas around urban centres. It also would free up vital government resources that could better be spent providing access to improved water sources for the rural population, currently provided through the Rural Water Supply and Sanitation Programme. As in the case of rural electrification, local communities and the donor community also can play strong roles in the provision of these rural services.

## Telecommunications and Information Technology

The current telecommunications market in Solomon Islands has one supplier, Solomon Telekom, which has a monopoly licence to supply all telecommunications, Internet facilities and television broadcast rights. The Investment Corporation of Solomon Islands has largely divested itself of

[7] Contracts awarded on the basis of tariff charges alone often have been used. However, the case of the Manila water supply concessioning, which has seen large rises in tariff levels after contracts were awarded to very low bidders, is a good example of some of the issues that would need to be considered in designing any concessioning schemes. Very low prices may not be sustainable and invite greater water use than is necessary, while contract managers need to ensure that consumers continue to be protected through any re-negotiations.

ownership of this enterprise, retaining only a 7.1 per cent share holding, while the Government-owned National Provident Fund now has a 51 per cent share. Cable and Wireless is the other partner in the venture with a 41.9 per cent share.

Solomon Telekom produced a profit of SBD7 million in 2002 after recording a loss of SBD3.1 million in 2001. The turnaround was assisted by an increase in charges by 10 per cent in 2001 and 15 per cent in 2002 (Central Bank of Solomon Islands, 2003). Local call costs are only slightly higher than other Pacific nations and competitive in a global sense. However, international and mobile costs are high and Internet costs are prohibitively expensive, even in comparison with other Pacific Island countries (Table 3.2).

Table 3.2

### Solomon Islands has high communication costs

**Communication costs in Solomon Islands and selected economies, 2001, US$**

| | Local call[a] | Mobile call[b] | Dial-up internet[c] |
|---|---|---|---|
| **Solomon Islands** | **0.09** | **1.16** | **90.96** |
| Vanuatu | 0.21 | 0.93 | 41.38 |
| Fiji | 0.05 | 0.29 | 74.33 |
| Samoa | 0.03 | 0.26 | 20.18 |
| Thailand | 0.07 | 0.20 | 14.46 |
| Malaysia | 0.02 | 0.36 | 10.76 |

Notes: a. Three minute, fixed line local call.
b. Three minute local call, peak.
c. 30 hrs use per month, peak costs.

Source: International Telecommunications Union, 2002; United Nations Conference on Trade and Development, 2003.

As technological change allows more competition in most segments of the telecommunications market, much scope exists for unbundling the services provided by Solomon Telekom to allow greater competition. However, in late 2003, the Government decided to grant a 15-year monopoly licence, reviewable after five years, to Solomon Telekom in all areas of communications and information technology provision. This severely limits the opportunity for immediate reform.

The supply of telephone fixed-line networks and the provision of telephone services need not have been conducted by the same company. The fixed-line network owned by Solomon Telekom could have been opened up to a range of service suppliers competing to sell local and international call services. However, little avenue now exists for new entrants to provide competitively priced services to consumers due to the high cost of installing new fixed lines.

The Government should take the opportunity of the five-year monopoly licence review to consider removing restrictions for mobile access. Competition from mobile providers can now play a major role in providing competition for traditional fixed-line networks, even where the fixed-line networks are provided by a monopoly supplier. Indeed, up to a minimum telephone density, mobile phones are more cost effective than fixed phones (Smith, 1995). The rapid growth of mobile subscribers in much of East Asia throughout the 1990s is at least partly attributable to the lack of reliability of the fixed-line networks and long queues for access (East Asia Analytical Unit, 1998).

Experience in Samoa has shown that new Internet providers, with access to the existing networks, can provide competition which results in much lower charges for consumers than existed before competition was permitted.

### INTERNET PROVISION IN SAMOA

The backbone of Samoa's Internet facilities are provided through Telecom Samoa Cellular, a joint venture between the Samoan Government (10 per cent ownership) and Telecom New Zealand (90 per cent ownership). While Telecom Samoa provides the infrastructure for Internet services, the market is open to several Internet service providers to compete. Three such providers, two of which were private providers, service the small but growing market, charging tariffs considerably below other Pacific Island economies where no competition exists. Average Internet access tariffs in Samoa are US$20 for dial-up and 30 hours use. In comparison, costs in other nations including Vanuatu (US$41), Fiji (US$74) and especially Solomon Islands (US$91) are significantly higher.

Source: Zieroth, 2001; International Telecommunication Union, 2003.

Solomon Telekom carried out projects in 2002 and 2003 to improve its Internet facilities and has succeeded in pioneering new technology for rural Internet provision through the 'People First' network. However, no competition yet exists in Internet service provision. Access to reasonably priced, reliable Internet services is essential for the people and businesses of Solomon Islands to overcome geographic isolation. Reliable access to the Internet can improve the efficiency of existing businesses and allow new activities, such as data processing and call centres, to be established. The impact of new telecommunications technology on productivity, efficiency and competitiveness means that it is in the national interest of Solomon Islands to have the best regulatory regime in place.

The Government should carefully assess the current monopoly licence for Solomon Telekom before the next five-year review of the 15-year monopoly licence, due in 2007. In many economies, deregulation of telecommunications has resulted in cheaper and more efficient services for consumers, and similar outcomes should be sought for Solomon Islands.

## Transportation

Transportation networks in Solomon Islands are limited and in poor condition. While private sector participation can bring efficiencies to some of these markets, limited demand for many services in the more rural and outlying islands means government involvement will continue to be required to provide these essential services. Without adequate transportation to access health, education and new markets, regional populations will continue to be left out of economic development.

In 2003, the Pacific Islands Forum Leaders' meeting endorsed a Pacific Regional Transport Study. Funded and managed by Australia, this study is exploring regional air and shipping services across the Pacific, focusing on how regional and sub-regional cooperation and collaboration might improve the efficiency of these services. The study will provide further valuable information on much needed improvements in transportation in the region. The Asian Development Bank also is considering support for transportation infrastructure and services in Solomon Islands.

## Inter-Island Shipping Services

Solomon Islands' geography means inter-island shipping is vital for economic and social development. Around 95 per cent of internal travel is done by boat. While the major form of sea transport for many of the provinces remains small outboard motor canoes, larger vessels are essential for inter-provincial transport and larger cargo movements. High shipping costs raise prices across Solomon Islands, particularly for rural products being shipped to the domestic and international markets. The rural population is the greatest loser from continued high shipping costs.

In recent years, shipping services have become increasingly expensive and unreliable, primarily through a lack of competition and high fuel costs. The depreciation of the currency has resulted in a rapid escalation of the cost of both fuel and spare parts. Shipping costs fluctuate widely across Solomon Islands; for example, the average cost to ship logs from Temotu to Honiara, a distance of over 600 kilometres, is less than the average cost to ship logs from Gizo to Honiara, a distance of less than 400 kilometres (Ta'aru et al., 2003). Many of the existing ships are old; the average age of ships registered in Solomon Islands in 1998 was 21 years, with some vessels in service for over 40 years. These ageing vessels need costly maintenance and parts are often not available. Additionally, all large ships, including some of the inter-island ferries, must be serviced overseas as there is no slippage for them in Solomon Islands.

While no recent statistics are available on the cargo carried by the inter-island shipping fleet, the collapse of the commodities trade and the ethnic tensions following 1998 are likely to have greatly reduced the demand for these services. Anecdotal evidence provides estimates of cargo volume reductions of over 60 per cent since 2000 (Hardin, 2003). The re-establishment of law and order and a more stable economic and political environment should result in some rebound in the demand for shipping services.

Cultural traditions play a role in the financial difficulties associated with many of the shipping services. The traditional 'wantok' system with its community-based obligations has resulted in many shipping operators allowing both cargo and passengers to travel without charge for those who are, in some way, connected to the operator. The loss of fare revenue has compounded the financial problems of vessels operated and owned by provincial governments (Ministry of Infrastructure and Development, 2003).

Many of the larger shipping services needed for transportation are provided through the individual Development Authorities of each provincial assembly. Many of these authorities, including those in the Western Province, Guadalcanal and Malaita, have vessels in poor condition and are financially distressed, in many instances unable to meet loan repayments for vessels. By late 2003, Guadalcanal, Malaita and Isabel provinces had obtained approvals to purchase ships with funds provided by Taiwan. Support aimed at providing funds for the purchase of ships without fundamental changes in the operation and management of these provincial authorities is unlikely to improve long-term shipping services or to decrease costs for consumers. A better solution could be the privatisation of the shipping services, most importantly through fair and open competitive processes, to bring private sector efficiencies into these businesses. Alternatively, private sector management of the authorities, tied strictly to business performance, could potentially be a useful first step towards more comprehensive privatisation and assist in improving the regularity of shipping services within the islands.

Increasing competition in shipping routes, particularly those that are potentially commercially viable, would improve services and reduce charges. Foreign investment restrictions (see Chapter 4 – *Creating the Right Environment for Business*), government control over which vessels can supply shipping routes and differing licensing fees and operations inhibit competition. Useful reform could include establishing a largely ‘open seas’ policy which would allow both domestic and foreign vessels to operate between the islands. While Solomon Islands currently has marine regulations, including safety, there has been little scope to police the regulations. Licensing fees should be largely restricted to amounts required to recoup costs for enforcing such regulation and not be used as a revenue tool.

Reforms to the financial sector to provide private sector access to investment capital are important to allow existing market operators to renew their current fleet, while also providing a mechanism for potential market entrants to access capital (See Chapter 4 – *Creating the Right Environment for Business*). The introduction of operators with newer, more efficient vessels also could potentially assist in reducing excessive maintenance and fuel costs.

Some routes, particularly those to outlying areas, will continue to be non-economical for private operators to service. In this instance, there remains a role for government to ensure these communities can access shipping and ferry services. However, government involvement should seek to access private sector expertise to deliver these services. Contractors could be chosen through a competitive bidding process for sub-commercial regional shipping services, with the choice of successful bidder based on the least amount of subsidy required to operate a specified level of service.

## Ports

Many of the ports, wharves and jetties across Solomon Islands are in poor condition. These facilities range from major ports (such as those at Honiara and Noro operated by the Port Authority) down to small structures built from local materials. These facilities are constructed through a variety of provincial and central government and donor resources, although most funding originates from the donor-funded development budget. The situation for shippers is made worse by the generally inefficient and unsafe cargo handling operations in many locations. The large reduction in inter-island trade since 1999 has reduced the amount collected in port user fees and further reduced the ability of these ports to maintain existing standards, let alone invest in new facilities.

The European Union marine project is constructing and repairing ports and jetties across the islands. This will assist in revitalising the industry. It is important that maintenance costs for these ports are included in the recurrent budget.

Options for port privatisations are likely, in the short term at least, to remain small with many of the outlying ports generating too little traffic for such enterprises to be profitable or, as with Temotu Province, pricing themselves out of the market. The central ports, particularly Honiara, could be privatised.

Solomon Islands' limited market makes it difficult to introduce competition into port services, including stevedoring services. The alternative, privatising the entire port operation, also is problematic as it creates the possibility of private companies exploiting a monopoly power. Private sector involvement through a concession arrangement may be a better strategy. Competition in bidding for the operation of the port on the lowest port user fees and a specified level of service could help to reduce charges and improve services. As other shipping services become more frequent and use of other ports increase, privatisation and concessions for some of the other major ports could be explored.

With the private sector participating in port operation, a danger exists in providing port management contracts to companies that have significant interests in shipping services. Port operators could then have incentives to block or impede access to competing shipping services and, without a sufficiently powerful regulatory body to oversee the industry, competition could be impeded. In general, shippers should not be permitted to operate ports unless authorities can enforce competitive behaviour.

## Air Services

The 100 per cent Government-owned Solomon Airlines Ltd was on the verge of liquidation in 2001, with severe cash problems and poor management. Although the company has progressed to a slightly more stable position and has embarked on restructuring programs under the direction of an acting managing director and new board of directors, the long-term viability of both the international and domestic services is uncertain. Air Vanuatu and later Air Nauru entered a leasing arrangement with Solomon Airlines, removing the need for Solomon Airlines to maintain a costly aircraft and saving the company from going into liquidation. The Investment Corporation of Solomon Islands believes the arrangement now in place with Air Vanuatu for international flights is working well, with the international service showing a profit for 2002 (Luiramo, 2003). The current operation of this 'virtual' international airline with services leased from other airlines appears to be a successful model for Solomon Islands. It also has increased the utilisation of other pacific airlines, although these companies continue to face financial pressures.

While Solomon Airlines' short-term future appears better placed than in 2001, it still has several major problems and remains in a poor financial position. In particular, the current domestic service has poorly operating craft, unreliable timetabling and consistently runs at a loss resulting in cross subsidisation with the international service.[8]

[8] In addition to problems with the financial sustainability of the airline services, control of the airspace has been a problem for Solomon Islands. As a result, Australia contracted with the Solomon Islands Government in 1998 to provide management of the upper airspace over Solomon Islands.

Tourism operators in Gizo (the previous hub for special interest foreign tourists) have indicated that the single biggest obstacle they face is the unreliability of Solomon Airlines' services. A more rationalised route structure – restricting the number of non-economical routes flown by the airline to limit losses – could increase in the domestic service's viability. Should the Government wish to provide non-commercial services, transparent subsidies will need to be provided to the airline.

Privatisation of the airline, or a concession, could be beneficial. Solomon Airlines has three domestic planes which could potentially be operated by the private sector, possibly through a concession arrangement should the Government not be willing to undertake a full sale. However, further opening up of the airline market would be the better option. Commercial operators are likely to make decisions, such as on aircraft selection and route structure, more closely aligned with market conditions. Creating competition in the market also could assist in refocusing the operations of the existing airline, thereby improving its efficiency. Services to rural areas could be carried out by businesses competing for government subsidies.

## Airports and Strips

Throughout the world, ownership, maintenance and operation of large airports also is increasingly handled by private companies. Seven countries within East Asia and the Pacific introduced private participation in airports between 1990 and 2001. Privatisation methods included concession, divestments of public enterprises such as in China and partial divestment of public enterprises such as in Malaysia. Of these methods, concessions dominated private sector activity between 1990 and 2001, accounting for around 76 per cent of investment (World Bank et al., 2003). Experience in other countries, including Australia, with airport privatisation has been positive.

The Government-owned airport outside Honiara, largely developed with donor funding, is the hub of air transportation within Solomon Islands, both domestic and international. However, the infrequency of flights into Honiara makes privatisation an unlikely option in the near future. The broader issues of air traffic management and safety require more urgent attention than the issue of airport ownership.

## Roads

The Government currently has limited ability to construct new roads or even maintain existing ones. With a large portion of the existing road network requiring urgent maintenance, the Government's focus is more on reconstructing and maintaining existing infrastructure than on developing new roads. With approximately 95 per cent of vehicles located in Honiara, there has been little focus on maintaining rural roads (Ministry of Infrastructure and Development, 2003). Typically, donors and commercial businesses, including forestry companies, have led construction of new roads and road maintenance.

### SUCCESSFUL COMMUNITY-BASED PROJECTS

The Community Peace and Restoration Fund national roads project has had some success in working with local communities to establish new roads. It partnered with the provincial outposts of the Ministry of Works, which had not been able to maintain needed roads as they did not have funds to repair machinery and purchase fuel. The project provided the communities along the roads with basic tools and assisted in engaging and training them in road construction, repair and maintenance. These roads are designed to have minimal maintenance costs to provide long-term sustainability.

Source: Australian Agency for International Development, 2003.

Community projects have had some success in establishing roads in rural areas where the central government has little capacity to undertake new construction. Often the benefit of these community roads is that they are demand driven rather than the result of who is in power. They are, therefore, more likely to have higher economic and social rates of return. It is important that the community coordinates with the Government in these projects if the project is to connect to a coherent transport network.

Where companies or major projects are the main beneficiaries of new roads, private funding should be required.

## Other State-Owned Enterprises

The Government operates a range of commercial enterprises outside of those providing basic infrastructure and services. These businesses cover such areas as printing, ship repair, fishing, forest plantation, commodity marketing and financial services. Such involvement from government crowds out private firms, limiting the ability of new businesses and entrepreneurs to enter markets. This is particularly so where state-owned commercial enterprises enjoy special tax, tariff or other concessions or are protected by special legislation.

National Economic Development Plans and previous government reviews of these enterprises acknowledge that the Government cannot afford to operate its range of state-owned enterprises. Many consistently operate at a loss and would require major investments before they could become profitable businesses, even if they were well managed.[9] Given the Government's limited resources, it should divest its loss-making enterprises. If the Government continues to own and operate businesses, they should face the tax, tariff and regulatory environment faced by existing or potential private sector participants.

Several recent reports urge the Government to implement its privatisation policy more vigorously to give a clear signal to investors and the private sector that the Government is serious about privatisation (Multi-Donor Economic Governance Mission, 2002; Industries Rehabilitation and Retention Taskforce, 2003).

9 For example, Solomon Island Printers Ltd, the Government printer, has never declared a profit since its incorporation (Investment Corporation of Solomon Islands, 2003).

The Government will need donor technical assistance to assist with the privatisation projects to ensure transparency in the tendering process and that the correct privatisation model is used.

Unless pressing market failure and national interest reasons exist for continuing government ownership, the best approach is to sell the enterprises through an open, competitive tender to reputable and financially fit buyers as soon as practicable. In particular, the Government could pursue privatisation of Solomon Islands Printers Ltd and Sasape Marina Ltd as a high priority. There is a critical need to improve the provision of shipyard and repair facilities to assist in inter-island shipping. The sale of Sasape Marina to private operators is likely to see an improvement in the quality of service delivery to this sector.

If the Government is unable to find a buyer for industries that are structurally unsound, it should seriously consider liquidation. The Government cannot afford to continue supporting these industries as they divert limited resources from more necessary activities such as health and education. Liquidation frees up the assets (plant and equipment and land) of the enterprise so they can be used elsewhere in the economy. It also allows as many lenders as possible to be paid, providing an injection of funds into the economy.

The Government retains other businesses that it could sell or for which it could seek private sector involvement. The Government could sell Soltai Fishing and Processing Ltd (see Chapter 5 – *Business Opportunities*). The business has large debts inherited from its former operating name, Solomon Taiyo Ltd. A major investment program is required to improve its current limited operating capacity. Divestment of this business to a suitable private sector interest could promote development of a significant and profitable business for Solomon Islands. The National Provident Fund is another government-owned business which has been performing badly and could derive some benefit from private sector involvement (see Chapter 4 – *Creating the Right Environment for Business*).

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# CREATING THE RIGHT ENVIRONMENT FOR BUSINESS

## KEY POINTS

- A robust private sector is essential for economic recovery and social stability as it will increase employment opportunities and sustain long-term growth.
- The public sector has had difficulty in providing the basic pre-conditions for private sector growth.
- A credible budget strategy, which allows the Solomon Islands Government to pay its bills, and a comprehensive debt management strategy will aid the private sector.
- The restoration of law and order by RAMSI has met one of the pre-conditions for the return of business confidence.
- Improving access to finance will be an important factor in encouraging new businesses. Re-establishing the Development Bank of Solomon Islands, or a similar body, is not likely to lead to a sustainable solution. Other mechanisms, including the further use of credit unions, may be the better option. Outsourcing the management of the struggling National Provident Fund should be considered.
- Uncertainty regarding land tenure affects the ability to secure finance and to use the land for profitable enterprises outside subsistence farming. Secure and tradable property rights are fundamental to a well functioning market economy and economic growth.
- Foreign investment inflows and the export of goods and services will play an important role in economic growth. More open trade and investment policies are needed to drive growth and attract private investors into infrastructure service delivery. Regulations should be limited to the protection of essential public goods like the environment and national security.
- Restrictive labour market regulations and inadequate vocational training have hindered growth. More flexible dismissal criteria and procedures and further training facilities could assist business. Streamlining and reforming work permits and business licences will ease the regulatory burden on businesses.

## IMPORTANCE OF THE PRIVATE SECTOR

A revival of Solomon Islands' private sector is vital for sustainable growth as it will increase employment and income-earning opportunities and generate tax revenues to fund the provision of basic services. Private sector growth is important to create a more diversified economy, reducing its vulnerability to external shocks. Given Solomon Islands' strong resource base and current focus on agriculture, fisheries and forestry, further development of these sectors and a focus on tourism could provide considerable potential for private sector growth.

With confidence improving following the ending of ethnic conflict, significant new business opportunities, both domestic and foreign, could emerge if the Government can make the business environment more supportive of private sector growth. This chapter identifies some of the main policies and conditions constraining private sector growth and examines options to address these constraints.

A growing private sector will provide Solomon Islanders with greater employment choices. They will be able to decide between a subsistence lifestyle and employment in the private sector. Private sector employment would provide higher incomes, allowing Solomon Islanders to increase their standard of living (in a western sense) beyond levels possible in the subsistence economy.

Fostering competition through a supportive regulatory environment is particularly important in a small economy like Solomon Islands as it is likely to have only a limited number of providers for most goods and services. A competitive environment should ensure that goods and services are provided efficiently and at lowest cost for consumers, and also encourage new entrants who will bring new investment and generate new jobs.

## SIZE AND NATURE OF THE PRIVATE SECTOR

The business sector of Solomon Islands involves a relatively small proportion of the working population. The private sector employed 23 713 people in 1998 in both the formal and informal business sectors out of a population of around 239 000 people aged 15 and over (Solomon Islands Statistical Office, 2000; Solomon Islands Census Office, 1999). However, since 1998 private sector employment has declined. The greater part of the population remains involved in subsistence and small cash-crop agriculture; the 1999 census shows that less than a third of the population is involved in paid work (Solomon Islands Census Office, 1999). This chapter focuses on the private sector, excluding the 'informal sector', that is, those engaged in subsistence agriculture (see Chapter 5 – *Business Opportunities* for discussion on the 'informal sector').

Around 98 per cent of the formal businesses operating in Solomon Islands are classified as small or medium-sized enterprises by most international measures; that is, they have fewer than 200 employees (Hardin, 2003). The retail, wholesale and hospitality, manufacturing and mining, forestry and agriculture industries dominate private sector employment (Table 4.1).

Table 4.1

## Services, mining, transport and communications grew fastest in 1990s

**Major private sector industries, number of employees**

| | 1990 | 1998 |
|---|---|---|
| | Employees | Employees |
| Retailing, wholesale, accommodation, restaurants | 2 637 | 4 641 |
| Manufacturing and mining | 2 285 | 4 348 |
| Agriculture | 3 928 | 3 356 |
| Forestry | 2 159 | 2 658 |
| Transport/communications | 1 348 | 1 878 |
| Fishing | 1 449 | 1 412 |
| Finance | 866 | 1 183 |
| Construction | 1 384 | 1 187 |
| Total of major industries | 16 056 | 20 663 |

Source: Solomon Islands Statistical Office, 2000.

Recent government data on private sector employment are unavailable. However, a representative survey of the private sector conducted in mid-2003 shows there were between 750 and 820 formal businesses (excluding self-employed persons). This represents a decline of 40 to 45 per cent between 1998 and 2003 (Hardin, 2003). Over this period, the relative importance of manufacturing, agriculture and fishing has declined. The representative survey indicates employment in the manufacturing sector has probably declined by up to 50 per cent since 2000, while in most other sectors the reduction in employment levels averaged between 35 and 40 per cent (Table 4.2).

Table 4.2

## Private sector activity in 2003

**Indicative composition of private sector activity, number of enterprises, 2003**

| | National Provident Fund[a] | | Hardin |
|---|---|---|---|
| | No | per cent | per cent |
| Wholesale, retail, hospitality | 546 | 44 | 40 |
| Forestry and timber | 119 | 10 | 10 |
| Manufacturing | 94 | 8 | 10 |
| Transport | 110 | 9 | 9 |
| Agriculture and fishing | 93 | 8 | 5 |
| Other sectors | 274 | 22 | 26 |
| **Total** | **1 236** | 100 | 100 |

Notes: a. Estimated employers in 2000 was 3930 (National Provident Fund data).

The decline in the private sector also can be seen through the number of private sector employers contributing to the National Provident Fund. In early 2000, 3930 employers were contributing to the National Provident Fund. By May 2003, there were 1236 employers contributing, a decline of around 68 per cent.

In addition to these businesses, around 6000 to 7000 informal, micro-enterprises are believed to operate around the country. These 'part-time entrepreneurs' are engaged primarily in agriculture and fishing, and their sales are primarily restricted to their immediate market (Hardin, 2003). The majority of the population in rural areas is engaged in essentially subsistence activities, including fishing and agriculture.

Most of the private sector enterprises are located in, or close to, Honiara and the Western Province. In 1998, 49 per cent of all enterprises were located in Honiara and 17 per cent were in the Western Province. The relative importance of the Honiara area, in terms of infrastructure support and market demand, has not declined. Well over 50 per cent of enterprises are now located in Honiara and at least 70 per cent of all manufacturing operations are situated there (Hardin, 2003).

The Western Province's private sector previously relied on the tourism industry and flow-on business from the agricultural and fisheries industries that used the port at Noro for exports. The significant decline in tourist numbers and difficulties experienced by other industries severely contracted private sector activity in this province. In the once buoyant town of Gizo, for example, local entrepreneurs report their business activity has declined by over 60 per cent since 2000 (Hardin, 2003).

In the other provinces, private sector activities have revolved around agriculture, logging and fishing. In Central Province, for example, employment in agriculture and fishing represented 69 per cent of total employment in 1998. In the same year, the logging industry in Isabel Province accounted for 29 per cent of total employment.

## PERFORMANCE OF THE PRIVATE SECTOR

All areas of the private sector, including micro and informal sector enterprises, have been adversely impacted by:

- weak local demand throughout the country
- rising transport and travel costs
- deteriorating infrastructure
- an overall lack of confidence
- security problems, including the recent civil unrest.

Larger businesses also were adversely affected but some of those with foreign ownership and financial backing managed to weather the storm more effectively than the smaller firms. Other foreign-owned companies closed their Solomon Islands operations.

Smaller, locally owned businesses clearly do not have this option. The business is the proprietor's livelihood and, in many cases, all of his or her assets are tied up in the business. Many of these smaller businesses were devastated by the economic collapse.

## MAJOR PRIVATE SECTOR ACTIVITIES AND PROBLEMS

**Agriculture** – focuses on food crops for the domestic market and copra, cocoa and palm oil for export. This sector was badly affected by the recent political and social turmoil with two major operations – the Government-owned Solomon Islands Plantations Ltd (SIPL) and predominately locally owned but foreign-managed Russell Island Plantation Estates Ltd – closing or reducing activities.

**Forestry and timber products** – activities consist primarily of log exports and some local processing. The majority of timber companies are foreign-owned and there is concern over the sustainability of current logging practices. Local timber product manufacturers are concerned at the difficulty of securing a reliable supply of timber.

**Fisheries** – revolves around tuna exporting. Foreign-owned vessels operating under licences issued by the Government dominate the industry. There are few professional local fishermen and apart from tuna, resources are not abundant. Bêche-de-mer, seaweed and other marine agricultural products currently being trialled could develop into significant exports if managed sustainably.

**Mining and exploration** – was an export oriented sector. Gold Ridge, the only mine in Solomon Islands, closed in 2000 as a direct consequence of the civil unrest. There is no active exploration for new mineral deposits apart from a study for a nickel mine in Isabel Province that has been under investigation for over 20 years.

**Manufacturing** – aims primarily at serving the domestic market, which has contracted due to a lack of domestic demand. The main activities are basic food processing, furniture and other timber products, fiberglass products and some construction materials.

**Construction** – The local construction market collapsed in 2000–01. Government contracts virtually ceased and private investors shelved construction projects. Some local contractors were not paid for government-funded projects, leaving them in a difficult financial position. Remaining contractors, the largest of which are foreign-owned, have relied increasingly on maintenance projects to cover overheads until the growth in 2003.

**Wholesale and retail** – also has contracted significantly, with total turnover across all businesses declining by at least 40 per cent since the outbreak of violence. The combined effects of reduced local demand and increased cost of imports have reduced turnover and margins, with the result that many small retailers have failed. Foreign-owned or managed wholesalers and retailers now have a more significant share of the market.

**Accommodation and hospitality** – The overseas tourism market almost evaporated in 2001–02. Security problems kept most tourists away and the unreliable internal air services discouraged overseas wholesalers and in-bound tourism operators. Most of the tourism-dependent hotels and resorts have suffered badly and several tour operators have closed or scaled back significantly. The only segment that has managed to perform reasonably well are the high cost, western-style hotels in Honiara that have frequently been full with guests attending donor conferences and workshops.

Source: Hardin, 2003.

## FACTORS CONSTRAINING PRIVATE SECTOR DEVELOPMENT

Numerous impediments constrain private sector development. Not all of these, particularly those relating to inappropriate government regulations, relate to the social and economic disruption around 1999 and 2000. A fundamental issue to be addressed is how to prioritise reforms needed to create a favourable environment for the private sector. Most of the pre-conditions for private sector activity to flourish have either never existed or have deteriorated over the last ten years. The following discussion examines the main impediments to private sector development, drawing on a comprehensive survey of business views done in the first half of 2003. Appendix 4.1 outlines the survey's main findings in more detail.

### Law and Order

The perceived lack of respect for the rule of law has had a profound and detrimental impact on the private sector. 'Street crime' was not a major problem throughout the troubled period from 1999 to 2003. However, the often blatant disregard for the property of major resource developers, the ongoing intimidation of individual businesses and the Government itself, the increase in malpractice in government bodies and the apparent immunity of those involved in illegal activities led to an environment that was not conducive to private investment by either local or overseas parties. The failures of both the Gold Ridge mine and SIPL palm oil operation were a direct result of lawlessness, which resulted in the destruction of these projects' infrastructure. Numerous smaller businesses also were directly affected by the breakdown in law and order.

#### CASE STUDIES

**Small Trader and Retailer**

A small business, owned by a capable local entrepreneur, was doing well until 2000. A few retail outlets were operating successfully around the country and overseas suppliers were prepared to provide credit. The operation employed about 20 people, including several in small-scale food processing.

In 2000, the owner's delivery vehicle was stolen and customers 'stopped coming'. The owner hoped things would improve but the company's cash reserves were exhausted. Loan repayments to the bank could not be met and the bank eventually took the owner's fixed deposit to cover outstanding repayments and accrued interest.

In the meantime, the owner sold what equipment he could and eventually did not have facilities to operate effectively.

While there are signs of increased consumer demand, this business has no cash flow to purchase stock and no security to offer for a bank loan. The prospects for this once successful business are bleak.

### Small Civil Construction Business

This locally-owned business was performing well until 2000. Projects were being done in several parts of the country and a small aggregate crushing mill was kept busy.

In the second half of 2000, business virtually 'dried up' and an outstanding government debt of SBD600 000 for completed projects was not paid. The company slashed its workforce and tried to lease out its ageing equipment. Attempts to sell some equipment have not been successful and over SBD100 000 is required to restore the remaining equipment to an operational state.

The owner hopes things will improve but prospects of securing a bank loan for repairs and working capital are poor. If some or all of the outstanding government debt was repaid, this small business might be revived.

### Fuel Retailing Operation

Prior to the ethnic tensions, this small business achieved a good turnover and the local owner was regarded by his bank as an 'excellent customer'.

During the second half of 2000, the operation was robbed and repeatedly harassed. The owner was eventually forced to close and Mobil's withdrawal from Solomon Islands destroyed any chance of reopening.

The owner has a large outstanding debt to the bank which he is unable to service. Attempts to start a small-scale export business have not been successful due to a shortage of working capital.

This entrepreneur's family home was put up as security for the bank loan. If the bank forecloses on the loan, this once successful businessman will lose everything.

Source: Hardin, 2003.

While serious law-and-order problems were largely confined to Guadalcanal, their consequences extended throughout the country. The decline in the relatively large, central market on Guadalcanal adversely impacted outlying areas which relied on this market. Additionally, the whole country suffered from international perceptions that Solomon Islands had degenerated into a lawless state. Both local and overseas investors will not risk their capital, assets or personnel in an environment where there is neither physical security nor confidence in the legal system.

## Governance Affected Business

Government has a key role in establishing an enabling environment for private sector development. However, the business sector in Solomon Islands believes the Government's previous poor standards of governance have undermined confidence, distorted the market and effectively punished those struggling to maintain their business (Industries Rehabilitation and Retention Task Force, 2003). This perception undermines confidence, encourages some entrepreneurs to avoid their tax and other obligations, and engenders a short-term, opportunistic approach to business.

Prior to RAMSI's arrival the private sector's belief that the public service had essentially failed to deliver was reinforced by instances of irregular, inconsistent and non-transparent procedures by government bodies. In the Industries Rehabilitation and Retention Task Force survey (2003), the private sector highlighted:

- perceived corrupt practices in the issuing of work and residency permits for foreigners; numerous reports exist of business operators facing long delays in renewing their permits, while some new business entrants have their permits approved in a matter of days
  - work permits are valid only for two years, which does not engender a welcoming environment for investors and creates practical problems for those considering an ongoing commitment to the country
- inconsistent application of customs regulations and import duties; prior to RAMSI, influential parties often received duty remissions resulting in massive government revenue losses and a loss of confidence in government
- selective pursuit of company and goods tax from businesses by taxation authorities, while at the same time refusing to acknowledge the government's liability for repaying provisional tax paid prior to 2000
- intrusive, obstructionist and, at times, apparently non-transparent decision-making by the Foreign Investment Board; this situation has a negative impact on potential foreign investors and creates problems for majority foreign-owned companies that have to apply annually for a renewal of their approval to operate
  - each time a majority foreign-owned company wants to diversify into a different type of business, it has to apply to the board for approval; this time-consuming and uncertain process can take more than six months for a relatively simple approval
- non-transparent or fair tendering procedures by government; major asset sales and other contracting decisions have been made after bypassing the Tenders Board, resulting in outcomes that provide little benefit, or even extra costs, to the community.

## Poor and Inadequate Infrastructure

The poor condition of infrastructure in Solomon Islands is clearly an impediment to private sector development. Power and telecommunications services do not encourage the establishment of competitive new ventures, especially those aimed at the export market. Expensive internal freight connections are a barrier to developing productive ventures in the provinces. The unreliable services of most of the inter-island shipping companies create problems for their own financial sustainability as well as restricting commerce and trade (See Chapter 3 – *Policies to Rejuvenate Utilities, Infrastructure and State-Owned Enterprises*).

## Limited Access to Affordable Finance

Solomon Islands' three commercial banks have been adversely affected by the recent social and economic disruption, as well as by their significant holdings of under-performing government bonds. The Government's financial decline has resulted in over 30 per cent of total assets of banks being represented by restructuring bonds, which are impaired (Central Bank of Solomon Islands, 2003). The Government's high level of borrowing also has crowded out much private credit. These issues increase interest rate spreads and reduce the willingness of banks to lend, despite the high liquidity levels of the banking sector. Since the arrival of RAMSI, confidence has improved amongst the banks and there has been a modest expansion in credit to the private sector.

While the commercial banks are reasonably liquid and are keen to receive quality loan applications, most small and medium-sized enterprises find it difficult to secure affordable commercial loans. High interest lending rates, now declining slightly from around 16 to 19 per cent per year to under 15 per cent per year, short repayment terms of three to five years, high security requirements of up to 150 per cent of the 'fire sale' value of tangible security and the requirement for the borrower to contribute 30 to 50 per cent of project costs have essentially restricted commercial loans to large local or overseas businesses.

The financing difficulties encountered by local small to medium-sized enterprises have been compounded by the insolvency of the Government-owned Development Bank of Solomon Islands. Its goal of promoting economic development means it operated on non-commercial considerations with lending rates reflecting cross subsidisation of some sectors. Its loan recovery rate was poor and its average return on assets was well below its cost of funds.[1] A large share of the bank's loan portfolio was located on Guadalcanal and most projects were destroyed in the ethnic tensions. Total losses in 2002 were estimated at around SBD2.4 million, down from a loss of SBD7.5 million in 2001 (Investment Corporation of Solomon Islands, 2003). Once external funds dried up due to non-servicing of debts, the bank began to raise cash locally through borrowing and deposits. With most of its loan portfolio non-performing, the bank experienced a serious imbalance between its liabilities and its loan portfolio. The deposits matured, but the bank could not find cash for repayments (Houenipwela, 2002). The bank has now effectively ceased lending and retains only its head office in Honiara. The proportion of outstanding loans, including its loans from the European Investment Bank, that may be repaid is unknown.

Credit unions were a mechanism for savings and small loan facilities for a broad cross-section of society (see Chapter 5 – *Business Opportunities* for discussion on credit unions and the informal sector). Donor assistance was used to strengthen the supervisory body, Solomon Islands Credit Union League, in the early 1990s, and in 1992 there were 93 credit unions operating with 12 000 members (Solomon Islands Government, 2002). By 1999, total membership in credit unions was estimated at 17 000.

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1 The Development Bank of Solomon Islands has provided cheap lending to the agricultural sector, a risky sector given ambiguity over land ownership. In 1995, it also started to take deposits to cover its liquidity problems but has had to pay higher interest rates to compete with the commercial banks.

However, a lack of funding for the Solomon Islands Credit Union League constrained support to this sector and 77 per cent of the 164 listed credit unions were described as dormant in 1999 (Asian Development Bank, 2001). As a result of the economic turmoil and in some cases mismanagement, the credit unions have further declined and many are now no longer viable. In most of the more remote areas of the country, there are now virtually no accessible savings facilities or small loan facilities. Mass redundancies also impacted negatively on cash flows of employee-based credit unions. As of late 2003, only 20 credit unions were operating, mostly in the Honiara area.

The Investment Corporation of Solomon Islands is the government body responsible for managing and financing central Government involvement in commercial enterprises. Over the last three years, its investment portfolio has been badly affected and it now has only sufficient funds to maintain its day-to-day operations. This situation is unlikely to change given the relatively poor position of its key investments which include Soltai, Solomon Airlines and SIPL.

Solomon Islands National Provident Fund has invested in a number of state-owned enterprises; it has 49 per cent equity in the National Bank of Solomon Islands and is a major investor in the Electricity Authority. The Provident Fund's capital growth has been eroded by bad investments and a legislated requirement to invest primarily domestically. Since 1998, this has been compounded by payouts of contributions of members who participated in mass redundancies. Amendments to the Act, which increased members' access to their savings, also have resulted in an outflow of capital from the Provident Fund (Makabo, 2003).[2] As a result, the fund has been reluctant to invest in additional projects in the country. The poor performance of many of the fund's investments, evidenced by total investment arrears to the fund as of 31 July 2003 of SBD109.9 million, has resulted in a lack of confidence in the fund amongst many contributors (Solomon Islands National Provident Fund, 2003). Some contributors have gained access to their contributions by obtaining a personal loan from a bank, offering their Provident Fund balance as security, and then deliberately defaulting on the loan repayments. Banks now no longer accept Solomon Islands National Provident Fund accounts as security.

There are numerous reasons for the high cost of and the stringent conditions imposed on commercial finance. These include market-related factors such as relatively limited competition and banks' perceptions of the 'bankable' opportunities in the market. The Government's poor record in honouring payments on government bonds held by the banks and mismanagement of the economy have made banks cautious and they have restricted the availability of credit and increased its cost. Finally, the traditional land tenure system and lack of transferable title means borrowers often cannot provide the most common form of acceptable security.

2 It reduced the age of eligibility for automatic withdrawal of members' entire savings from 50 to 40 years of age, made members who have been made redundant and been without continuous employment for three months eligible to withdraw savings and introduced a one-third pledge of contributions to provide security for members' commercial bank loans so that where a member defaults on a loan one-third of their contributions will be called on by the bank (Houenipwela, 2002).

## Problems with Land Ownership and Tenure

Two distinct and co-existing systems of land tenure operate in Solomon Islands – 'customary' or communally-owned land covering from 85 to 90 per cent of land and 'alienated' or registered land. Under the *Land and Titles Act of 1969*, last amended in 1988, no person other than a Solomon Islander, defined as a person born in the country with two indigenous grandparents, can hold a perpetual title to registered land. No freehold land exists in the country although registered land is available on 50-year leases through the Government.

The *Customary Land Records Act* was passed in 1994 with the intention of providing a mechanism to record customary land boundaries. However, since its introduction, no customary land has been recorded under the Act due to its complexity, institutional and financial shortcomings and mistrust of the outcomes by landowners.

The current system for resolving disputes, involving chiefs' committees, local courts, Customary Land Appeals Court and the High Court, has several shortcomings. The process can take years to achieve a final decision. When decisions are made, they are only binding on the parties to the dispute and new claimants can further delay a final decision. Many landowners and chiefs feel that the system does not take account of customary practices. The process is both expensive and under-resourced.

While the traditional land ownership system worked well for traditional subsistence methods, reform is required if the fundamental requirements for a robust private sector are to be established. The current land ownership and tenure processes make it difficult for private investors to obtain secure titles and use land titles for collateral. Coupled with the other impediments to private sector development, land title insecurity has led to problems for some projects. An underlying problem behind the closure of the SIPL palm oil operation is contested land ownership. The traditional landowners leased the land to the Government which, in turn, allowed the project to utilise the land for the plantation. This meant the Government assumed the responsibility for paying lease rentals to the landowners. It could not make payments for the period after the plantation was closed, and the landowners have refused to negotiate with any new investor in the project until these rentals are paid.

One successful Solomon Islands' model of cooperation between landowners and a resource developer is Kolombangara Forest Products. This plantation timber project has managed to retain a cooperative relationship with the traditional landowners. The resource developer, the Commonwealth Development Corporation, has instituted a responsible and inclusive management policy and the Government has had minimal involvement in this project.

An AusAID-funded trial land administration project, Solomon Islands Institutional Strengthening of Land Administration Project, has been underway in Solomon Islands for some years. It is improving access to land records and information, reviewing existing legislation and improving the capacity of the Ministry of Agriculture and Lands. The program has been extended for three years, beginning 2004, and now includes an investigation of registration of customary lands, including a pilot registration scheme.

The cautious approach to land registration of the Australian-funded lands administration project recognises that communal land tenure arrangements are an important element of traditional society in Solomon Islands. Recognising the traditional structures, but reforming them to work in a modern economic society, will require a long-term effort by the Government and community support.

## Foreign Exchange Policies, Trade and Investment

To protect the country from a severe decline in foreign exchange reserves, the Central Bank of Solomon Islands instituted controls over foreign exchange outflows in 2000. By early 2002, the continuing economic decline had depleted reserves to under SBD100 million, barely enough to cover one month's imports. Reserves have since expanded and by February 2004 had reached over SBD300 million (Central Bank of Solomon Islands, 2004).

Restrictions on foreign exchange transactions are an impediment to commercial enterprise operations (Industries Rehabilitation and Retention Task Force, 2003). Applications for the purchase of foreign exchange for purposes such as import payments, travel expenses and foreign borrowings by residents are made through the Central Bank of Solomon Islands. The Central Bank has authorised commercial banks to deal in small quantities of foreign exchange on behalf of their clients. Delays in processing applications and quantitative restrictions on foreign exchange allocated create uncertainty and additional costs for businesses which rely on imported machinery, production inputs, parts and general merchandise. These problems are compounded by the lack of credit available for importers due to overseas suppliers' negative attitude to the risks associated with exporting to Solomon Islands' businesses. As a result of lags in receiving foreign exchange clearance, several local businesses have lost their credit ratings (Honiara Chamber of Commerce, 2003).

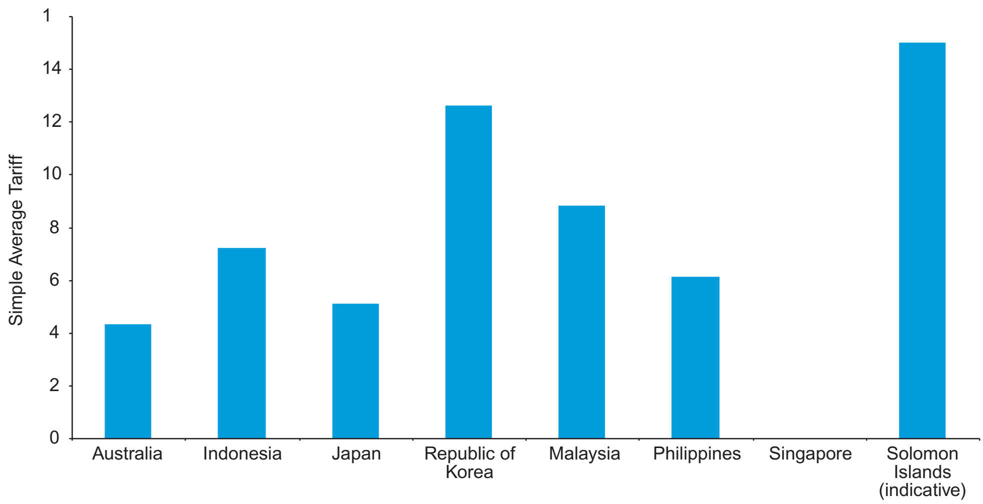
While the Central Bank has implemented measures to protect foreign exchange reserves, it recognises that this imposes costs on the economy (Central Bank of Solomon Islands, 2003). In April 2004, following a review of all controls, foreign exchange limits for customers and the overnight limits for banks were raised. Additionally, the bank resumed participation in the foreign exchange market.

Businesses also confront high and variable tariff rates on imported inputs and machinery, reducing their competitiveness. The Government has made significant changes to tariff levels, including the reduction of maximum tariff rates from 70 per cent prior to 1999 to 20 per cent in 2000 and some concessions for manufacturing inputs. However, tariffs remain high in comparison to a number of other economies (Figure 4.1).

Figure 4.1

**Solomon Islands' tariff rates relatively high**

**Average applied tariff rates, Solomon Islands and other selected economies, per cent**




Notes: Australian average applied tariff levels in 2003. Indonesia, Japan, Republic of Korea, Philippines and Singapore average applied tariff levels in 2002. Malaysian average applied tariff level in 2001. Simple average tariff levels are a simple average of the *ad valorem* Most Favoured Nation applied HS 6-Digit duties.

Latest available World Trade Organization data for Solomon Islands shows a simple average applied tariff of 22 per cent in 1998. However, substantial reductions in tariff levels occurred in 1999 and 2000. Based on 2003 data from Solomon Islands Customs, Economic Analytical Unit calculations indicate a simple average applied tariff level of around 15 per cent.

Source: Department of Foreign Affairs and Trade, 2004; Solomon Islands Customs and Excise Division, 2003.

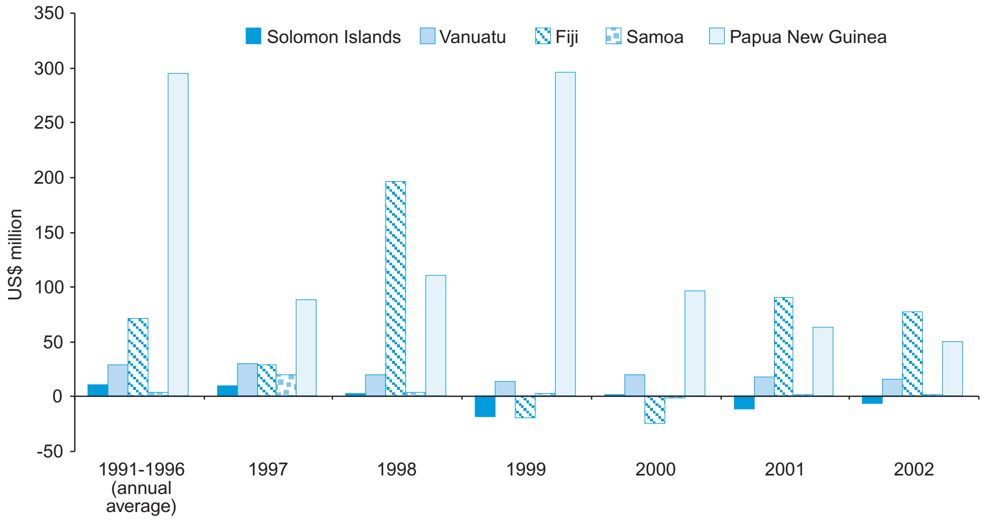
## Foreign Investment Possibilities

Foreign investments, such as Gold Ridge mine and SIPL, have made a significant contribution to economic growth, employment, foreign exchange and tax revenue earnings. However, since the ethnic crisis, there has been a net outflow of foreign investment. The withdrawal of foreign investors like Gold Ridge mine and SIPL, two of the most significant export projects in the country, demonstrates the importance of a stable political and social environment to attract and keep foreign investors (Figure 4.2).

Figure 4.2

**Solomon Islands loses foreign direct investment**

**Foreign direct investment inflows to various Pacific island economies, US$ million**




Source: United Nations Conference on Trade and Development, 2003.

Prior to 2000, the Foreign Investment Advisory Service of the World Bank Group was helping the Government to examine the foreign investment regulatory environment and its investment promotion capacity. This included assistance in legislative drafting. However, this work was halted following ethnic unrest and loan defaults. Work with the Foreign Investment Advisory Service recommenced in 2004.

Many businesses surveyed in early 2003 indicated that Foreign Investment Board decisions were non-transparent and could discourage new foreign investment (Industries Rehabilitation and Retention Task Force, 2003). The Foreign Investment Board requirements also are a problem for majority-owned foreign companies, which must apply annually to renew their approval to operate. Each time such companies wish to diversify into a different type of business, they are required to apply to the board for approval; this is a time-consuming, expensive and uncertain process.

Reputable foreign investors are likely to hold off committing resources to long-term projects until:

- they are convinced the law-and-order situation and macroeconomic regime will remain stable
- they can secure clear property rights or enforceable leases on the land the project requires
- business licensing and work permit conditions are liberal and welcoming
- foreign investment decision-making procedures are rapid and transparent
- infrastructure services are more reliable and cost effective.

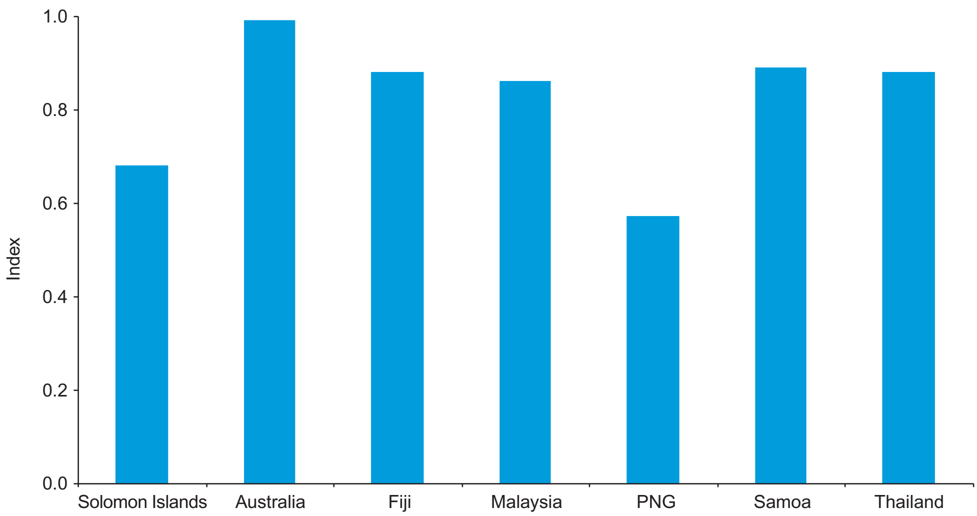
## Labour Laws and Wage Structures

Manufacturers and maintenance and technical services sectors complain of shortages of capable and experienced workers with accredited skills in machining, welding, plumbing, electrical installations, carpentry and joinery (Honiara Chamber of Commerce, 2003). Using education levels as a proxy for average skill levels, Solomon Islands appears to have relatively low levels of human capital compared to East Asia and even other Melanesian countries (Figure 4.3). Due to the shortage of technical training facilities, companies requiring skilled labour send their staff overseas to obtain recognised certificates and diplomas. In many key areas, there is a shortage of experienced workers (Industries Rehabilitation and Retention Taskforce, 2003).

Figure 4.3

**Educational achievement relatively low in Solomon Islands**

**Education Index, Solomon Islands and other selected economies, 0 to 1**




Note: The Education Index is calculated from weighted data on adult literacy levels and combined primary, secondary and tertiary gross enrolment, based on 2001 data.

Data comparisons should be treated with caution as data may be obtained from different sources.

Source: United Nations Development Programme, 2003.

Employers also face relatively high ‘on costs’ for employees, that is, costs above the direct wage cost. In addition to the compulsory contribution to the National Provident Fund and other costs such as annual and maternity leave, employers also are often expected to provide transport, clothing and housing allowances, medical assistance and performance-based allowances (Solomon Islands Chamber of Commerce and Industry, 2004). The cost of these additional benefits results in lower levels of employment and inhibits the growth of private companies.

Private employers believe the difficult and potentially hostile dismissal procedures, due to regulatory and cultural constraints, are another impediment to taking on new staff (Industries Rehabilitation and

Retention Taskforce, 2003). Employers who dismiss staff for legitimate reasons can be subjected to time-consuming investigations by the Government and face union difficulties. Overall, the quality of labour and wage structures make it difficult for local employers to compete against lower cost and more productive overseas suppliers in local and international markets.

## DESIRABLE POLICY REFORMS

To make Solomon Islands an attractive place for private businesses to invest, grow and drive output and employment growth, the Government will need to improve implementation of some current policies and undertake a range of reforms. With the restoration and maintenance of law and order as a base, the major policy reforms should be aimed at improving public sector governance and accountability; providing efficient and cost-effective infrastructure services; removing regulatory barriers faced by the private sector, including by foreign investors; building human capital through greater emphasis on vocational skills and training; removing labour market rigidities; making finance more available, including investment finance for indigenous entrepreneurs; and improving security of land tenure and abolishing foreign exchange controls. Work on some of these areas has started.

A reformed business environment is necessary to create a stable base on which the private sector can build. However, given the limited size of the private sector and number of experienced workers, further services to assist in the understanding and knowledge necessary for establishing and sustaining a new business could be considered. In this sense, programs such as donor-funded short courses on starting and growing businesses may be beneficial.

### Law and Order

The arrival of RAMSI has resolved immediate law-and-order problems. Solomon Islands is now a relatively well policed country including some 300 RAMSI police working with the Royal Solomon Islands Police in Honiara and 16 provincial outposts. Current levels of crime are low, consistent with those found in other Pacific Island countries, while threats against business and armed crime are almost non-existent. As a result, business confidence is returning cautiously. Given that investments are usually based on potential long-term returns, the work being carried out to strengthen the police force and provide a stable environment is an essential component of the recovery. Law-and-order issues are no longer a constraint on the immediate viability of businesses.

The restoration of law and order will need to be supported by:

- a professional and respected police force throughout the country
- an accessible, efficient and independent judicial system
- a review and possible update of many current laws to ensure they provide equal treatment for local and foreign business.

## Governance

The Government has been making positive changes to stabilise the environment for businesses. Notably, inconsistent and irregular applications of import and export duties have largely ceased and a significant campaign to increase understanding of taxation and gain greater business compliance has had positive effects on government revenue while standardising the business taxation environment.

Comprehensive reform of government administration is needed to ensure a more market-friendly and supportive environment for the business sector. In a general sense, desirable reforms would include:

- reviewing, updating, streamlining and, where necessary, abolishing procedures and regulations related to work permits, business licences, foreign investment approvals, pricing, foreign exchange and labour laws, to ensure they encourage development of an efficient private sector which enhances national welfare
- improving capacity to enforce remaining necessary regulations and to implement policies in an effective, transparent, non-discriminatory and client-friendly manner; this will require significant improvements in the capacity of the public service, effort in public servant training and strengthening of relevant departments and agencies' management capacity (see Chapter 2 – *Public Sector Reform and Recovery*).

## Access to Affordable Finance

Local small and medium-sized enterprises and the rural population need greater access to finance facilities. The availability of finance for indigenous small and medium-sized enterprises could possibly be facilitated through the revitalisation of viable credit unions (the previous number of credit unions is not likely to be sustainable). While there has been a call for the establishment of a new, independent development finance facility, the ability of such a facility to remain independent in a micro-economy such as Solomon Islands will be difficult and it may well follow the path of the Development Bank of Solomon Islands.

International experience suggests that when a bank reaches the stage of decline similar to that of the Development Bank, there is little option but to gradually manage its closure by collecting the maximum number of loans and paying out depositors to the maximum extent possible. Recapitalising the bank is not an option because the Government does not have the necessary funds, and support from donors is unlikely. The Central Bank of Solomon Islands is best placed to manage the bank's liquidation and, at the time of writing, had begun action to gain control of the Development Bank of Solomon Islands.

To further improve access to affordable finance, the Government, with help from development partners, needs to:

- service its domestic and external debts
- increase financial sector competition by opening up sectors like superannuation to new entrants

- strengthen the Central Bank's capacity to provide prudential oversight of the financial sector, including placing the supervision of credit unions under the Central Bank
- seek technical support for the National Provident Fund or, preferably, outsource its management or privatise the fund to a reputable private sector financial institution to help it develop a more viable investment strategy and separate it from Government control; it should be allowed to restructure its assets away from poorly performing state-owned enterprises towards a more balanced, profitable and less risky portfolio, including profitable local private and foreign assets
- strengthen land leaseholders' security of tenure and creditor rights to improve local borrowers' capacity to use local assets as collateral.

## Land Tenure

The Government and, as appropriate, aid donors, should give priority to achieving a workable land tenure system by:

- in close consultation with traditional landowners and as part of a long-term project, mapping out and registering traditional land use rights and patterns and, over time and with consent from customary owners, registering clear village and ultimately individual titles that reflect this customary use
- establishing a more secure and efficient mechanism, possibly based on Fiji's Native Land Trust Board, for compensating customary owners for land and selling long-term, market-priced land leases to commercial enterprises
- strengthening the Customary Land Appeals Court to ensure resolution procedures are fair, efficient and transparent
- providing supporting consultation and guidance procedures to assist traditional landowners understand their rights and obligations and effectively manage lease rental incomes in the interests of all landowners; lease payments should cover the cost of government assistance for landowners and project developers negotiating to transfer leases on customary land
- introducing supporting legislation protecting financial institutions' rights to transfer sound land leases to another party if defaulting borrowers provide land as security.

### FIJI'S SUCCESSFUL COMMUNAL OWNERSHIP

Communal land ownership is common throughout the Pacific Islands but some countries have addressed this potential obstacle to development in a constructive manner. In Fiji, a Native Land Trust Board manages and controls all customary land for the benefit of Fijian owners. It makes general policy relating to administration of land, approves new leases and renewal of leases, collects and distributes land rent, improves the pattern of land subdivision, and helps improve landlord–tenant relations. This system demonstrates good land recording, which was developed from land surveys and registration recorded during the colonial period, and can resolve many simple disputes without undermining the organic nature of customary land ownership. The Fijian system facilitates improved land management and stimulates development opportunities because valid leases can be created for customary land.

The Native Land Trust Board currently administers 28 701 leases on native land. Of these, 50 per cent are agricultural leases, 38 per cent are residential leases, 6 per cent are educational, recreational and religious leases, 5 per cent are commercial leases and the remaining 1 per cent is made up of industrial leases.

The board encourages landowner participation in major projects involving intensive investment, both locally and offshore. They observed that when landowners are part of the development, the business usually proceeded smoothly with minimal risks of dissatisfaction with the project's purpose.

The board was created under the Native Land Trust Ordinance of 1940.

Source: Native Land Trust Board, 2003.

## Developments and Land Tenure

Central and provincial government authorities need to establish a process for potential developments whereby:

- traditional landowners affected by a resource project are clearly and unambiguously identified from the outset
- a Landowner Council or similar body is established, through an open election process, to negotiate with prospective resource developers on behalf of landowners
- options for an equitable agreement with the resource developer are explained in an honest manner to all of the landowners; this can be a time-consuming process but it is vital in ensuring landowner groups have realistic expectations regarding the commercial value of their land
- negotiations with the intending resource developer reflect the wishes of the landowners rather than the interests of individual Landowner Council members or influential outside parties

- implications of any proposed agreement are explained accurately and objectively to the landowners
- trust funds are established to manage any land lease payments in the interests of all landowners.

Successfully addressing land tenure and development of communally owned land requires developers to foster a sense of ownership of the development process in the local community. Mutually beneficial relationships need to be developed. While it is important that new resource developments are not restricted in their sourcing of labour and goods, the engagement of local people and the development of local spin-off businesses can assist in local relationships.

Papua New Guinea's Lihir Gold mine shows that substantial investment in helping landowners develop income generating enterprises can result in resource developments and allow landowners to benefit significantly from development (see Chapter 5 – *Business Opportunities*). For example, in 2001 over K50 million was paid to Lihirian businesses that provided goods and services to the mine (Papua New Guinea Chamber of Mines and Petroleum, 2002).

## Foreign Exchange Policies, Trade and Investment

The future growth of many medium and large-sized businesses will depend on their capacity to access international markets. Solomon Islands is a small, low-income economy, so local markets provide limited growth opportunities for local firms. Open, predictable, transparent and rational trade and foreign direct investment regimes and foreign exchange policies are vital to support internationally competitive export sectors. Experience in many countries demonstrates that as trade barriers decline, exports and imports expand, the local economy becomes more integrated into global markets, local businesses become more internationally competitive and national income grows more rapidly (Economic Analytical Unit, 2003).

For investment recovery, it will be important to attract fresh foreign investment. This is because the economy has limited domestic savings and investment capacity. Few local investors have the capacity to undertake major projects urgently needed to generate significant export income and employment. Large-scale, export-oriented resource projects will require the human, financial and international marketing resources of experienced overseas investors.

The security environment and market conditions are improving. Prime Minister, Sir Allan Kemakeza, also has publicly welcomed foreign investment and, in a speech in early 2004, identified the minerals, forestry and fisheries sectors as suitable for foreign investment (Solomon Islands People First Network News, 25 February 2004). While the attraction of foreign investment should be pursued, care must be taken with specific financial incentives or exemptions which may attract short-term investments and advantage foreign companies over local firms. Instead, the Government should encourage investment through improvements in the general operating environment which also benefit local communities.

Important elements of a more open government approach to international trade and investment could include:

- reviewing the current tariff structure, trade quota restrictions and concession measures with the aim of streamlining, lowering and harmonising tariffs, possibly at one flat rate, tariffying quotas and abolishing unjustified concessions, thereby creating a more open, competitive and export-oriented private sector. Lower trade barriers would increase the access of enterprises involved in internationally competitive operations to lower priced imported inputs, as well as increasing the efficiency of all local enterprises by exposing them to international competitive pressures. With the increasing compliance with domestic taxation, this should not have an undue impact on government revenues

- reviewing foreign investment legislation to determine whether it is assisting Solomon Islands become a prosperous and internationally competitive economy or is merely protecting local business interests from competition; if necessary, legislation should be revised to encourage new investment
- reviewing and, if necessary, revising Foreign Investment Board membership and procedures to ensure they facilitate independent and timely processing of foreign direct investment applications and do not place unnecessarily onerous requirements on foreign investors. Board members should not include individuals with business or political portfolio interests in Solomon Islands as this creates a conflict of interest. In most economies, the board's functions are carried out in the Ministry of Finance or Central Bank. The Government could consider abolishing the Foreign Investment Board and moving its functions to the Ministry of Finance or Central Bank of Solomon Islands (with appropriate resources), or transforming the board into an investment promotion facility
- reviewing and, if necessary, revising land ownership and work permit legislation and regulations to ensure they are assisting Solomon Islands attract foreign investment
- gradually easing temporary foreign exchange controls to lower business transaction costs with overseas markets.

### Dollarisation Unlikely to Ensure Financial Stability

To provide financial and macroeconomic stability, several commentators have suggested Solomon Islands should 'dollarise' and adopt the Australian dollar in place of the Solomon Islands' dollar. Such analysts believe dollarisation would provide stability by reducing currency, interest rate and country risks, thus significantly improving the investment environment. They also believe it would increase fiscal discipline, removing the Government's ability to run significant budget deficits (Duncan, 2002).

Other commentators have drawn attention to the costs of dollarisation. Two issues are critical in deciding whether to adopt the common currency of another economy. First, the economies sharing the currency should be likely to share the same external shocks. Second, nominal wages should be flexible, particularly in the downwards direction, so that the economy can adjust to shocks to which the common currency does not, otherwise all adjustment must be through unemployment (Duncan, 2002). Solomon Islands exports only a few commodities while Australia has a much broader export base not focused on similar products. While Solomon Islands does not have restrictive wage legislation, it is heavily unionised in some sectors and has price controls, reducing price flexibility significantly.

On balance, dollarisation may not be a prudent option for Solomon Islands at this time. The reasonably limited potential benefits from fiscal discipline and foreign exchange stability are unlikely to outweigh costs imposed from loss of currency flexibility to respond to domestic and international shocks.

### DOLLARISATION'S COSTS AND BENEFITS

Proponents of dollarisation anticipate its benefits would include the following:

- as dollarised economies cannot print their own currency, dollarisation precludes central bank financing of budget deficits, inducing a higher degree of fiscal discipline. It also saves the costs of running a central bank. However, governments may run large arrears as a means of avoiding fiscal discipline
- economies that dollarise may benefit from lower interest rates by removing exchange-rate risk, particularly the possibility of devaluation, reducing debt-servicing costs and spurring investment
- reduced transaction costs. By using a developed economy's currency, the cost of international trade and foreign direct investment would be reduced, as their exchange-rate markets are much more liquid
- the economy cannot experience its own exchange-rate crisis. Such crises are debilitating for firms that have assets and revenues in local currency, but liabilities denominated in foreign currency; depreciation undermines balance sheets, reducing the collateral firms can use to secure credit.

However, dollarisation also has several major costs:

- dollarised economies lose the ability to respond to adverse real shocks or, in fact, to reach fair value of an overvalued exchange rate by allowing the exchange rate to depreciate. This forces them to rely on less flexible adjustment through prices and nominal wages
- dollarised economies cannot independently set nominal interest rates so cannot respond to adverse real shocks by loosening monetary conditions
- the central bank of dollarised economies cannot respond to domestic liquidity needs in the event of a banking crisis as it cannot extend credit to distressed banks
- dollarising economies also incur the cost of acquiring the foreign exchange of another economy and losing the revenue earned from printing money (seigniorage).[3]

Source: De Brouwer, 2000; Edwards, 2001; Duncan, 2002.

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[3] Furthermore, dollarisation could be an expensive exercise. Dollarisation would require all local currency in circulation and commercial bank and government deposits at the Central Bank of Solomon Islands to be replaced with Australian dollars. At September 2003, around SBD100 million was in circulation, commercial banks held SBD110 million in the Central Bank and the Government held SBD58 million (Central Bank of Solomon Islands, 2003d). Focusing on these alone and ignoring any outstanding Treasury bills that eventually would have to be redeemed for Australian dollars, this totals to SBD268 million, or around A$54 million at the September 2003 exchange rates. Thus, at September 2003, the Government would need to have over $50 million in Australian dollars or credit to meet this currency swap.

## Labour Market

As the economy improves it will be important, for future economic growth, to have a flexible and productive labour market. Removing unnecessary rigidities, such as excessive employment costs and difficult dismissal procedures, in the local labour market is essential to ensuring the private sector can expand and absorb the country's growing population into productive and rewarding employment. As labour moves out of low productivity subsistence agriculture and into higher productivity activities in the formal economy, incomes will grow and living standards will improve. Expanding employment also is essential to spread income-earning opportunities more equitably across the population, improving social stability and helping sustain the recent restoration of law and order.

At present, restrictive labour market regulations and inadequate vocational training facilities discourage formal sector employment, holding back private sector growth and overall economic development. To address these problems, the Government should give priority to labour market and related reforms in consultation with interested parties. Specifically, the Government should:

- permit more flexible dismissal criteria and procedures
- review minimum wage rates for skilled and unskilled workers, allowing labour supply conditions and labour productivity to play a greater role in determining wages
- promote more realistic provisions related to substantial 'on costs' associated with employees. Expectations that employers meet such costs as housing, medical expenses, and transport and clothing allowances make it difficult to provide an internationally cost-effective business.

The Solomon Islands Government and development partners also could encourage private sector employment growth by ensuring adequate demand-driven and accredited technical training facilities are available within Solomon Islands. The Solomon Islands College of Higher Education could be strengthened to better provide this service.

## Other Regulations

Many other regulations, including many the Honiara City Council enforces, hold back private sector growth.[4] Regulation is an important tool in providing a stable environment for business to operate within. However, the balance between a stable operating environment and a regulatory regime which overly impinges on the operation of business has been lacking in Solomon Islands. The Government could usefully consider establishing a one-stop-shop approach to provide easy access for local businesses to deal with government and could review, simplify, reform or abolish:

- business licensing regulations and provisions with a view to: a single permit covering a range of related activities; cutting the cost of licences; reducing administrative hurdles and time taken to secure the single permit; and increasing the duration of licences

4 The Honiara City Council was dissolved in January 2004 and an authority under the Government's Department of Home Affairs has taken over these responsibilities, pending election of a new Council later in 2004.

- customs regulations and operations which business believes are non-transparent; the Audit Department in 2003 carried out an audit of Customs and made significant recommendations for reform
- work permit regulations, increasing the maximum permissible length of stay.

In addition, business believes the implementation of the taxation regime needs to be more transparent and equitable (Industries Rehabilitation and Retention Workforce, 2003). The work in late 2003 and early 2004 to increase taxation awareness and compliance will address some of these concerns. The numbers of exemptions should be minimised and a workable appeals process for disputes over assessed tax should be introduced.

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## APPENDIX 4.1 – RESULTS OF SOLOMON ISLANDS BUSINESS SURVEY

The Industries Rehabilitation and Retention Task Force, a Solomon Islands Government and private sector body tasked with facilitating the rehabilitation of closed industries and the retention of existing businesses in the Solomon Islands' economy, commissioned an extensive survey of the private sector during the first half of 2003. A summary of its results, outlined below, helped inform much of this chapter's discussion on the major constraints facing private sector development and policy implications.

| What businesses need | Private sector's perception of situation in Solomon Islands in mid-2003 | Implications for supportive private sector policies |
|---|---|---|
| Confidence in the rule of law | Perceived political interference, ineffective law enforcement and corruption undermined the private sector's confidence and stopped productive and responsible foreign investment. | The restoration of law and order and transparent government procedures are the fundamental first steps in developing an appropriate environment for private sector growth. |
| An appropriate legal framework and an effective court system | The legal framework itself is not the main concern – it is the manipulation and flouting of the laws that has undermined the private sector's confidence. The local court system is regarded as reasonable but inadequate government funding risks the collapse of the system. The High Court has, however, performed well and handed down a number of landmark decisions. | The initial emphasis needs to be on the impartial and efficient application of the existing legal framework as it relates to issues such as political interference; this undermines the original intention of the law. Once this has been achieved, appropriate amendments to laws and regulations can be considered, especially in those areas which impact on the day-to-day operations of a business, such as customs procedures and tax regulations. |
| Simple and transparent land and property registration process | The difficult, cumbersome and unclear land registration process is a major impediment to private sector development in the provinces. This creates problems with disputes, uncertain compensation claims and in the provision of acceptable security for bank loans. | Further work on a comprehensive land titling and registration system should be undertaken as a priority. The current system is a serious impediment to foreign investment and to the economic development of the provinces because of the uncertainty for private investors and the associated difficulties in providing acceptable security for bank loans. Appropriate dispute resolution procedures also are required. |

| What businesses need | Private sector's perception of situation in Solomon Islands in mid-2003 | Implications for supportive private sector policies |
|---|---|---|
| Minimal bureaucratic control and red tape | The Government was perceived as intruding into all aspects of business and the 'collapse' of the public service has compounded this problem. There is no 'level playing field' and the private sector simply wants the government to focus on its role of public investment in infrastructure and social services. The Foreign Investment Board and the Honiara City Council, in particular, are frequently criticised for their intrusive, disruptive and non-transparent procedures. | Government at all levels needs to adopt a more private sector-friendly approach. Priorities should include reviews of the Foreign Investment Board's functions, the perceived disruptive and unpredictable practices of the Honiara City Council, the operations of Customs and the procedures applied to the provision of work permits. These reviews need to identify practices that will be more transparent, predictable and customer friendly. |
| Easy access to information on laws and regulations | The private sector complained it is difficult to secure copies of relevant laws and regulations – these are frequently not obtainable at any cost. | It will be important to institute a program to make available copies of relevant laws and regulations on a user-pays basis. |
| A reasonable and comprehensible taxation system | The taxation system is not regarded as difficult to understand and there were few complaints about it being unreasonable. However, the private sector objects to arbitrary collection and enforcement procedures and the government's apparent refusal to acknowledge provisional tax refunds that are due. There also is concern over the relatively high import duties imposed on manufacturing inputs (despite the allowance for duty-free entry under Item 26 of the Customs and Excise Act) and the perceived blatant circumvention of import duties by influential parties. | A more transparent and equitable taxation regime is badly needed. This should incorporate very few exemptions to minimise the scope for actual or perceived favours to particular parties, as well as a workable appeals process for disputes over assessed tax. |

| What businesses need | Private sector's perception of situation in Solomon Islands in mid-2003 | Implications for supportive private sector policies |
|---|---|---|
| Clear and consistent economic and private sector policies by the government | The private sector in Solomon Islands felt that the Government has no understanding of, or commitment to, economic and private sector development. This reinforced its negative attitude to longer-term investment in the country. | A clear and pragmatic economic and private sector development blueprint needs to be implemented in the near future that takes into account the fundamental preconditions for a vibrant private sector. There should be a close liaison with the private sector and other stakeholders to ensure a credible and supportive program that is supplemented by appropriate laws, regulations and practices. |
| Transparency, consistency and efficiency in government services | The private sector felt that government 'services' do not pass any of these tests. There is perceived increasing corruption, collusion, inconsistency and inefficiency in all areas of government. | Measures will need to be implemented to both reduce the level of government interference in business and, where this is unavoidable, to ensure a transparent and efficient service. While government bodies are involved in various forms of regulatory approvals (for example, business licences and work permits), these procedures need to be more transparent and efficient in order to reduce the administrative burdens on business. |
| Availability of statistics and other information | Apart from the well-regarded Central Bank, other government agencies were not considered as capable of providing any useful or up-to-date information. | A medium-term priority needs to be the collation and publication of information that will assist the private sector in its decision-making processes. The first step should be accurate and up-to-date import and export statistics, local market sales and the more effective sourcing of available information on overseas markets. |

| What businesses need | Private sector's perception of situation in Solomon Islands in mid-2003 | Implications for supportive private sector policies |
|---|---|---|
| Access to available and appropriately skilled workforce | Most medium and larger-sized businesses reported that they experience difficulties in securing reliable staff with technical skills appropriate to their requirements. The perceived lack of suitable training institutions in the country means selected staff have to be sent overseas for qualifications and this adds to the cost of doing business. There also was increased concern over the arbitrary and perceived corrupt practices in granting work and residency permits for foreigners. The difficulties involved in dismissing staff also were regarded as an impediment to employment growth. | The policies and procedures involved in issuing work and/or residency permits and those relating to dismissing staff should be reviewed and streamlined as quickly as possible. Future government and aid donor programs in the education and technical skills training areas should take account of the needs of the private sector, particularly in terms of technical skills required by local businesses in the construction, manufacturing and resource development sectors. |
| Supportive and efficient infrastructure | Most businesses reported problems with the reliability and costs of utilities, telecommunications and transport infrastructure. These add to the costs of doing business, restrict opportunities for sales in the local market and seriously impede economic development in the non-urban areas. | Through a process of corporatisation and privatisation, a more supportive and internationally-competitive infrastructure needs to be developed for both overall economic development and to reduce the tendency for enclave resource projects. Power and communication costs in particular are high and often unreliable, while the reduced standard of inter-island freight services has had an adverse impact on the agricultural sector. |

| What businesses need | Private sector's perception of situation in Solomon Islands in mid-2003 | Implications for supportive private sector policies |
|---|---|---|
| Access to affordable and appropriate finance | Apart from those large companies with international connections, businesses reported that it was very difficult to secure a commercial loan and the high interest rates often made a loan, when available, untenable. The great majority of small businesses, particularly those owned and operated by local entrepreneurs, feel they have no chance of securing a commercial loan. The collapse of the Development Bank has eliminated this possible alternative source of finance.<br><br>A related and serious impediment raised by the private sector was the slow, cumbersome and ultimately costly procedures involved in securing Central Bank approval for import transactions. | A more stable political, economic and social environment would have a positive impact on the commercial banks' risk assessment of Solomon Islands and possibly result in lower interest rates. The Government also needs to address its outstanding bond obligations to the commercial banks to increase their liquidity and restore confidence in the 'sovereign risk' associated with operating in the country. Assistance and guidance needs to be provided to smaller business operators to understand the banks' funding proposal requirements. As soon as it is prudent to do so, controls over import transactions by local manufacturers and other productive enterprises should be relaxed. |
| Access to other financial services | Property and equipment insurance had become either impossible to secure or extremely expensive. There are no leasing facilities, the commercial banks' presence in the provinces was cut back and the number of operating credit unions has declined significantly. | The restoration of law and order will have an immediate and positive impact on the availability and cost of insurance. An institutional strengthening project for the credit unions could result in the provision of savings and small loan facilities in the provinces. Other financial services important to the private sector will develop in concert with economic growth and stability. |

| What businesses need | Private sector's perception of situation in Solomon Islands in mid-2003 | Implications for supportive private sector policies |
|---|---|---|
| Business support services and facilities | The private sector reported that there were a small number of capable accountants and business advisers and lawyers, but their charges restrict their services to mostly the larger companies. The calibre, reliability and confidentiality of the other business support service providers were regarded as questionable. Government agencies no longer have the resources to provide business advisory services and the New Zealand-funded Small Business Enterprise Centre focuses primarily on a (reduced) training course program. There is a range of other business support services (repair, servicing, freight etc.) but these have reduced since 2000 and are limited in scope by the relatively small market. | To promote small and medium-sized enterprises, particularly indigenous entrepreneurs, business support services need to be affordable and accessible. |
| Domestic market opportunities | The single most reported impediment to business was the poor local market conditions. The absence of customers, the drying up of liquidity in the economy and increased overseas competition from low cost Asian countries have resulted in weak cash flow and an overall poor financial position for most businesses. Most of the small and medium-sized businesses regarded the domestic market as their best option but until the economy improves and there is more disposable income amongst consumers, the prospects for increased sales are not bright. | Governance, regulatory, competition policy, trade, foreign investment and infrastructure sector reforms should boost domestic economic growth and market demand, while continued depreciation of the exchange rate should provide some protection from low-cost imports. |

| What businesses need | Private sector's perception of situation in Solomon Islands in mid-2003 | Implications for supportive private sector policies |
|---|---|---|
| Overseas market opportunities | Despite the apparent export opportunities afforded by the depreciated value of Solomon Islands' currency, most of the businesses interviewed did not consider they had the resources or knowledge to tackle overseas markets. This is understandable given the poor local market conditions as most businesses no longer have a solid income base to support exports, relatively weak commercial infrastructure and the overall lack of confidence in the private sector, reducing willingness to invest in new capacity. | Policies and programs are needed to facilitate a vibrant export sector in Solomon Islands. These include a welcoming and supportive environment for foreign investors with the resources to develop exports, privatisation of state-owned enterprises with the potential to export and possible duty draw backs on exporters' inputs. Promoting linkages and infrastructure connecting dispersed commodity producers and export-oriented enterprises also would encourage exports. |

Source: Industries Rehabilitation and Retention Task Force, 2003.

# BUSINESS OPPORTUNITIES

## KEY POINTS

- Several key industry sectors including palm oil, copra, cocoa and fish have contracted substantially causing a huge fall in foreign exchange earnings and employment.
- Major businesses, such as Solomon Islands Plantation Ltd, Russell Islands Plantation Ltd, Gold Ridge mine and Solomon Taiyo Ltd, were either forced to close or struggled to survive as markets dried up, infrastructure and equipment were destroyed, landowner problems intensified and access to finance was curtailed. Russell Islands Plantation and Solomon Taiyo (now Soltai) are operating, but with limited production capacity.
- Encouraging investors to consider nucleus estate programs for agricultural plantations may further assist palm oil, copra and cocoa production. Strengthening of the Department of Agriculture and Livestock to provide more effective extension services also could assist these industries.
- Mining opportunities are closely aligned with landowner issues. Adequate consultations with landowners and realistic landowner expectations are required. The development of spin-off businesses can contribute to peaceful and productive relationships between local communities and resource developers. While mineral extraction would be a valuable source of revenue, sustainable growth and development will require the development of other opportunities.
- Current timber production is unsustainable. Australia is providing assistance to strengthen the timber licensing regime. This is necessary to develop a more sustainable industry.
- To assist key productive sectors to become internationally competitive, a major effort needs to be undertaken to attract foreign investors who have capital, technology and a global marketing network and to support these investors with the business-friendly policies recommended in Chapter 4. Government divestment of its major businesses and plantations also would assist this process.

## NATURAL RESOURCES AND GROWTH

Solomon Islands' economy relies heavily on natural resource production, including logging, fisheries, and small-scale holder and, to a lesser extent, plantation agriculture. Prior to the turmoil in 1999 and 2000, a few key businesses dominated the copra, seafood, palm oil, cocoa, timber and gold sectors which accounted for over 85 per cent of all exports and the bulk of private sector employment. With the exception of round log exports, these sectors contracted after 1998-99, significantly reducing economic output, foreign exchange earnings and private sector employment. As Solomon Islands' international comparative advantage mostly still lies in these sectors, enabling them to regain and surpass their former production and employment levels is likely to be one of the quicker means of increasing private sector income and employment growth. Tourism and resource-based manufacturing also could have good prospects if the business environment improved.

The existence of natural resources alone does not necessarily translate into a competitive advantage in the further processing of those resources. Factors including productivity and the cost of labour are important. Private sector decisions should lead the formation and growth of industries. The Government can help by liberalising the regulatory environment, strengthening economic governance and reforming infrastructure service delivery. This would enhance economic prospects across the economy.

Natural resource exploitation requires careful management by government. A number of economies have performed poorly and experienced civil unrest despite the existence of significant natural resources. Solomon Islands can learn from the experience of other economies and its own natural resource experience in moving forward.

### NATURAL RESOURCES – 'BOON' OR 'BANE'

Some analysts believe possessing many natural resources is a fast route to national wealth. However, the evidence of economic failure in many resource rich countries does not support this belief. Botswana's diamond wealth has been used to fuel one of the fastest rates of economic growth in the developing world. Its performance equals that of East Asian economic tigers. However, Botswana's performance contrasts with that of Sierra Leone, Angola or the Congo, whose diamonds have become the cause of savage civil wars and national disintegration. Norway, the second largest oil producer in the world, has built up substantial assets abroad while Saudi Arabia, the largest oil producer in the world, has accumulated debts. While much of the literature focuses on mineral exploitation, resource exploitation extends to other areas, including forestry and fisheries.

Recent empirical research suggests an abundance of natural resources can hinder economic growth by unleashing forces that undermine national economic development, through rent-seeking behaviour, neglect of education, poor governance and the so-called Dutch disease.

**Rent-seeking.** Huge natural resource rents, especially combined with ill-defined property rights, imperfect or missing markets and lax legal structures create opportunities for rent-seeking behaviour. Making money from market distortions and illegal activities can divert resources away from more productive economic activities and breed corruption in business and government, thus distorting the allocation of resources and reducing both economic efficiency and social equity (Shleifer et al., 1993). Collier et al. (1998) show how natural resources increase the probability of civil war. Civil wars such as Africa's diamond wars not only divert production from socially productive uses, but also destroy social institutions and the rule of law.

**Neglect of education.** Natural resource abundance may reduce private and public incentives to invest in education due to a high level of non-wage income including dividends, social spending and low taxes. Empirical evidence shows that, across countries, school enrolment at all levels is inversely related to natural resource abundance as measured by the share of labour force engaged in primary production (Gylfason, et al., 1999). It is possible that abundant natural resources reduce the demand for training and education.[1]

**Poor governance**. Abundant natural resources may imbue people with a false sense of security and lead governments to lose sight of the need for good governance and growth-friendly economic management including free trade, bureaucratic efficiency, institutional quality and sustainable development (Sachs et al., 1999; Rodriguez et al., 1999). Incentives to create wealth through good policies and institutions may wane because of the relatively effortless ability to extract wealth from the soil or the sea.

**Dutch disease.** A natural resource boom and the associated surge in raw material exports can drive up the real exchange rate, causing manufacturing and service exports to fall (Corden, 1984). Dutch disease is named after the Netherlands where this phenomenon was first identified during an oil export boom. Recurrent booms and busts also tend to increase exchange rate volatility, reducing investment in the tradable sector as well as exports and imports of goods and services (Gylfason et al., 1999). Dutch disease also can occur in countries that do not have their own currency. A boom in the resource sector increases wages in that sector, thereby attracting labour from other industries or imposing higher wage costs, especially in economies with centralised wage bargaining. Through some or all of these channels, the Dutch disease can reduce total exports relative to total output or at least skew the composition of exports away from manufacturing and service exports that may contribute more to economic growth and employment (Gylfason et al., 1999).

Source: Gylfason et al., 2002.

1 However, this finding may be distorted by including in the sample large numbers of resource rich but low-income developing countries in which most people are employed in agriculture.

## SMALLHOLDER AND PLANTATION AGRICULTURE

After 1998, production of palm oil, copra, coconut oil and cocoa decreased significantly (Figures 5.1–5.3). While recent estimates indicate that production for 2003 was much improved, cocoa was the only agricultural product, aside from timber, to approach or exceed 1998 production levels.

Many factors constrain agricultural output including:

- unreliable and, in some cases, expensive sea, land and air transport, electricity and water supplies, and storage infrastructure
- difficulty in accessing land suitable for agricultural projects stemming from problems in converting customary land to secure long-term leases
- poor or non-existent agricultural extension services
- crisis-induced deterioration of most copra and cocoa plantations and copra dryers and other equipment used by suppliers
- a weak and fragmented local market, with many buyers and exporters suffering from inadequate working capital
- inadequate access to finance due to commercial banks' risk aversion to agricultural projects and the Development Bank's failure.

Several of these impediments can be addressed through broad-ranging policy initiatives that address the land registration, transport, sea freight and financial services shortcomings already outlined. Provincial governments also have an important role to play in providing supporting infrastructure and extension services that prioritise agricultural and plantation projects.

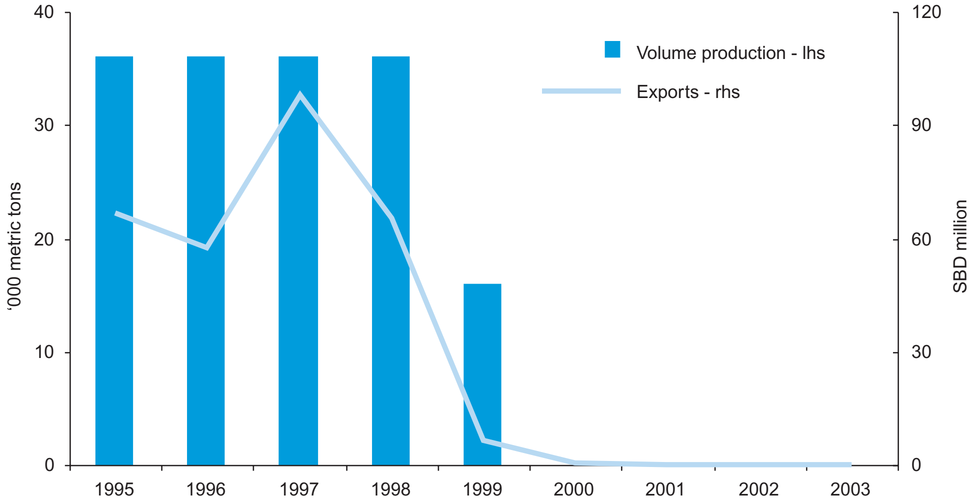
### Palm Oil and Kernels

Between 1995 and 1998, palm oil and kernel production was 36 000 tonnes per year. Since the closure of Solomon Islands Plantation Ltd (SIPL) in 2000, production of both products has virtually ceased and a valuable export industry, worth SBD98 million in 1997, has been wiped out (Figure 5.1).

Figure 5.1

**Palm oil industry wiped out**

**Palm oil and kernels production and exports, 1995–2003**




Source: Central Bank of Solomon Islands 2000, 2001, 2002, 2003a, 2003b, 2004; Asian Development Bank, 2003.

## SOLOMON ISLANDS PLANTATION LTD

The large and internationally competitive SIPL palm oil plantation and processing operation on the main island of Guadalcanal was an early casualty of the social unrest in late 1999. This project was jointly owned by the Commonwealth Development Corporation (now CDC) and the Solomon Islands Government. It employed almost 1800 people, mainly from the province of Malaita, and its palm oil output and palm kernels were exported to several overseas markets.

During the height of the civil unrest the operation was forced to close and most of the infrastructure and the oil mill itself were subsequently destroyed. While there were broader law-and-order issues involved, the key factor was a simmering dispute between the traditional landowners and the primarily Malaitan workforce. The former felt that these workers and their extended families who joined them were increasingly encroaching on their land. A perception also developed that the financial benefits of the project were not being distributed equitably.

The SIPL landowners have indicated they will not negotiate on the reopening of the operation until the Government pays the outstanding land rentals for 2001 and 2002, amounting to SBD1.3 million, and strikes a satisfactory arrangement for payment of the landowners' compensation claims. The landowners' initial claim was for SBD23 million. The Government has determined that the outstanding land rentals cannot be paid. While landowners may be prepared to negotiate on their claims, extensive consultations would be required before some consensus could be achieved.

The Commonwealth Development Corporation estimates it would cost up to US$25 million to rehabilitate SIPL and has indicated it is not prepared to risk this level of investment.[2] It has no further interest in SIPL beyond an appropriate exit. The Commonwealth Development Corporation has offered its majority shareholding to the Solomon Islands Government for a nominal amount.

Until recently, there was little overseas interest in SIPL and there was doubt whether this once valuable business could be restarted. However, a number of businesses now have expressed interest in SIPL. The plantation trees are in reasonable condition, despite the spread of some disease and the end of their period of maximum productivity. The main obstacle to restarting the business is its troubled and unresolved history.

The SIPL project clearly demonstrated that palm oil can be a profitable business in Solomon Islands but its failure also showed that ethnic conflict and unrealistic expectations of landowners can destroy the economic activity from which they wish to exact benefits. Potential undoubtedly exists for new palm oil plantations and processing operations; plans exist to commence a new palm oil plantation in Malaita. Overseas companies have shown interest in palm oil projects other than SIPL, but there are concerns that their prime interest is in the timber that would have to be cleared either to expand the existing small-scale operations or to establish a new plantation. However, any overseas investors in new palm oil projects will be deterred from proceeding unless the following conditions are in place:

- clear and enforceable land lease provisions
- an available and willing local labour force and acceptance of good employees irrespective of their ethnic background
- supporting physical and transport infrastructure
- a transparent and welcoming investment regime and acceptable work and residency permit regulations and procedures.

The central and provincial governments need to help ensure these basic pre-conditions are met to attract genuine investors rather than those interested primarily in the timber on the selected plantation site.

A potential model for palm oil and other plantations which has succeeded in Melanesia is the nucleus or outgrower scheme. This is where a centralised plantation has an arrangement with smaller, surrounding plantations for the purchase of their product. This approach revolves around input–

2 The New Britain Palm Oil Company, who have expressed interest in SIPL, are reported to have estimated that it would cost around SBD129 million to rehabilitate SIPL (Solomon Islands People First Network News, 14 April 2004).

output linkages for small-scale farmers who may receive such assistance as credit and extension services from the nucleus estate. Given the relatively poor access of most agricultural suppliers to credit, extension services and agricultural inputs, and their inexperience in national and international marketing, considerable benefits would flow from a nucleus estate and/or farm strategy in Solomon Islands. The interest of the New Britain Palm Oil investors in Solomon Islands is a positive step.

## HARNESSING PRODUCTION THROUGH NUCLEUS ESTATE SCHEMES

The purpose of nucleus estate schemes is to generate mutual benefits for both the nucleus farm and the outgrower. Central processing and some plantation acres complement surrounding small-scale holders. The nucleus farm benefits from an assured supply of product from outgrowers to supplement its own production for marketing while outgrowers are assured of a stable market for their production. Outgrowers also can benefit from credit, organisational and managerial skills, and extension services from the nucleus farm. Both the nucleus farm and outgrowers stand to benefit from bulk purchase prices. Storage facilities also can be shared and some production risks can be managed more effectively through a large production unit.

Most past experience with nucleus estates relates to industrial crops; this model also can be used for food crops, livestock and fisheries. Usually a large agri-processing investor will be needed to initiate large nucleus estate schemes, but smaller farmers could launch smaller schemes on a cooperative basis around lower cost processing facilities. While national or provincial agriculture offices could provide advice on how to start up such schemes, they should not attempt to replace private sector players. Establishing nucleus estate outgrower schemes may involve identifying and mobilising interested farmers, undertaking initial surveys to assess project viability, matching potential nucleus estates with suitable outgrowers, identifying appropriate processing technologies and demonstrating these to nucleus and outgrower farmers, drafting appropriate contractual agreements between nucleus farmers and outgrowers, advising nucleus farmers on relations with outgrowers and, if necessary, possibly helping train participants in business management.

A number of successful examples of different schemes exist, such as the Nucleus Palm Oil estate in West New Britain, Papua New Guinea, and export-oriented horticultural nucleus estates in Kenya. In India, a milk producer’s nucleus farm run by the National Dairy Development Board involves small-scale producers and Pepsi Co. runs several major nucleus schemes to purchase vegetables in the Punjab.

## Copra and Cocoa

Copra and cocoa were both important commodities before the turmoil in 2000. The leading producer and exporter of these products has been the Russell Islands Plantation Estates Ltd (RIPEL) operation.

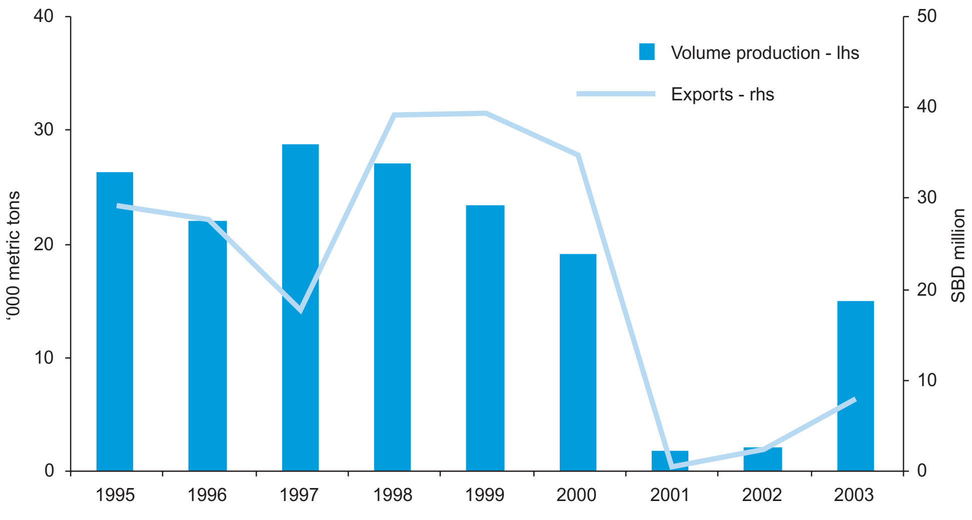
### Copra

Collecting and drying copra is one of the few income earning opportunities available to most small-scale farmers throughout Solomon Islands and generates significant export revenues for the country. In 1997 and 1998, the country produced 27 000 to 29 000 metric tonnes of copra, and in 1998 and 1999 the sector generated income over SBD39 million (Central Bank of Solomon Islands, 2003a). However, production plummeted in 2000 and 2001 due to the ethnic crisis and low world copra prices. World prices have increased from the very low prices in 2000 and 2001, but remain well below historical levels (Figure 1.9). Production is rising but remains well below 1997–98 peaks (Figure 5.2).

Figure 5.2

**Copra industry collapsed but recovering**

**Copra production and exports, 1995–2003**




Source: Central Bank of Solomon Islands 2000, 2001, 2002, 2003a, 2003b, 2004; Asian Development Bank, 2003.

After the copra industry was liberalised in 2000, the Government's Commodities Export Marketing Authority, which market players had criticised for its inefficiency and bureaucracy, lost its monopoly purchasing rights and the copra price stabilisation program was abolished.[3] However, the authority still allocates export licences to private companies, most of which do not have the resources to fill the collection void created by the authority's withdrawal. High inter-island freight costs and limited services to most coastal wharves also are a significant barrier to the industry's recovery, particularly given low world prices for copra. During the downturn in the industry over the past three years, much of the local drying and handling equipment has deteriorated, and financially weakened local producers have few resources for replacement. Those suppliers who are able to supply copra have often found that the financial rewards, after payment of the internal freight costs, do not warrant the effort involved and do not provide sufficient profits to rehabilitate the plantations and the processing equipment.

Despite the long run decline in world prices, copra is one of the few potential income sources for a large number of rural suppliers. Until other, more lucrative agricultural commodities can be developed, assisting the rehabilitation of the copra industry must remain a priority. Private sector suppliers are starting to supply new drying equipment in some provinces, but cost and lack of access to credit remain a problem. Another urgent need is for an improved transportation network including efficient and affordable inter-island shipping.

The following measures would assist the industry:

- abolish the requirement for export licences
- privatise the government-owned Western Coconut Products operation at Noro, Western Province, to provide a reliable market for copra in this region; the Western Coconut Products operation has the equipment (including an oil crushing mill) and enjoys a strategic location at the Noro port to become a significant player in the copra industry, but it is hamstrung by its government ownership and weak financial position
- encourage entry of a new investor in RIPEL to enhance the company's financial position. This would enable both increased purchases of copra and the re-establishment of its coconut oil mill
- privatise sea freight services around the country to reputable and efficient operators; current irregular and expensive services undermine the industry's commercial viability
- encourage the entry of private oil millers and copra buying agents around the country by completing the sale of the Commodities Export Marketing Authority's oil mills to reputable private oil millers and by removing regulatory and investment restrictions.

3 By 1999, the Commodities Export Marketing Authority had set up 50 buying points and its inter-island freight vessels called at 55 locations around the country. In addition, the authority established six small coconut oil processing mills providing an ongoing market for local copra suppliers. However, the authority operated at a loss and the industry was liberalised.

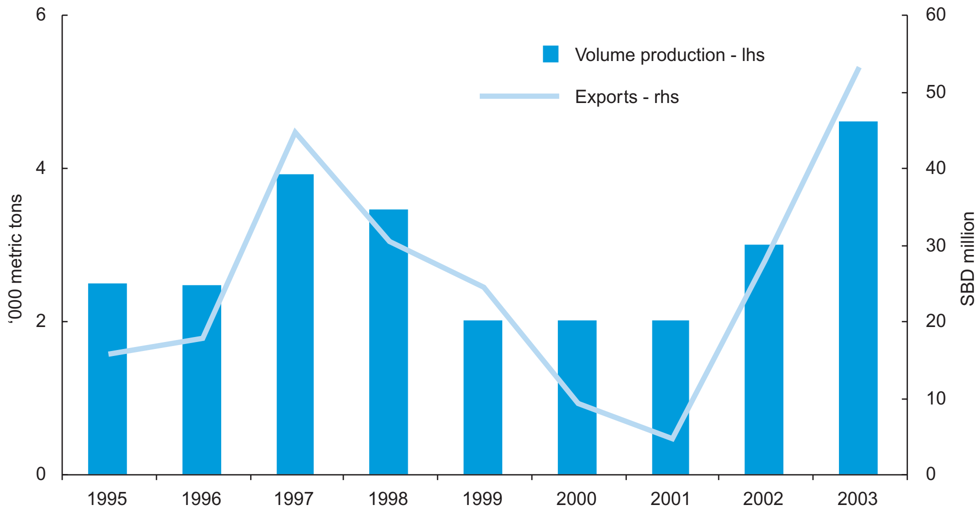
## Cocoa

Cocoa represents a potentially valuable export commodity for Solomon Islands. The Commodities Export Marketing Authority estimates Solomon Islands could supply over 4000 tonnes of cocoa per year, the level achieved in 1997 (Figure 5.3), and estimates of production for 2003 support this. The Government's target is to increase annual production from the 2002 level of around 3000 tonnes to 5000 tonnes per year. However, many cocoa plantations deteriorated in 2000 and 2001. RIPEL's cocoa plantations on Guadalcanal were taken over by squatters, while core operations on Russell Island have suffered due to inadequate working capital and poor management.

Figure 5.3

**Cocoa industry volatile**

**Cocoa production and exports, 1995–2003**




Source: Central Bank of Solomon Islands 2000, 2001, 2002, 2003a, 2003b, 2004; Asian Development Bank, 2003.

The cocoa industry's problems are similar to those in the copra industry, including inadequately financed local buyers and exporters, high cost and unreliable inter-island freight services and suppliers' inadequate access to finance for rehabilitation of plantations. The relatively good prices paid for cocoa by local and overseas buyers have meant that the costs of the inter-island sea freight services have not represented a significant impediment in 2003 and production levels reflect this. However, the reliability and frequency of these services do impede expansion of the industry in more remote areas.

As is the case for copra, opening inter-island freight and the commodities marketing to capable and appropriately financed foreign investors could make a major contribution to this sector. Over time, institutional strengthening of the Department of Agriculture and Livestock to provide effective extension services to local producers also would assist the industry.

Few developing economies have comparative advantage in downstream processing of cocoa into cocoa powder, paste or butter. An adequately financed and experienced investor would be required to ensure success in this difficult and competitive market, but no subsidies or financial inducements would be justified.

### RUSSELL ISLANDS PLANTATION ESTATES LTD

RIPEL was the premier coconut, copra and cocoa plantation operation in Solomon Islands. The cocoa plantation alone was capable of producing 1200 tonnes per year and the business had a copra production capacity of close to 10 000 tonnes per year. A coconut oil processing mill also was installed at the site after the Commodities Export Marketing Authority's acquisition of the operation in 1995.

In the late 1990s, RIPEL sold some valuable land leases and it appeared to be performing reasonably well. However, due to continuing mismanagement, falling world commodity prices and ethnic tensions, RIPEL began to make losses in 1999 and 2000. It was forced to close in October 2000 and, around the same time, the Commodities Export Marketing Authority's monopoly role in the commodities sector was abolished. By September 2001, RIPEL was unable to meet its debt and was placed into provisional liquidation. A Scheme of Arrangement was approved in 2002 which involved a private overseas company gaining part ownership of RIPEL. It structured a deal that provided them with only a minority shareholding but a commission on all sales.

RIPEL currently is struggling to survive due to a weak working capital position and unwillingness by investors to commit additional working capital. Income levels are close to break even but the business does not have the financial resources to upgrade the operations. Coupled with a lack of adequate infrastructure and transportation, large volume exports have not been achieved. There is a real risk that this potentially significant contributor to the economy will continue to stagnate. Total copra exports by RIPEL in 2003 are expected to reach 6000 tonnes but this will not improve markedly its working capital position.

Unfortunately, the minimal shareholding held by the private overseas investor may make it difficult to sell this operation to a more appropriately resourced overseas or local investor, while the substantial shareholdings held by the landowners and the workers are unlikely to be surrendered easily and may make it difficult for another investor to obtain a majority interest in the company. Ongoing labour disputes, which have regularly reached the point of strike action, also decrease the attractiveness of the asset.

## Rice

Over the last few years, a number of pilot rice-growing projects have been undertaken under aid programs and, in 2003, several of these were converted into commercial operations when they were handed over to local landowners. Provided these operations are properly managed there is a domestic market for their output. However, the potential for exports is limited given competition from large international producers, while the labour intensive production methods required relative to other potential agricultural products also deters potential growers.

A local rice processing or polishing mill could potentially enhance the prospects for the industry's expansion, but it should be a commercial decision made by private investors without government assistance.

## Chilli, Ginger and Other Spices

A range of spices suitable for small-scale holder operations could potentially be grown effectively in Solomon Islands. The development of local chilli growing projects in the country was disrupted by a diversion to a new, untested variety that failed to capture sales. In those areas suitable for the growing of birds eye chilli, cardamom, vanilla and similar spices, good prospects exist for an export-oriented industry, provided local traders can undertake the overseas sales and provide growers with technical back-up.

Ginger is another product that could be grown in appropriate regions of the country. To date, this potential industry has been forestalled in Solomon Islands by weak local market demand, poor government extension services and the absence of a local operation to undertake the relatively simple processing that is required for export.

## Honey

Under a donor-assisted program a honey industry was developed prior to 1999. While the production volumes were relatively small, exports to New Zealand and other markets were well received by the customers as a high quality, organic honey. During the disruption in 2000, the industry collapsed and donor involvement was withdrawn. Attempts to revive the honey industry have been delayed by the discovery of disease in the bees and the absence of an investor with the resources to supply new hives and to develop exports. These problems will need to be overcome for the industry to develop into a viable export business.

## Livestock and Poultry

The cattle raising projects on Guadalcanal and at RIPEL were virtually wiped out in 2000 when most of the cattle were stolen and consumed. Herds have not been replenished because the private sector owners have been waiting for an overall improvement in the economy and, in the case of RIPEL, the business does not have sufficient capital to undertake a rapid re-stocking. Vanuatu has successfully developed a beef export industry and offers a good model. However, despite previous attempts by donors and the Government to develop the cattle industry in Solomon Islands, it has yet to develop into an export activity. Large growth in this industry would require significant capital, but a smaller industry, based on import replacement, could be viable. This is particularly the case where cattle can graze in coconut plantations.

The raising of pigs is a widespread traditional agricultural activity that has considerable commercial potential. Pig farmers returning to Malaita from Guadalcanal have established commercial pig farms in recent years. The unreliable supply of weaner pigs is the main constraint to further expansion of pig farming. A private sector abattoir with well-enforced hygiene standards would encourage this industry.

A high proportion of the chicken market relies on imported goods because no commercial suppliers or processors operate. Day-old chicks are imported from Papua New Guinea and a high proportion of chicken feed also is imported. As the economy improves, increasing potential should emerge for both commercial chicken farms and processing facilities to satisfy the local market demand.

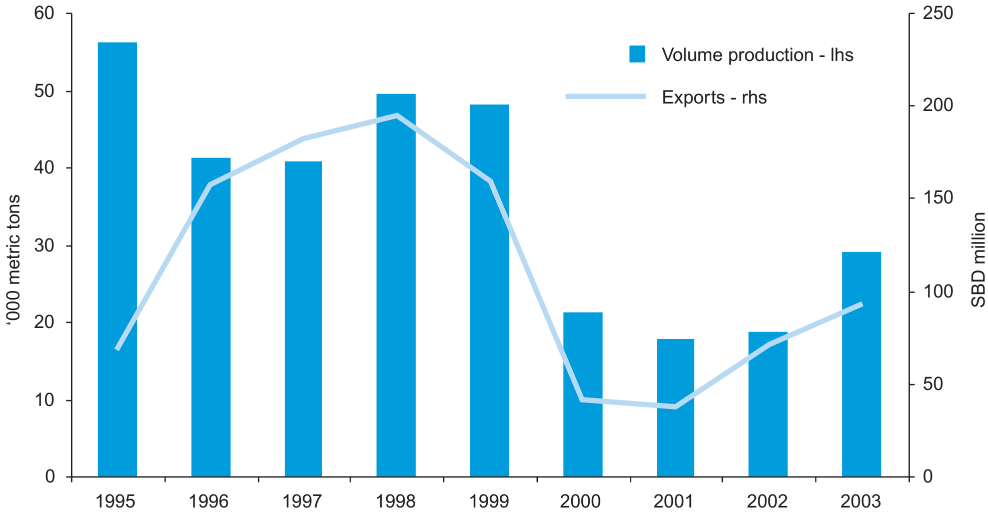
## SEAFOOD AND AQUACULTURE

The seafood industry offers potential for further development. Solomon Islands has abundant supplies of tuna but reported fish catches decreased by almost two-thirds after 1999 due to reduced operations of Soltai and the National Fisheries Development (Figure 5.4). Data indicates the annual quota of 120 000 tonnes of tuna allocated under the Distant Water Fishing Nations' agreements has not been achieved in recent years, although to what extent this reflects insufficient monitoring and under-reporting is unclear. Many international fishing fleets operate offshore and are largely insulated from any instability.

Figure 5.4

**Fish industry weak**

**Fish production and exports, 1995–2003**




Source: Central Bank of Solomon Islands 2000, 2001, 2002, 2003a, 2003b, 2004; Asian Development Bank, 2003.

Many impediments restrict the expansion of the local fishing industry, which is essentially subsistence with very few professional fishermen. Relatively poor infrastructure and transport facilities hold back the industry, including inadequate inter-island and international airfreight connections. Solomon Islands' stocks of reef and bottom fish are inadequate and depleted, with the exception of tuna. Tuna is being heavily fished by international vessels which dominate the industry. Of the 317 vessels licensed to operate in the country's exclusive economic zone, only 32 are local vessels. Commercial banks have a negative attitude to financing fishing projects because of the bad track record of such ventures in the country.

Among the large commercial operators, Soltai has inadequate working capital which prevents it from replacing and expanding its ageing fishing fleet. The privately owned National Fisheries Development's cautious business approach since 2000 has seen it reduce its operations. Solomon Islands also has inadequate ship repair and services facilities.

To stimulate more commercial fishing operations, the European Union and Japan funded the construction and management of 20 fishing centres around the country to provide both the market and supporting infrastructure for local fishermen. However, this project has had several significant problems and by late 2003 only seven were still operating effectively, all of which remain closely supported by the donors. Provincial government authorities primarily determined the sites for the fishing centres and in several cases the facilities could not easily access transport linkages for the on-selling of the seafood. While consultation with local communities is necessary and can be useful, donors need to be aware that non-commercial considerations can strongly influence local views and donors need to make their own professional assessment on matters that are critical to project viability. The supply of consistently high quality fish has been constrained by both a weak cool supply-chain system and the capabilities and commitment of local fishermen. Fishing centres have experienced difficulties in locating viable markets and transporting fish to market due to inadequate coastal freight services and unsuitable on-board facilities. Transportation of fish in coolers provides a very short timeframe to get the products to market. Declining reef and bottom fish stocks also undermine centres' viability as did the ethnic crisis.

In the aquaculture sector, a successful, export-orientated prawn farm operated in Guadalcanal prior to the crisis. This project incorporated appropriate technology and the output was highly prized by the overseas customers. However, the facility was destroyed and the private sector operators are not prepared to recommence until they see sustained improvements in the security environment.

In the newly improved security environment, considerable potential exists for other aquaculture projects. Several trials have occurred of coastal water giant clam-growing projects, sustainable capture and harvesting of live tropical aquarium fish and small-scale commercial farming of seaweed and bêche-de-mer. While appropriate technologies have been developed and trialled, the ethnic tensions terminated the former two activities, while the latter progressed slowly in 2002 and 2003. Good prospects also exist for aquaculture projects involving the growth of bait fish for the local and overseas fishing operations; most of the bait fish currently used is imported.

Several sector-specific policy initiatives could enhance the seafood industry's contribution to the economy. These include measures to increase adherence to the current Tuna Management Plan, implementation of the new Fishing Rights Based Management System and improved monitoring of the operation of overseas companies. Other industry-specific measures include the encouragement, through a functioning investment promotion facility, of projects incorporating seaweed farming, giant clams and the export of live tropical aquarium fish. Another industry-specific measure could include the sale or leasing out of the fishing centres to private sector operators who could use them to store and distribute marine products that do not require a cool chain such as trochus shells, bêche-de-mer or, where appropriate, more general agricultural products.

Revitalising the Government's health laboratory to allow it to operate as an accredited competent authority for the testing of tuna exports to the European Union would support Soltai and any other new investor in seafood processing and export. Privatising Sasape Marina also would assist the industry by improving this facility's capacity to provide maintenance and repair services.

Aid donors could assist the industry's growth by providing technical assistance, training and equipment for a competent authority that could provide inspections of seafood exports. Institutional strengthening of the Department of Fisheries and Marine Resources to increase its extension capacity to the aquaculture industry and its monitoring of foreign tuna licences also could be beneficial.

The development of the relatively new tuna export industry in Samoa holds lessons for Solomon Islands. This industry has become, within the last five years, one of Samoa's leading export sectors; prior to this Samoa was not a large exporter of seafood. Most of the smaller fishing operators supply larger companies who have the resources and knowledge to satisfy the overseas customers' demanding requirements.

The Samoan Government has supported the private sector, mainly through macroeconomic, monetary and taxation reforms, and it has allowed the private sector to take advantage of commercial opportunities in a stable and less-regulated environment. However, the low catches now being experienced by the fishing industry in Samoa are evidence of the need to adhere to a sustainable growth plan.

## SOLOMON TAIYO LTD AND SOLTAI

In 1999, Solomon Taiyo Ltd, a Japanese joint venture operation, was a significant exporter of canned tuna with an annual production of 1.1 million cases per year. It also produced 1200 tonnes per year of frozen and smoked tuna. The company operated an extensive fishing fleet, exported other tuna products and employed almost 2000 people.

However, the deteriorating security and economic situation resulted in the closure of Solomon Taiyo in August 2000 and the subsequent withdrawal of the Japanese joint venture partner in 2001. Following this, the Soltai Fishing and Processing Company Ltd (Soltai) was formed, with a 51 per cent shareholding held by the Government and the balance allocated to the Western Provincial Assembly.

Since its formation, Soltai has been struggling to grow. The canning plant is operating at below capacity, the remaining fishing fleet is securing relatively low yields and the operation is burdened with an inherited debt of SBD20 million. Employment has increased to almost 800 but this remains less than half the number employed in 1999. Soltai requires a substantial capital investment to upgrade and expand its ageing fishing fleet, boost liquidity and facilitate the required international marketing of its products.

Export opportunities are good for smoked and frozen tuna, but Soltai requires additional working capital to gear up for these opportunities and to meet the processing standards overseas customers and regulators require. Volume export sales of canned tuna also will require an investment in marketing and the support of an internationally approved government testing authority to verify the quality of the canned product. Sales of canned tuna in the domestic market will be constrained by weak demand and strong competition from Papua New Guinea.

Neither of the current government shareholders has the resources to refinance this operation. Despite the operation's effective management team, it could eventually fail due to inadequate investment. A capable foreign investor is required to revitalise this potentially valuable project. As no investor is likely to make such a commitment without majority ownership, the Government should privatise this enterprise as soon as possible via a transparent bidding process.

# MINERALS AND PETROLEUM

Solomon Islands may contain considerable mineral and petroleum resources. However, no overseas companies are currently exploring actively and the only mine in the country, Gold Ridge, has ceased operations. Some small-scale alluvial gold mining occurs, but this does little to boost the economy.

## GOLD RIDGE MINE

The Gold Ridge mine on Guadalcanal was commissioned in 1998 and prior to its closure in 2000 it generated in excess of SBD140 million of gross earnings in a single year. In addition to the economic benefits of the gold exports, the mine operation provided flow-on benefits to numerous other businesses.

The initial mining agreement between the owner, Delta Gold Ltd of Australia, and the Solomon Islands Government was signed in March 1997 and the lease was to last for 35 years. Ownership of the mine was subsequently transferred to Placer Dome and prior to its closure around 450 Solomon Islanders were employed at the site, approximately 80 per cent of whom were landowners.

In 2000, the deteriorating law-and-order situation resulted in the closure of Gold Ridge and all of the portable equipment, machinery and vehicles were stolen. The Gold Ridge landowners want the mine to reopen but they also want to negotiate a new and, from their perspective, more equitable agreement with the mining lease owners. Placer Dome had indicated that it would not contemplate reopening the mine until such time as law and order stabilised and those responsible for the theft of property were apprehended.

Placer Dome has now decided that it no longer wants to retain equity in the mine and the company has offered its remaining shareholding to AIG Insurance who acquired a substantial shareholding on payment of the insurance claim following the mine’s closure in 2000. AIG Insurance is not interested in operating Gold Ridge. It has arranged with CDC, which has a large outstanding loan to the operation, to undertake a study of the costs of reopening the mine and to then offer the project to interested investors through an international tender process. The tender procedures are likely to be finalised towards the end of 2004 and, assuming there is an interested investor, the first output of gold is hoped for in the second half of 2005. However, a successful outcome from the tender process is by no means assured.

In addition to the future commercial viability of the mine, there remains the outstanding issue of the landowners’ compensation demands which have increased from SBD3.1 million to SBD6.8 million and their future cooperation with a new mine operator. A prospective investor will be discouraged from any involvement with Gold Ridge if landowner issues remain unresolved and disunity is evident amongst the various landowner groups, or if any other factor points to future trouble.

An equally important requirement is the development of a consensus amongst the landowners at the grassroots level on the agreement they need with a new mine owner. In the past, problems arose when certain parties, either deliberately or inadvertently, misled the landowners into adopting unrealistic expectations in relation to the monetary and other benefits which would flow to the landowners.

The Solomon Islands Government Productive Sector Taskforce was established in early 2004 with a mandate to work with the Landowner Council toward re-starting the mine and to investigate new mine operators. Following this, elections for the Gold Ridge Landowner Council were held in March 2004 following the lapse of the previous Landowner Council. There could be benefits in demonstrating to the Landowner Council the advantages of an effective local business development strategy similar to the relatively successful approach adopted by the Lihir mine in Papua New Guinea.

When Gold Ridge will reopen is uncertain at this stage although there has been interest from appropriately resourced international companies. Reopening would require concessions from all parties and considerable leadership by the Government.

Solomon Islands' poor record to date in attracting and keeping foreign miners reflects negative international perceptions of the local business, political, security and investment environment. The closure of Gold Ridge compounded these assessments. Many infrastructure, regulatory and institutional obstacles currently restrict potential for developing the minerals and petroleum industries. The shortcomings in physical infrastructure including roads, airline connections, internal sea freight services, communications and power add significantly to the cost of any possible operation.

The minerals sector regulatory regime is set out in the *Mines and Minerals (Amendment) Act 1996* which stipulates that the owners of the land, under which mineral deposits are located, cannot claim in law to be the sole owners of those deposits. Such rights as they do have are shared between the Government and people of Solomon Islands. Under the minerals law and the similarly designed Petroleum (Production) Act, a commercial operation only negotiates with the landowners for 'surface access rights'; the right to grant licences for the search, exploration and extraction rests with the Minister for Mines and Energy. However, this concept does not reflect custom, whereby everything that both grows on and below land is inseparable from the land itself.

Landowner opposition to the minerals regime can seriously disrupt resource projects. In the interest of future harmonious relations with landowners, authorities need to strengthen procedures to ensure the traditional landowners are identified from the outset, receive an equitable distribution of royalty payments and are accorded the optimum opportunity to benefit from flow-on business development opportunities. The development of policy guidelines and appropriate strategies for the creation of viable spin-off businesses for landowners also could contribute to peaceful and productive partnerships between resource developers and the local communities.

The Department of Mines and Energy currently lacks the financial, manpower and equipment resources to effectively promote and monitor the industry. Ensuring adequate non-salary resources flow to the department via the recurrent budget and donor assistance to strengthen its capacity to assess and, if appropriate, facilitate potential projects by negotiating with landowners, advising on investment regulations and monitoring mining operations would be beneficial.

Landowners themselves must recognise the benefits of foreign investment and be more willing to negotiate with potential investors. Previous experience in Solomon Islands has deterred many potential investors and much work will need to be undertaken to attract new investors. While investment in mining is potentially a source of revenue for both Solomon Islanders and the Government, the belief that locals should be able to reap many rewards without significant commitment needs to be countered. Potential investors will look elsewhere if there is not significant reform both in the Government and in the attitudes of landowners.

Efforts continue to be made to reach agreement with landowners to allow a reopening of Gold Ridge. Reopening the mine would send a signal to international investors that the short and long-term outlook for the economy and law and order are both good and may stimulate exploration for other mineral and petroleum sources. However, failure to negotiate some settlement and reopen this proven mine would provide an equally powerful, but negative, message to potential investors. Apart from assisting landowners to reach an appropriate negotiating position, the Government also needs to provide certainty and predictability, including in the taxation regime, for companies looking to invest in Solomon Islands.

### LIHIR GOLD MINE IN PAPUA NEW GUINEA – A SUCCESSFUL PARTNERSHIP

The Lihir Gold mine in Papua New Guinea, established on Lihir Island in 1995, is an example of how landowners can be helped to become genuine business partners with the resource developer. Lihir Gold Ltd established a local business development office as one of its first activities. The landowners were organised into formally-constituted business groups and companies, and Lihir Gold’s business development office provided training, guidance and funding support to ensure that all the participants were capable of operating a viable business.

After 12 months, Lihir Gold subcontracted most of its services to Lihirian-owned businesses, including bus services, security, catering, hire of tradesmen and drivers, rubbish removal, food suppliers, secretarial services, office cleaning, vehicle maintenance and earthmoving equipment. Even the electrical services were subcontracted to the locally owned electrical authority. Forming landowners into well-organised associations which are legal business entities has been the key to the success of this approach.

Lihir Gold also helped the community by donating materials and money to schools, clinics and the local hospital and by sponsoring students for further studies. Mine managers promoted agricultural development by working with government agencies to rehabilitate project sites disturbed by the mine’s operation. The landowners planted cash crops such as coconut and ngali nut trees and commenced other income generating projects that will continue after the mine ceases operating.

Source: Papua New Guinea Chamber of Mines and Petroleum, 2002.

Mining is a useful source of revenue and can potentially provide both employment and investment. However, mineral exploitation in a poorly governed state often proves to be anything but a boon to the larger population. For sustainable economic growth and development, Solomon Islands also will need to develop other opportunities.

## TIMBER AND TIMBER PRODUCTS

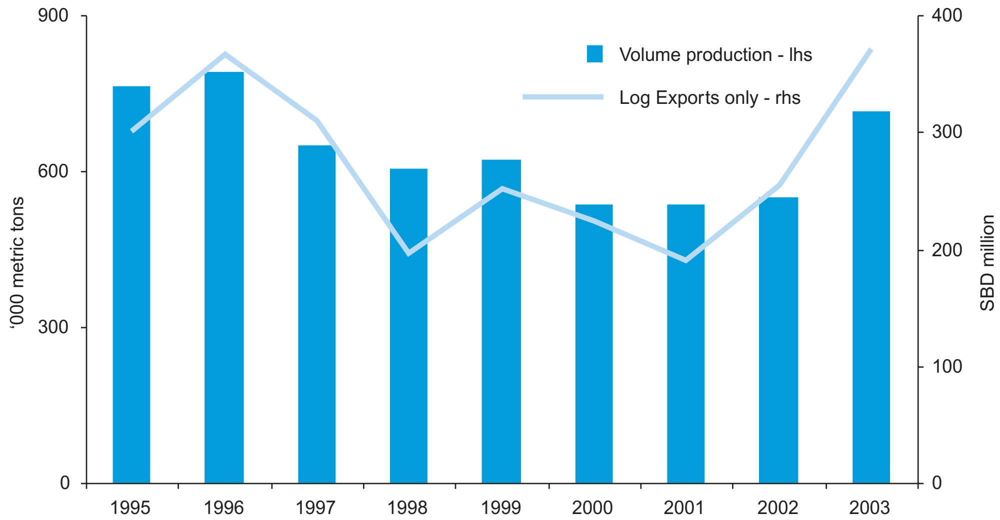
Since 1995, loggers have cut timber at the rate of close to or over 600 000 cubic metres per year (Figure 5.5). Based on an estimated cut of around 650 000 cubic metres in 2003, loggable natural forest resources would be depleted by 2015 (URS, 2003). However, the actual timber production of well over 700 000 cubic metres of timber in 2003 would see resources exhausted even sooner. Most of the harvest is exported in round log form to markets in Asia and there is very limited local processing of timbers.

The unsustainable harvesting of natural forests has been an issue of concern for almost 10 years. In light of the over-extraction in recent years, the annual cut would need to be capped at 263 000 cubic metres until 2049 to ensure a sustainable industry (URS, 2003). The over-harvesting not only represents a serious environmental problem but, as logging is estimated to have earned over 40 per cent of all customs and excise revenue in 2003, exhaustion of the natural forests also will have economic, government revenue and social implications (Ministry of Finance, 2003).

Figure 5.5

**Unsustainable logging operations**

**Timber production and log exports, 1995–2003**




Source: Central Bank of Solomon Islands 2000, 2001, 2002, 2003a, 2003b, 2004; Asian Development Bank, 2003.

Export taxes from log exports, at 25 per cent of the free on board value, provide the Government with significant revenue. In 2002, timber export duties accounted for just over 15 per cent of the Government's domestic revenue and around 38 per cent of all customs and excise collections (Ministry of Finance, 2003). The income from log exports to landowners, 15 per cent of the free on board value, also is significant. The foreign exchange earnings from ongoing log exports are particularly important to the economy as the foreign exchange earnings from gold, copra, cocoa and tourism have declined. A shortage of local timber will impact negatively on the local building materials, furniture and other industries.

Fortunately, in recent years, the Department of Forestry, Environment and Conservation and other investors have established several commercial plantations; production from these will increase from around 120 000 cubic metres in 2004 to around 200 000 cubic metres in 2020. Villagers also are planting teak and mahogany which will start to yield timber around 2008, when the first thinnings of teak and mahogany are undertaken; their production will increase timber production to around 250 000 cubic metres per year by 2030.[4] However, the available natural forests are expected to be exhausted before regrowth and commercial and village plantations can make a significant contribution. Hence, government revenue is expected to decline significantly from 2015 onwards, while village revenues from these high value plantations are expected to become substantial only from 2025 onwards.

Several larger-scale commercial timber plantations exist, but the only certified sustainable operation is Kolombangara Forest Plantation Ltd. This venture is jointly owned by CDC and the Investment Corporation of Solomon Islands. It leases and manages a 38 000-hectare site on the island in the Western Province from which it takes its name. The plantation forest occupies 12 000 hectares and produces around 70 000 cubic metres of hardwood logs for export each year. In ten years, it is expected production will be 120 000 cubic metres per year.

While this project experienced some difficult times around 2000, it managed to survive because of the harmonious relationship with the landowners, all of whom feel that they are a part of the business and have benefited materially from the operation. From a commercial perspective Kolombangara Forest Plantation Ltd is now experiencing strong demand for its Forest Stewardship Council certified timber and cannot satisfy all of its customers' orders.

One of the impediments to the imposition of more sustainable logging activities in Solomon Islands is the pre-eminent role of the landowners in agreements with the logging companies. Under the Forest Resources and Timber Utilisation Act, last amended in 1991, the role of government essentially is to ensure that there is an agreement between the customary landowners and the logging company.

4 While it takes 30 years to fully re-grow teak, the first thinnings can be sold after about five to seven years. Reforestation required of loggers has not, to date, worked well. About 13 000 hectares per year are logged and one estimate of the land already logged is 200 000 hectares, but altogether only about 60º000 hectares have been reforested. However, the Department of Forestry, Environment and Conservation remains optimistic about the speed of reforestation with some 4000 kilograms of teak and mahogany seed sold by September 2003 (Bugota, 2003).

The landowners have the right to exploit the timber resources and the Government has encouraged them to do so. Any attempt to reduce annual cut rates would require almost half of the valid landowner logging licences to be revoked; this would create a backlash from the affected parties and claims for compensation.

As at early 2004, the Forests Bill 2002 was awaiting Parliamentary approval. This bill proposes a code of practice, as well as national and provincial forest policies. In the matter of timber rights, the bill also proposes a more methodical and sustainable approach than in the past but this will not undo the damage already done.

## Strengthening the Timber Licensing Regime

The Government would find it difficult to override current valid logging licences but, with AusAID support, is attempting to enforce more rigorously the Code of Logging Practice entailed in the new draft Forest Bill due to be presented to Parliament in May 2004. In conjunction with ongoing institutional strengthening, potential methods of strengthening code supervision include:

- more comprehensive consultations with landowners prior to any new agreements with logging companies to ensure that fundamental code of practice requirements are understood and incorporated in such agreements and that the royalties paid benefit all the landowners, not just a few
- increased monitoring of all logging sites, three to four times per year, and suspension of licences held by those companies not achieving relatively high compliance; the current proposal is for suspension to occur if compliance is below 55 per cent but this should be increased within two years
- random and regular physical inspections of log shipments to check volume, species and pricing; training has already been provided and the Department of Forestry, Environment and Conservation should be able to fund these activities from the recurrent budget
- stricter enforcement of the required reforestation of harvested sites, preferably by requiring companies to provide seeds or seedlings to villagers to undertake reforestation.[5]

## Manufactured Timber Products

Downstream processing of timber is a sector in which Solomon Islands could have some competitive advantage and offers opportunities to generate local employment. The existence of a timber industry alone does not guarantee the existence of any competitive advantage in timber processing. Competitiveness depends also on the availability of skilled workers and their productivity.

5 The Forestry Department has found villagers prefer to undertake reforestation themselves as they then consider this ensures they retain ownership of the land and the newly planted trees. Plantings by forestry companies can raise concerns among villagers that the companies then have future rights to access or own the land and the new plantation (Bugota, 2003).

Local species are in strong demand overseas and, in the future, teak and mahogany village plantations are likely to have excellent international sales prospects. While good opportunities exist for rough sawn timber and finished timber products, the timber products sector remains relatively underdeveloped. Several companies produce sawn timber, mostly for export to Australia, but the volumes are only a fraction of log exports. A few local timber building material and furniture manufacturers also operate but mainly supply the local market.

Major impediments to the further development and export of manufactured timber products include:

- the shortage of local timber for milling because of the focus on round logs and exports; most logs are directly exported on special purpose ships from ports close to where they are logged
- the high costs of freighting the timber from outlying provinces to Honiara, where most manufacturers are located
- a generally inexperienced local workforce
- inadequate local kiln drying facilities
- the relatively high utility and imported input costs confronting the industry
- the high cost and infrequent timing of international sea freight services for mixed cargoes
- future expected declines in available local timber stocks.

Increased exports of rough sawn timber would be the logical first step, but would require increased local production capacity, more regular international shipping and kiln drying facilities. An export-oriented timber furniture industry would take some time to develop and in the medium term the emphasis might more profitably be on simply transformed items such as flooring, parquetry, decking and furniture components.

In relation to the future development and diversification of the timber and timber products industry, the Government could adopt a number of supportive policies, including:

- further institutional strengthening of the Department of Forestry, Environment and Conservation to provide extension services to small-scale, rural timber suppliers and family and/or village-based eco-forestry ventures, including the facilitation of closer linkages between small-scale timber suppliers and local processors
- sale of the Department of Forestry, Environment and Conservation's commercial plantations to investors who may maximise downstream processing in the country
- strengthened governance and economic management generally to attract foreign investors including in value-added timber production and kiln drying operations
- support for the establishment and initial operation of a local Timber Council to provide input to government on the development of a more responsible and internationally competitive industry.

## TOURISM

Given Solomon Islands' close proximity to Australia and New Zealand and its natural beauty, the tourism industry has strong potential to deliver broad economic benefits, including employment generation in the provinces, encouraging supporting businesses' development and earning foreign exchange. However, to date, the tourism industry has made only a modest contribution to the economy. Between 1997 and 2000, an average of around 14 000 visitors per year visited Solomon Islands; the only Pacific Islands receiving fewer visitors during this period were Kiribati, Niue and Tuvalu (Pacific Islands Trade and Investment Commission, 2003). The industry's contribution to government revenues also was modest. In 1999, it is estimated that the Government's 10 per cent tax on tourism facilities reaped SBD1.6 million, while departure tax receipts in that year were SBD512 000.

Tourists visiting Solomon Islands traditionally include diving enthusiasts, 'adventure' tourists and those interested in war sites and relics. Occupancy rates at the limited number of hotels have not been high and the more remote eco-lodges have fared poorly. Between 1996 and 1998, the average occupancy rate at the eco-lodges located near the Morovo Lagoon was only about 5 to 6 per cent. The industry has suffered badly since 2000 and will take some time to recover.

The tourism industry relies heavily on international perceptions and supporting infrastructure to be successful. The improvement in law and order is a necessary condition for the industry. Further improvements in the general business environment, including through improved infrastructure, better transport connections and a more welcoming foreign investment regime, would assist this industry.

The tourism industry could benefit from steps to increase the availability of training for hotel and hospitality staff in Solomon Islands, including through the Solomon Islands College of Higher Education.

## OTHER SECTORS

The recovery of other industry sectors, such as manufacturing, services and the wholesale and retail sector, will depend largely on the generic reforms needed to improve the private sector's operating environment (see Chapter 4 – *Creating the Right Environment for Business*). In the short to medium and even long term, only primary industries and manufacturing operations linked to competitive local resources supplies are likely to become internationally competitive. Most other manufactures and service providers will remain import replacement operations until they can achieve the economies of scale and internal strengths fundamental for a successful export business. Hence, reforms and policies that open the market to international investment and offer a more predictable and conducive overall business environment will promote economic growth, increasing the size and vigour of the local market and exports, and boosting prospects for all manufacturers, service providers and traders.

### Informal Sector

The informal sector, consisting of ad-hoc micro-enterprises, provides a vital, though small, source of cash income for a large proportion of the population. These informal, primarily rural-based, operations include small-scale commodity selling, vegetable growing, home sewing and similar part-time activities. The income these activities earn injects cash into small formal businesses such as trade stores. A high proportion of informal sector workers are women; their activities provide some independence and help meet families' essential needs including cash to pay for school fees. A common requirement of all those involved in the informal sector is a market for their output whether this is a commodity buyer or a vegetable market in a nearby town.

While from this base of part-time entrepreneurs some future indigenous business operators will emerge, experience in other Melanesian countries has shown that the majority of those involved in the informal sector do not have the desire or commitment to graduate to formal business operators. Therefore, the emphasis for government policies relating to this sector should be on those broad economic and governance issues that will improve the overall market for the output of the suppliers. If there is an improvement in consumer confidence and disposable income and the suppliers are able to get their produce or products to the market, they will be able to secure desired cash income more readily.

While improving access to credit can assist informal sector participants, experience with micro-credit schemes designed mainly to alleviate poverty in economies like Papua New Guinea has shown that they are fraught with difficulties. Limited local market opportunities, cultural and geographic impediments and the high costs associated with managing a micro-credit scheme in such an environment result in low repayment rates and, hence, an ongoing dependence on donor funding. A high failure rate amongst the supported micro-enterprises also creates adverse social and economic costs.

Rejuvenating credit unions in the provinces may be a more appropriate way to assist informal sector participants who genuinely wish to become permanent entrepreneurs. Prior to the crisis, credit unions provided savings and small loan facilities at the grassroots level. They were better placed than the formal commercial banks or even the Development Bank of Solomon Islands to assess small-scale loan requests, monitor performance and assist small-scale entrepreneurs on an ongoing basis. Donors with expertise in credit unions could assess whether, in the improved security environment, re-establishing local credit unions is a viable option. The Government could encourage the growth of all financial institutions including credit unions by strengthening and extending the Central Bank's prudential control capacity and undertaking comprehensive land tenure reform. The latter would increase the villager's capacity to provide security for even small loans. Aid donors could assist with technical support to the required credit union peak body which, in turn, would be responsible for training and other support to individual credit unions.

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# REBUILDING THE SOLOMON ISLANDS ECONOMY: PRIORITIES

RAMSI successfully restored law and order soon after it arrived in Solomon Islands on 24 July 2003. To ensure a lasting peace and progress towards economic prosperity, Solomon Islands will need robust economic growth. Any transition from the current economic state to economic prosperity will take some years. The economy needs an enabling environment for new private sector investment and income-earning activities in the villages. The Government's willingness to progress with reform is assisting this transition.

This report has focused on the many problems confronting the economy and presented options for reform of policies. In recent years, Solomon Islands has suffered from political instability, poor macro and microeconomic policies, fiscal mismanagement, a hostile investment climate and a lack of political will to undertake necessary reforms. While these problems cannot be solved overnight, this report has attempted to present a logical and reinforcing set of policies that, if effectively implemented, could turn around the economy and lead the country to a sustainable and successful economic growth path. A logical sequence of reforms which could be adopted by the Solomon Islands Government is outlined in this chapter.

In the short term, Solomon Islands' economic recovery depends on strong high level political commitment to fiscal consolidation and maintenance of the newly restored law and order. In the medium term, Solomon Islands needs to rehabilitate the core organs of government and to reform policies which currently undermine private sector activity including infrastructure service provision, state-owned enterprise operation, trade and foreign investment restrictions, and foreign exchange controls. In the longer term, Solomon Islands needs to address historical and cultural impediments to maximising the use of its resources and harnessing its people to gain competitive advantage in the globalised world. This includes clarifying customary land ownership.

## SHORT-TERM PRIORITIES, 2003–04

With the help of its RAMSI advisers, the Solomon Islands Government has made a good start in resolving its serious fiscal problems, but major challenges must still be addressed in 2004. These include resolving the significant arrears owed to local businesses and negotiating servicing of the country's massive foreign debt and local government bonds. Under-performing or non-performing government and state-owned enterprise debt is an issue for the Solomon Islands National Provident Fund, the Development Bank of Solomon Islands and commercial banks, while unpaid arrears are threatening local business. For some years, the Government did not pay its employer superannuation contributions to the National Provident Fund, nor did it pay state-owned utility providers for its electricity and water purchases. The public sector's wage bill consumes far too much of the budget, leaving little for essential non-salary, recurrent or development spending. Donors pay all of the country's development budget and about 25 per cent of its recurrent budget including 24 per cent and 33 per cent of recurrent health and education costs respectively. Reducing government borrowing and related debt obligation is essential to bringing down interest rates to encourage private investment.

The Ministry of Finance's priorities for the next 12 months include implementing the balanced Government budget, continuing to cleanse the payroll to remove ghost workers, ensuring no unauthorised, extra-budgetary expenditures occur, closing down illegal bank accounts, and ensuring departments receive their allocated funds and spend them on agreed essential goods and services. It also has developed a medium-term fiscal strategy which could usefully identify fiscal consolidation and spending priorities.

Maintaining newly achieved law and order, providing credible policing services, prosecuting wrong-doers and preventing any resurgence of militant activity also will be essential if Solomon Islands is to achieve a peaceful future. Apart from ensuring personal freedom, restoring and strengthening public security is necessary to reduce risk premiums associated with investment and provide a secure operating environment for existing businesses. Maintaining law-and-order services will require adequate funding to be allocated to these areas in the national budget including for police training.

## MEDIUM-TERM PRIORITIES, 2004–09

As Solomon Islands re-establishes fiscal stability, the next major priority will be removing the raft of barriers to income-earning activities and employment. These include a host of regulatory barriers, unreliable or high cost infrastructure services and expensive or absent credit facilities. Due to the ethnic crisis, lack of business confidence in government, high interest rates, weak infrastructure and communal land tenure, Solomon Islands suffers from a severe shortage of new investment in almost all sectors. However, the Foreign Investment Board has, in the past, sometimes allowed local vested interests to influence new foreign direct investment proposals. Foreign exchange controls also discourage new foreign investment and undermine the operations of existing companies. A raft of petty licensing and other regulations also discourage private sector activities. Reviewing and, where necessary, removing regulatory restrictions on business that serve no useful public policy goal is a high priority (See Chapter 4 – *Creating the Right Environment for Business*).

State-owned enterprises, plagued by inefficiency and poor management, under investment and massive arrears, currently operate inter-island shipping, domestic air, electricity and water services. To utilise fully and effectively all the resources available to it, the Government will need to attract and harness private sector finance and skills, and conserve its own scarce financial and human resources to deliver services only government can provide. In many developing and developed economies, private operators provide most infrastructure services more efficiently and at lower cost than government agencies as they have the incentives, policy independence and capital to do so. As soon as possible, the Government usefully could privatise or concession-out most state-owned enterprises in a tendering and regulatory framework that ensures costs to consumers are minimised and incentives to efficient operation and expanded services are maximised (See Chapter 3 – *Policies to Rejuvenate Utilities, Infrastructure and State-Owned Enterprises*).

Solomon Islands also faces severe pressure from local and foreign parties seeking economic rents from its natural resources, particularly timber and tuna. Timber exploitation is currently well above sustainable levels and will be completely depleted in 12 years unless urgent action is taken. The licences of loggers illegally ignoring environmental conditions of their leases should be reviewed with a view to terminating them. Pilot programs involving landowners reforesting their land, which currently are aid funded, should become a licence condition of operation for remaining licensees. Fishing monitoring and regulation should be improved to ensure sustainability of catches and the collection of appropriate licence fees. Sector-specific regulatory reform, state-owned enterprise and infrastructure privatisation and landowner concessions also are a high priority to kick-start recovery in the mining, palm oil, copra and local fishing sectors (See Chapter 5 – *Business Opportunities*).

In the medium to long term, the Solomon Islands Government will need to maintain its commitment to reform and growth if it is to have any hope of breaking its dependence on donor assistance and fully fund its recurrent and eventually its development budget. Solomon Islands has traditionally been heavily donor dependent and to break this dependence in the medium term will require steady determination in the implementation of reform. This will require undertaking a vigorous process of economic renewal and reinvigoration and right-sizing of the public sector focusing on retaining and streamlining only those activities which government can undertake. Boosting taxation compliance, rigorously vetting all government spending proposals and selecting only the highest return projects which fall within the Government's revenue limit is essential.

## LONG-TERM PRIORITIES, 2009+

Solomon Islands also faces a set of longer-term economic challenges. While Solomon Islands has many rich natural resources, past economic policies have failed to address its endemic economic vulnerability. It is a very small economy with a narrow economic base, mainly reliant on primary commodities. The economy is susceptible to commodity price swings and terms of trade falls. Encouraging the expansion of the resource production base and new higher value agricultural exports, through agricultural extension and better infrastructure delivery, is necessary. Better infrastructure would also assist natural resource-based manufacturing, mining and tourism. In the long term, a diversified economy will reduce economic vulnerability.

While communal land ownership, a strong subsistence sector and the 'wantok' system of community welfare generally ensures Solomon Islanders do not go hungry, average living standards are not improving and, in fact, are deteriorating. Customary land ownership places serious constraints on the growth of new higher value private sector activities. Ill-defined land ownership also fuels ethnic tension. Approaches based on formalising land boundaries, streamlining dispute settlement processes and eventually creating a workable land tenure system are important to help Solomon Islands achieve its optimum growth potential.

To break out of the recent past's negative cycle of conflict and poverty, the Government recognises it must adopt a bold set of new policies to attract investment into higher value activities, build the country's economic and social infrastructure, and develop the human capital of its young people. The people of Solomon Islands must understand that outsiders are wary of investing in Solomon Islands. They too must support the changes necessary to make the country a more attractive place in which to do business. RAMSI and other donors have provided an opportunity to restart economic growth. In the post-RAMSI period, the Government will need to remain committed to sound policies and to addressing long term issues, such as land tenure reform, if peace and economic growth are to be sustained.

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