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Hard times ahead? Issues and reform in Solomon Islands public finance

Gordon D'Arcy Lilo

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The period of the 1990s was marked with a dramatic shift in public finance management in Solomon Islands. Severe fiscal imbalance was triggered by a consistently high budget deficit owing largely to poor policies and gross mismanagement. Ironically it was supposed to be an era of favourable fiscal performance given the scope for increased government revenue with the boom in the forestry sector. That opportunity slipped past and the country plunged into severe fiscal crisis between 1995 and 1997. With the Asian financial crisis in mid 1997, that had drastically affected the country's log export, the Solomon Islands economy had found itself virtually in recession in the second half of 1997 and the greater part of 1998, losing a major source of government revenue and foreign exchange earnings and savings.

The difficult task for the government now is to keep the balance in matching expenditure with revenue. That is not going to be an easy task, especially as four of the core essential services account for 60 per cent of total government expenditure. The Government has to maintain this commitment in providing public services to the rural people. This being the case, the obvious targets for reducing expenditure are the payroll and other savings through restructuring of government ministries. Hence, the Policy and Structural Reform Programme initiated by the Solomon Alliance for Change (SIAC) Government that assumed power in mid 1997.

In order to grasp the gravity of the problems that the government is now faced with it is important to understand the underlying issues of mismanagement that gave rise to the fiscal crisis. These are as follows

- Poor financial recording and control which has made the task of setting the budget difficult. The high turnover in qualified accounting staff and the shift in culture and practice in the public service have contributed to the problem and the increasing politicisation of recruitment that has derailed the morale and performance of public officers.
- Unaudited Government accounts since the mid 1980s have also added to the problem with the Government not being able to account for mismanagement which should have been considered in the process of preparing the budget. In fact by 1998, Government Accounts were audited up to 1984. Recognising this problem, the institutional strengthening project was put in place as part of the policy and structural reform program to improve the capability of the Audit Department.
- The expenditure over-run that was experienced in the early 1990s was not taken seriously by the government and therefore failed to opt for sound policies and approaches in averting such excesses in expenditure. Some of these include the significant costs associated with containing the border tension with PNG as a result of the Bougainville crisis. The failure by both governments to resolve the border tension amicably in a 'Melanesian way' had led to increased militarisation on both sides of the border. Expenditures for health and education especially to the Western part of the country, increased to cater for the influx of Bougainville refugees. Other unnecessary expenditures included the purchase of arms from the US, which started in 1995 at the time when the fiscal crisis had deepened.
- Poor debt management as a result of build-up in expenditure led to domestic debts

increasing from about $83 million in 1990 to 392 million in 1997. Arrears on external debts have risen considerably to an unacceptable level.

- Revenue performance has weakened and been undermined considerably by government actions and policy decisions. Generous tax breaks and exemptions granted to logging companies and other local manufacturers have drastically undermined revenue performance which means increased taxes to other sectors to subsidise revenue foregone through exemption. A good part of this represents a huge loss in economic rents to logging companies in particular who have already been enjoying economic surplus from resource exploitation.
- Ineffective and inefficient management in the two main revenue departments – Customs and Inland Revenue – has also affected revenue collection. Corruption has gained foothold in these two departments further undermining the revenue performance.
- Government's attitude and behaviour in using the temporary advance facility with the Central Bank is absolutely appalling. Using the facility to service maturing Government Securities and shortfalls in the budget has been excessive without a credible servicing arrangement. In September 1995 the Government had exceeded the statutory limit of advances from the Central Bank which led to the collapse of the Securities Market. The domestic financial institutions were the worst affected having at least 40 per cent of their total assets invested in Government securities. Also, the Solomon Islands National Provident Fund (NPF) had a total exposure of 53 per cent of total assets which includes investment in Government Securities and direct loans to the Government and loans to SOEs and Provincial Governments Business Arms guaranteed by the Government. As the borrowing with the Central Bank to finance budget deficit led to being monetised it had an inflationary effect reaching double-digit figures.
- The poor financial performances of most of the State-Owned Enterprises (SOEs) have been a real burden on the Government. Most of the external debts are loans secured by the Government from concessional sources, which were on-lended to some of the SOEs. A good number of the SOEs because of poor performance have not been able to make repayments and therefore have placed the burden on the Government. This alone has formed a major part of public debt since the mid 1990s as most loans were then due for repayment.

Given the magnitude of the problem what action has been taken to address the problem?

The SIAC Government that came into office in August 1997 was timely and had the determination to undertake serious reform to arrest the worsening fiscal crisis that the country was faced with. The Government immediately embarked on a policy and structural reform program. The immediate focus was on public finance and public sector reform to instil fiscal stability and place the economy on a sustainable path towards recovery. The strategy was to embark on various economic and financial stabilisation measures and secure program funds from multilateral donors to regularise servicing of both external and domestic debts including the arrears. The immediate tasks undertaken as part of stabilisation measures include

- Cancellation of all discretionary exemption
- Rearrangement of domestic debt servicing through negotiation with the financial institutions and the Central Bank.
- Establishment of a revenue enhancement committee to look into improving collection of revenue arrears to the Government.
- Ensuring of a 'balanced budget' for 1998.
- Cancellation of all discretionary expenditures and reduction in payroll expenditures through restructuring of the public service.
- Commencement of dialogue with both multilateral and bilateral donors to secure program fund assistance to undertake restructuring of public service and regularisation of external debts.
- Privatisation and reform of State-Owned Enterprises (SOEs) with the proceeds thereof to be used to service domestic debts.

What have the result been? By the second half of the 1998, the Policy and Structural Reform Program had been implemented with support from the ADB, IMF, World Bank, EU and bilateral donors including Australia and New Zealand. With the approval of the program loan and the release of the first tranche of program loan from the ADB in July 1998, the public service restructuring program immediately got under way and by March 1999 a total of 447 employees were made redundant. This, however only represents a saving of 8.4 per cent in payroll reduction as compared to the expected target of 15 per cent, which represents capping the payroll expenditure at $130 million on an annualised basis for 1998 (ADB 1999:317). However, the saving was put to good use in servicing debts. It would appear though, that managing payroll level to a reasonable level is essential given the rise experienced in 1999 which led to an overall budget deficit.

Also, the government was able to clear all debt arrears by the end of 1999 utilising most of the resources from the program loan with ADB and World Bank. The only exceptions were the debts with Marubeni and EFIC (Export Finance Insurance Corporation of Australia), which have been planned for a negotiated write-off or partial write-off. The EFIC loan certainly is one, which would need to be handled candidly on a bilateral basis in view of the Auditor Generals Report in 1991. The Marubeni Loan has serious flaws that need proper negotiation between the Government and Marubeni. The restructuring of all frozen Government securities was also completed through the auctioning process, which saw the Government's securities market being revived in May 1999.

The institutional strengthening project to improve the capability of revenue departments seems to be on track. This relates to strengthening of the Customs and Inland Revenue Department and the Lands Administration Project to address arrears in land rent. The expected output in terms of enhancing revenue is still slow and definitely will take some time. But the early push to have some impact on revenue is important to protect the achievements made so far.

The speedy completion of unaudited Government accounts is also a matter of priority. This should be a real boost to the whole process of improving management in public finance.

The project, which started last year through assistance from AusAID, has made considerable headway in improving the capability of the audit department, which has been grossly ignored for quite some time.

The slow progress in the privatisation and reform of SOEs means that the revenue support to accelerate debt servicing will be delayed for a while. This obviously is due to the social unrest, which pose serious doubts about the potential to privatise Solomon Islands Plantation Limited (SIPL) on Guadalcanal and Kolombangara Forest Product Limited (KFPL) in the Western Province, which seems to be the most likely candidates for privatisation. The transfer of a certain percentage of Government shares in Solomon Telekom to SINPF had led to liquidation of a good proportion of debts with the Fund.

Just as some progress have been made to arrest the worsening situation in Government finance then came the ethnic crisis, which started in mid 1998. It was not expected and the whole atmosphere of reform was clouded with uncertainties. Government has had to put all efforts to address the ethnic crisis in an acceptable customary manner and protect the reform in public finance. Obviously this was proven difficult as Government was forced to pay out compensation of some $45 to 50 million for the displaced people. There have also been heavy costs associated with new recruitment in the police as a result of escalating tension in Honiara and Guadalcanal throughout most of 1999. Obviously the credibility of reform in public finance has been shattered and hence the need for the current problem to resolved. Understandably the government was not able to address the demand for compensation as claimed by the displaced people from Guadalcanal. Government has to stick to its commitment to maintain unbudgeted and discretionary expenditures at a lowest level as much as possible to comply with the conditions of Agreement entered into with the Development Partners. And the consequence of which is the escalation of the crisis over the past three weeks.

Base on the figure being indicated as compensation by the "Malaita Eagle Force" (MEF), Government will definitely require external assistance to address that issue. Definitely there will be multiple claims for compensation and the Government has to handle these issues sensitively and in a transparent manner. There will obviously be some costs for reconstruction of infrastructure in Honiara and in some Provinces that will create a huge burden for Government finance.

That aside, generally it would appear that maintaining expenditure level to a reasonable level seems to be an area of real concern. Ensuring effective expenditure control and keeping discretionary expenditures lower has proven to be quite difficult in view of political pressure to fund constituency development project. An alternative to include funding of constituency projects under the development budget with funding sources from the development partners poses the risk of politicising the use of aid resources which may not be acceptable in view of past experiences of gross misuse. This means that strengthening of the Development Planning Department and establishing proper procedures on prioritisation and development of projects would be essential in setting a credible National Development Plan for the country.

On the revenue side, efforts should be to put more focus on the revenue enhancing program and promotion of private sector development to expand the revenue base and establish a solid foundation for the economy. The institutional strengthening program of all revenue departments have proceeded very well but the early realisation of improve revenue performance will be at least for awhile. In view of the decline in logging industry as most concession are now near the expiry date and some have already closed operation in major concession areas, reduction in revenue from log export is expected. This means that focus should be given to encourage investment in potential key resource sectors such as mining, forestry, agriculture, and tourism should be equally given priority. This would mean the review of procedures and policies in investment, taxation and trade and removal of tax and other forms of barriers as part of 'inward looking policy' is necessary to ensure transparency and equity in dealing with application of both domestic and foreign investment. Privatisation and reform of SOEs should be an important prerequisite, to set an impetus for private sector development.

Obviously under difficult circumstances there has been some progress made in the reform of public finance in Solomon Islands. However, it would not be unrealistic to suggest that much will still have to be done to underpin effective policies and practices to improve management and results needed. Obviously the current political and ethnic crisis adds a new dimension to the complexities that will have to been confronted and managed in the reform process. The need for community and civil society to participate in the reform process is therefore necessary. This must be the focus if the country is to pull through the present crisis. The process of educating the people about the need for reform and to accept the sacrifices will need to be demonstrated throughout the stabilisation process.

And given the current status of the crisis, certainly government will need the support of development partners in setting the foundation to move forward with process of rebuilding the damage on the economy. This however is conditional upon the early return to democratic government and the commitment of future government to maintain sound policies and reform measures that have been put in place. The road ahead for Solomon Islands is going to be tough, as additional financial resources will be required to address the present crisis.

Reference

Asian Development Bank, 1999. *Reforms in the Pacific: An Assessment of the Asian Development's Assistance for Reform Programs in the Pacific*, Manila.