

The Solomon Islands experience

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The South Pacific archipelago nation of Solomon Islands is endowed with abundant natural resources and a relatively high land-to-population ratio. It benefits from a tax-to-GDP ratio and steady aid inflows of over US\$100 per capita per annum that are both high by developing country standards. In spite of these favourable circumstances, after little more than twenty years of independence the country has one of the lowest levels of human development indicators and income per capita in the South Pacific region and globally.

With the mounting evidence that macroeconomic policies are central to a country's development performance, it appears timely to review the recent history of macroeconomic management in the Solomon Islands as the current Solomon Islands Alliance for Change (SIAC) government grapples with structural and policy reforms in cooperation with its multilateral and bilateral development partners (Dornbusch 1993; Little 1993; Fry 1998; *The Economist* 15 April 2000:96). The timeframe is limited to the 1990s because the most dramatic policy errors occurred during this period, yielding the most useful insights into the conditions for improved economic policymaking in Solomon Islands.

Important policy issues need to be addressed within the context of the Solomon Islands government, particularly the aid donor relationship, including that of partial debt forgiveness. Enacting reforms to make future economic mismanagement more difficult is an urgent task now as the growing importance of the minerals sector (and the

economic rent it generates) can be expected to endanger the pursuit of good governance and protection of the environment (Sachs and Warner 1995).

Monetary policy in the 1990s: captive to fiscal policy?

A recent study by the Bank of England of 70 developing countries found that

larger [fiscal] deficits and the greater reliance by governments on the domestic banking system are associated with accommodating monetary policies. In turn such inflationary macroeconomic policies are associated...with higher inflation and lower economic growth (Fry 1998:48).

In a recent study, Fielding concludes that, for a range of Anglophone and Francophone African countries, the Central Bank could not influence monetary conditions independently of fiscal policy in the long run, although in the short run it could affect monetary growth to some extent through changes in net foreign assets and/or net bank lending to the private sector (Fielding 1999). Similarly, the Caribbean economies, which probably share a common economic structure with the Pacific Island economies, have experienced the same entanglement of fiscal and monetary policies (Dean 1998; Seerattan 1995).

Under the Central Banking Act, the Governor of the Central Bank of Solomon Islands is appointed by the Finance Minister and can be forced to resign on reasonable grounds of incompetence. Nevertheless, this

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insecurity of the Bank Governor's tenure has not prevented Central Bank *Annual Reports* from criticising government economic policies in the past, though such criticism may have been toned down. However, under the Central Banking Act, the Central Bank must lend to the government, if so requested, up to a ceiling determined by average government revenue over the previous three years. In practice, the Central Bank has found it hard to refuse lending increasing amounts to the government until the ceiling was reached and temporarily raised (Table 1).

The relatively large size of the fiscal deficit, combined with the requirement of the Central Bank to lend considerable amounts of high-powered money (M0) to the government, left the Central Bank with little scope to stabilise the resulting monetary growth by tightening other elements of monetary policy.

- From 1990 to 1992, the outstanding stock of commercial bank loans to the private sector declined by SI\$20.1 million to SI\$72 million, a fall of 23 per cent. Monetary policy net of Central Bank lending to the government was set tight by raising the liquid assets ratio (LAR) and there was little excess liquidity in the banking system: monetary policy could not have been tightened much more (except for 1991). Yet in spite of this policy stance, M0 and M3 rose by 33 per cent and 35 per cent, respectively. Thus, in the face of high fiscal deficits, the Central Bank could not keep rapid monetary growth from occurring, even with a tight monetary regime (net of Central Bank lending to the government) and a decline in the stock of bank loans to the private sector.
- For 1993–95 the picture was more mixed. In the presence of considerable surplus liquidity in the banking system, the Central Bank in 1995 could have reduced reserve money growth (M0 rose from SI\$41.4 million to SI\$75.7 million over 1993–95) by SI\$12 million (assuming banks keep a prudential reserve stock of

SI\$10 million) without restricting private sector borrowing. In the face of high Central Bank lending to the government, however, dampening M0 growth further than this (for example, by another SI\$7 million) would probably have undone much of the rise in private sector borrowing during the period through the money multiplier process.

In a situation of high budget deficits, monetary policy was both dwarfed and to a large extent constrained by fiscal policy through forced lending by the Central Bank to the government, which was heavily reliant on the domestic banking system for finance. This experience broadly accords with the general pattern reported in the Bank of England study.

Fiscal policy in the 1990s

Given the dominance of fiscal policy, how is a regime's handling of fiscal policy and thus macroeconomic management to be evaluated in an objective manner? Three criteria would seem to be of importance.

One criterion is sustainability. Governments spend for both recurrent purposes and on investment, or development, projects. It is commonly accepted that recurrent expenditures ought to be financed out of recurrent revenues, whereas investing in new projects may necessitate borrowing from the domestic private sector or from overseas if the government faces a shortfall of revenue. Eventually, these borrowings have to be paid back, so the borrowed funds must be expected to yield an economic rate of return at least equal to the interest rate on the loan. A sustainable fiscal policy is thus one where the government invests in productive projects and manages its financial situation such that it matches anticipated future expenditures with anticipated future revenues. In short, the government does not fall into a cash or debt crisis.

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Table 1 Financial and fiscal indicators, 1990–96 (SI\$ million, except where noted)

	1990	1991	1992	1993	1994	1995	1996
Fiscal deficit (per cent of GDP) ^a	6.9	13.3	7.2	7.9	6.6	2.4 ^b	2.4 ^{b,c}
Change in net Central Bank lending to the government	10.7	26.3	-20.1	7.4	19.1	13.5	-4.9
Change in commercial bank lending to the private sector	-10.0	-6.7	-3.4	12.0	22.8	14.9	6.3
Commercial bank reserves	5.8	14.1	6.6	4.9	12.5	22.0	39.9
Monetary base (M0)	31.1	41.9	41.4	47.0	61.5	75.7	98.6

Notes: ^aThe SINURP Government stopped publishing data on its accounts in the early 1990s. The figures used are World Bank estimates of the overall fiscal balance including grants (Codippily 1996:116). ^bIn 1995 and 1996 the Government amassed over SI\$50 million in unpaid arrears to trade creditors. ^cIn August 1995, the SINURP Government stopped servicing interest payments on its Treasury bills. The growing financial crisis over 1995–97 explains the steep decline in lending to the Government from the banking system.

Sources: IMF *International Financial Statistics*, Washington, DC (various issues); Codippily, H., 1996. *The Pacific Island Economies: building a resilient economic base for the twenty-first century*, World Bank, Washington, DC; Central Bank of Solomon Islands, *Annual Reports*, Honiara (various issues).

Another obvious criterion of a well-designed fiscal policy is a maximum tax effort. With some taxes, such as domestic income and corporate taxes, this does not mean collecting the highest amount of tax revenue since the government may be unable to invest all such revenues in worthwhile development projects. In that case, it may be more efficient to leave more resources in the hands of the private sector by limiting taxes. Rather, a maximum tax effort is here taken to mean that in an economy with considerable interaction with international companies, the government ensures that tax rates are set as high as possible so that resource rents are appropriated for the country's own citizens. This entails setting tax rates to permit international companies to earn an internationally standard risk-adjusted return on their invested capital, but not excessive profits (duly accounting for the level of risk of the investment).

A third criterion is that government revenues are allocated to the most productive ends for society. Note that the optimal

distribution of Government spending depends on society's values or preferences: one spending distribution pattern may favour objectives of equity whilst another pattern may promote economic growth. Sometimes, there is no conflict between the different objectives: an allocation of resources that most reduces poverty may also stimulate growth to the greatest extent. The information requirements to evaluate how well government revenues are spent are substantial, however, thereby making evaluation difficult. It is easier to isolate cases of clearly wasteful or inefficient spending, and the number and scale of these incidents may give an idea as to whether the government allocated its spending according to economically justifiable criteria.

1990–97: the SINURP administration

Sustainability of government spending levels

The SINURP regime was fortunate in being in power during a long and rapid export

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boom in Solomon Islands. The terms of trade experienced a cumulative increases of 60 per cent over the 1990–96 period. During the dramatic rise in round log export income, exports more than doubled in value: from SI\$307 million in 1992 to SI\$658 million in 1996. Log exports eventually provided more than half of total export receipts, while total exports accounted for a little over half of GDP. Taxes collected from log exports grew to represent more than a third of total government revenues.

The rapid increase in export and government revenues in the 1992–96 period was clearly not sustainable. By the mid 1990s log exports were estimated to be two to three times the sustainable rate, and would have completely exhausted the stock of accessible and commercial natural hardwoods in less than 15 years (Dauvergne 1998 and numerous aid donor-sponsored country reports from the period). This meant in turn that more than half of Government revenues deriving from taxes on log exports were unsustainable (around one-fifth of total government revenues). The SINURP government was fully aware of these circumstances. Reports by the Central Bank of Solomon Islands and aid donors at the time highlighted the need to keep spending under control and take actions to restrict logging activity (see ‘Overview’, Central Bank of Solomon Islands *Annual Reports* 1992–96). All such recommendations and warnings were ignored.

In the face of the pressing need to control spending and run a fiscal surplus, the SINURP government did the opposite of what it was required to do from a fiscal sustainability perspective, and borrowed heavily every year from 1990 to 1996 (Table 1). This placed government spending on a highly unsustainable path that would have required sudden, large and painful cuts in government expenditure ten years down the track when the commercial timber resources ran out.

In the event, the SINURP government’s inept handling of its financial affairs

hastened the inexorable debt crisis of 1995. In that year the government could no longer service interest payments on its local and foreign debt. A better policy would have used revenues to buy back debt in order to reduce the rapidly increasing interest payments on the debt, which only exacerbated the fiscal situation. This would have also made better use of the large increase in wealth in the mid 1990s.

Efficiency of government spending and the tax effort

Was government spending under SINURP, including that funded by borrowing, allocated to uses that could be expected to yield an adequate economic rate of return?

No publication or statement was produced by SINURP to justify in economic terms its spending decisions. Records from the period were destroyed in a mysterious fire that burned down much of the Finance Ministry just before SINURP made way for the SIAC government in 1997. Furthermore, there is a strong presumption that Solomon Islands does not have enough economists or financial experts trained in carrying out project appraisals and more generally evaluating investment decisions (see Fairbairn and Worrell 1996 on the general skills shortage in the Pacific islands). There is the further likelihood that the economy did not have the capacity to productively absorb the abrupt increases in income during the export boom.

To the contrary, an examination of the composition of government spending shows that a good part of it was spent in unproductive ways, such as on public sector wage increases, an expansion in the size of the public sector and government services that were inefficiently provided. By 1995, government spending was 43 per cent of GDP and the public sector wage bill comprised 9 per cent of GDP, both far higher than most developing countries (Codippily 1998:7). A public sector so large in proportion to the

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economy creates a suspicion that many civil servants are unproductive. To some extent, the large public sector has been caused by relatively substantial foreign aid inflows. But there was also a rapid and unjustifiable expansion of the public sector under SINURP. In early 1999, the new SIAC government, in consultation with the World Bank and Asian Development Bank, made 500 public sector workers redundant, judging that they performed no essential role.

It is commonly argued that the promotion of sustainable development requires investing funds in essential projects and in education and health. Employing workers, on the other hand, in jobs of no value to the economy, represents an inefficient form of spending: it does not raise the productive capacity of the economy nor does it augment human capital. Moreover, the major part of civil servants' wages leak out of the Solomon Islands economy via purchases of imports.

The percentage of government spending allocated to health and education remained broadly constant under the SINURP administration (Codippily 1998:27). Together they accounted for one-quarter of government spending by 1996. However, the social infrastructure was not well maintained as the 1990s progressed. The Solomon Islands Development Trust (SIDT) published issues of its LINK magazine documenting that schools lacked textbooks and other equipment and rural health clinics were deprived of medicines.

As part of the economic services rendered by government, in 1996 the Constituency Development Fund was created, granting Members of Parliament several hundred thousands of Solomon dollars each to develop their constituencies. No mechanisms were put in place to monitor and evaluate how the money was spent. Contemporaneous issues of LINK reported widespread popular dissatisfaction with the Fund.

The opportunity cost of actual government spending was the amount the government would have saved by paying

back its debt and thereby reducing the annual interest payments on this debt. By the mid 1990s, over half of the budget was spent on public sector wages and salaries and interest payments on government debt. Interest payments on public debt steadily rose to reach over SI\$50 million per annum by the late 1990s. Interest rates on Treasury bills owned by the three commercial banks had been as high as 13 per cent for a time. Evidently, the financial return on retiring government debt must have considerably exceeded any return on expanding the public sector.

Wasted resources under the SINURP administration

Added to these losses are the tax revenues the government could have collected under a maximum tax effort. The lion's share of tax revenue is collected from duties on exports and imports. The three main export sectors before 1997 were timber, fish and palm oil. Taxation of palm oil exports was more or less optimal, while that of the fishing sector is more appropriately treated at the regional level. However, low duty rates and inadequate monitoring of logging activities cost Solomon Islands hundreds of millions of dollars in unclaimed tax revenue.

Table 2 shows losses in potential tax revenue. Duncan (1995) estimates that this amounted to SI\$130 million in 1993 alone. General log duty rates of 30–35 per cent, with increased granting of partial exemptions to this tax, were well below the 50 per cent level that the World Bank estimates represented excess logging profits, based on log prices and logging costs prevailing in 1994 and 1995. Thus, 50 per cent of the log value could have been taxed and claimed by the Solomon Islands government while still leaving logging companies with an incentive to produce.

Inadequate efforts to strengthen Customs led to an even greater loss, estimated at SI\$94 million. On the basis that log prices and

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falling rates continued at the same levels until 1996, crude estimates are given in Table 2 on the amount of extra tax revenue that might have been raised in subsequent years.

A conflict existed between public and private interests as the Prime Minister and leader of SINURP owned a logging company which received tax concessions worth an estimated SI\$1.5 million in 1995 alone (Transparency International). In 1995 the SINURP government also disbanded the Timber Control Unit, a watchdog responsible for surveillance and reporting on the logging industry. The Billy Hilly-led government, which had won the elections of 1993, was forced out of office after a year when it attempted to raise the duty rate on log exports and found that four of its members abruptly crossed the floor to the opposition party. The opposition party was SINURP.

Use of import duty exemptions lowered import duty revenues below what they could have been. Some of the exemptions did not have an economic rationale. Over the years they constituted a considerable sum.¹ The national newspaper the *Solomon Star* covered the story of one local businessman who had received around SI\$12 million in duty remissions on imports of Australian beer in exchange for a commitment to renovate the country's prison.²

To take a balanced view, one should also look at the achievements of the SINURP administration. In the author's view, the only major achievement is the negotiation of the country's first gold-mining operation. By the late 1990s, gold exports had brought the economy considerable extra employment and income. Nevertheless, a different government may have also successfully negotiated such an agreement.

In the later stages of the SINURP tenure of office, aid inflows declined somewhat, but most aid relationships remained in place. The World Bank and IMF cancelled the reform programs they had been negotiating with the Billy Hilly regime. The European Union

suspended some aid programs and the Australian Government in early 1997 did not disburse around SI\$7 million in aid to the forestry sector after the Timber Control Unit was forced to close down.

Careless financial management generated the debt crisis in August 1995. When civil servants' wages were not being paid on time late in 1996 and into 1997, pressure welled up for a change in economic management. The SIAC coalition won the elections in August 1997 with the narrowest of margins.

1997 onwards: SIAC administration

The SIAC government assumed office in inauspicious circumstances: a lingering financial crisis and the beginning of the Asian crisis, which led to a collapse of around 10 per cent in GDP in 1998, mostly due to lower log prices. The new government embarked on a Policy and Structural Reform program, with assistance from multilateral and bilateral aid donors. The Asian Development Bank granted a large reform-related loan in late 1998, followed by an IDA credit from the World Bank in the summer of 1999.

These loans and a revival in aid flows have provided much-needed resources for the reform effort and boosted foreign reserves. Foreign reserves stood at 3 months of import cover in May 2000, the highest level for a decade. The fiscal deficit was limited to around 2.6 per cent of GDP in 1998 and 1999, respectable given the circumstances of ethnic unrest that began in 1999. Because of the ethnic troubles, the production and export of palm oil has shut down and the government has incurred a cost of SI\$50 million in security-related expenditures (Central Bank of Solomon Islands Governor's Speech, 12 May 2000). With regained control of fiscal policy, the Central Bank has been able to more effectively tighten monetary policy. Broad money growth was

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only 4.3 per cent over 1999 and inflation dropped to 5.5 per cent by May 2000. Such macroeconomic aggregates indicate the beneficial impact aid can have on a small economy receiving large aid inflows with a government committed to sound and reformist policies.

The government instituted a two-year (1998 and 1999) wage freeze in the public sector to help limit public spending and make the 20 per cent devaluation of the Solomon dollar in December of 1997 effective. It would be interesting to know if such wage freezes conflict with the IMF's general policy of setting 'efficiency wages' in the public sector. Research is needed to determine whether civil servants' wages had already been too low or high prior to the wage freeze.

In 1998, when the East Asian crisis led to a dramatic fall in world log prices, the SIAC government mandated a temporary lowering of the log export duty to enable logging companies to continue to produce profitably at lower prices. Log exports have expanded in 1999 relative to 1998. Projections for 2000 are for similar levels of log exports.

At this stage, it is too early to judge the success of the reform efforts. To its credit, the

SIAC administration has so far normalised relations with aid donors and domestic creditors, cleared all debt arrears (except those on two controversial external loans) and negotiated highly concessional financial assistance from the World Bank and Asian Development Bank. The SIAC government must address the issue of bringing log exports down to a sustainable rate as the reform program continues.

Implications for the government-aid donor partnership

The review of the last decade's economic history of the Solomon Islands attests to the need to view development in its political context. The financial costs of the economic mismanagement of the SINURP government had reached such levels—annual costs of over SI\$100 million—that the nation might have been better off had the aid donors completely suspended aid relations with a regime that was not dedicated to good governance. This might have precipitated the debt crisis and facilitated a change in government sooner than occurred.

Table 2 **Lost resources under the SINURP administration, 1993–96** (SI\$ million)

	1993	1994	1995	1996	Total
Loss in tax revenue ^a , of which	130	140 ^b	140 ^b	100 ^b	510 ^b
i) sub-optimal export duty rates	36	40 ^b	40 ^b	20 ^b	..
ii) under-reporting of log prices	94	100 ^b	100 ^b	80 ^b	..

Notes: ^aThis tax rate takes into account local cost conditions and still leaves foreign logging companies making an acceptable rate of profit at prevailing prices. The figures represent a lower limit since the Government was negligent in monitoring logging companies to ensure they paid the full pre-agreed royalties to landowners whose trees were being cut. There were common instances of landowners not receiving the full log royalties owed them. ^bPresent author's own rough estimates. Through the mid 1990s, high growth in log export income was partly caused by the temporary rise in log prices on the world market following the ban on log exports by Indonesia, one of the world's largest suppliers of round logs, and partly by increased volumes of round log exports.

Sources: Codippily, H., 1998. *Enhancing the Role of Government in the Pacific Island Economies*, World Bank, Washington, DC:82; Duncan, R., 1995. *Melanesian Forestry Sector Study*, International Development Issues No. 36, Australian International Development Assistance Bureau, Canberra.

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As aid is fungible to some degree, the Solomon Islands government and its development partners need to carry through reforms to create permanent incentives for good governance and transparency. For a small country like Solomon Islands which continues to receive substantial aid flows, the threat to cut off aid links could be very effective in preventing a government from reneging on a commitment to follow standard practices of good governance. Using good governance reforms as conditionality in its lending is becoming increasingly common amongst the World Bank and IMF, and in so far as aid donors need to coordinate their aid programs, would need to be pursued by bilateral donors as well.³

Institutional changes would appear to be required now to prevent a re-occurrence of economic mismanagement. The new codes of conduct of fiscal and monetary policy being agreed amongst IMF members need to be implemented (*Financial Times*, 12 April 2000). Yet, institutional change may not go far enough. As an example, the experience of a strong Ombudsman Office in Vanuatu that highlighted cases of corruption and then had its powers circumscribed by Parliament illustrates the need to seek deeper changes in popular political awareness and expectations.

Probably the best safeguard for good governance involves strengthening civil society. The work and results of SIDT provides evidence of this. Its educational and awareness-raising village outreach programs better informed rural villagers of the economic policies being pursued and their effects on ordinary citizens. Through its magazine, regular surveys are conducted to report on people's opinions on various policies and developments. Further educational programs could have a high pay-off in '... help[ing] people understand what they should expect of a legitimate government' (Rose-Ackerman 1999:167).

Given the record of SINURP in office, there is a case for aid donors forgiving debt

that was incurred during this time. The United Kingdom government last year forgave all debt owed by the least developed countries, including that of the Solomon Islands, coinciding with the Jubilee 2000 campaign for debt relief for the world's least-developed countries.

Notes

The views expressed herein are the author's alone, and should not be attributed to the Central Bank of Solomon Islands.

- ¹ Central Bank *Quarterly Reports* record potential import duty revenue in the government finance section.
- ² The businessman's side of the bargain had still not been honoured as of late 1998. The same businessman was elected as a Member of Parliament in the 1997 elections and joined the SINURP party, now in opposition.
- ³ In support of this position, Rose-Ackerman (1999:185) writes: 'Conversely, they [international organisations] should be willing to cut off aid to countries that demonstrate an inability to use it effectively.'

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