Private Sector Assessment
For
Solomon Islands

JULY 2005

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Private Sector Assessment for Solomon Islands (SI): Executive Summary and Policy Priorities

SI needs a business environment conducive to the private sector to achieve:

- **Higher GDP Growth**
  SI business environment does not encourages growth. In many cases the government itself constitutes a barrier to private sector investment.

- **More Job Creation**
  Population growth has fuelled a need for jobs, particularly in rural areas.

- **Continued Stability**
  SI needs growth to remain stable and the long term presence of RAMSI is needed to ensure security and investment confidence.

- **Lower Costs**
  Inefficient state involvement in the economy and poor or non-existent infrastructure raise private sector costs and increase the effects of distance and isolation.

The Private Sector Needs:

- **Better Infrastructure**
  - Infrastructure is poor and badly maintained in urban areas and virtually non-existent in the rest of the country.
  - Electricity and telecommunications are expensive, unreliable and often unavailable outside urban areas.
  - Low quality of available transport hinders private sector development—air and sea transport in-country is expensive and unreliable, out of country transport is expensive, and the road network is inadequate, or in many cases does not exist.

- **Continued Donor Presence**
  - The timing and coordination of aid is crucial. The country currently has a limited ability to absorb aid, which should rise only with its ability to absorb it, but aid must be maintained for an extended period.

- **Less Involvement of the State in the Economy**
  - There are many poorly functioning or essentially defunct SOEs that provide inferior quality, high cost services, and crowd out the private sector.
  - Many of activities are reserved for Solomon Islanders but few local skills exist, which means that investment in these activities does not occur at all.
  - Public administration is weak. Staff are under-qualified, there is widespread absenteeism, and the systems of government are poor.

- **A More Equitable and Simple Tax System**
  - Tax rates are high and reduce incentives for success. Simultaneously, public finances prohibit tax reductions without significant expenditure cuts—this is unfeasible without a re-evaluation of the role of government.
  - Many businesses ignore tax rules and pay little tax, which burdens businesses that do pay and makes the playing field uneven.

- **Secure Property Rights in Land**
  - Land lease property rights are uncertain and disputes common, some of which have caused major natural resource investors to leave the country.
  - The process of allocating government owned land is non-transparent.
  - There are huge differences between formal land valuation, on which lease payments are based and actual land value.
  - The Land Act only allows lease payment adjustments every 20 years.
  - Land lease payment collections are low.
  - Currently, leaseholders do not have to give lessees notice of non-renewal

- **An Updated Legal System**
  - Every aspect of business—from start-up, operation, and closure – is expensive and difficult in Solomon Islands.
  - The commercial dispute resolution system is dysfunctional and outdated.
  - The machinery of the legal system is weak—registries are inefficient and unreliable, and court processes slow and uncertain.
  - There are reports of endemic corruption in most areas of the economy.
  - The regulatory system is burdensome forcing businesses to spend time and effort running the gauntlet of rules, taxes and licenses that do not provide any economic benefit.
**Improving Infrastructure**
- Action 1: SI needs to upgrade its infrastructure by taking a new approach to infrastructure provision with private sector and community involvement.
- Action 2: Donors should focus on rural infrastructure development.

**Ensuring Donor Coordination and Continued Aid**
- Action 1: Disbursement of aid should not exceed the capacity to absorb it.
- Action 2: Donors should coordinate and plan to increase aid as absorption capacity increase—but a 6 to 10 year time horizon is needed.

**Refocusing Government**
- Action 1: Abolish investment approvals and the reserved list of activities. This is part of an ongoing reform program and should continue.
- Action 2: Close down SOEs that should not be publicly owned and allow private participation to improve the remaining entities.
- Action 3: Open public activities to private and community based suppliers.

**Reforming the Financial Market**
- Action 1: Reform the collateral framework to increase lending.
- Action 2: Provide for microfinance via market mechanisms, not subsidies.
- Action 3: Abolish interest rate ceilings on Credit Union loans.

**Encouraging Rural Development**
- Action 1: Develop a rural strategy that includes investment in infrastructure, legal and regulatory reform, and microfinance development.
- Action 2: Undertake local education on the benefits of mining, logging, and large-scale agriculture and ensure local involvement and ownership of decision-making.
- Action 3: Encourage community-based organisations to assist with the delivery of basic services in rural areas. E.g., investigate utilising traders to deliver schoolbooks, and churches to provide social services.

**Undertaking Tax Reform Following PFTAC Recommendations**
- Caveat: SI must rationalise government expenditures; otherwise, merely focusing on measures to increase tax revenue will put too great a burden on the private sector.

**Undertaking Land Reform**
- Action 1: Persevere with land reforms to improve access and use of land, so Solomon Islanders can mobilise their most valuable resource.
- Action 2: Use the Australian Defence Force’s remapping of the country to promote land reform which could include: determining family ownership through genealogy; providing for binding arbitration in the case of disputes; fixing property boundaries through surveys and maps; and using a modified corporate structure for communally owned land.

**Undertaking Legal Reform**
- Action 1: Continue the current initiative to reduce the costs of entering the formal business sector.
- Action 2: Establish a private, competitive, and Internet-based Company and Business Licensing Registry.
- Action 3: Create a clear legal framework for low cost, easy, business property rights enforcement, possibly through private policing.
- Action 4: Revise the Bankruptcy Act to increase economic efficiency.
- Action 5: Reform consumer protection legislation.
- Action 6: Reform the collateral framework to increase lending and ensure that Solomon Islanders can use their land to secure loans.
- Action 7: Accelerate the process of putting Solomon Islands’ laws on the Web.
1. Introduction

1. Solomon Islands’ economy has begun to recover from the effects of the “Tensions”. Indeed, several observers claim that the recovery commenced before the arrival of RAMSI. Nevertheless, uncertainty surrounding how long RAMSI will remain in the country clearly has a strong impact on investor confidence. The recent announcement that RAMSI is committed for the long term will no doubt have a positive effect, but dispelling all uncertainty is not possible - only time and stability can heal the most fundamental damage done to the social and economic wellbeing during the “Tensions”. Furthermore, evidence from other post conflict countries supports strongly the need for the long term presence of peace keepers¹, as well as a particular phasing of aid and the ways in which it is implemented. These issues and how they relate to private sector development constitute one of the major themes of this report.

2. Private sector development faces severe challenges in Solomon Islands. Following the euphoria resulting from the restoration of order that occurred with the arrival of the RAMSI force, uncertainty has crept back into the economy. On the one hand, there are promising signs of a resumption of foreign resource investment as well as a pick up in local economic activity. However, in Solomon Islands, the foundations of private sector growth are weak. Virtually none of the essential features of a good environment for entrepreneurship, investment and risk taking exist and most public goods required to support the functioning of businesses and contracting are absent or inadequate. In addition, there is a pervasive culture of interference and control by the public sector that exists along with an extremely weak public administration capacity. The juxtaposition of these factors result in serious impediments to doing business. There is a central role for Solomon Islands’ Government in improving those conditions, primarily by recognising the private sector as a source of growth, by reducing the impediments to investment and entrepreneurship and by strengthening public goods such as the legal system and property rights.

3. Paradoxically, however, there is potential for promoting private sector development in Solomon Islands. Although the practices surrounding the interface of the private and public sectors are dysfunctional, there are elements that could be brought into play far more effectively if governance can be improved. To date, the various components of technical assistance have been focused on restoring the most basic government functions such as restoring financial stability and rehabilitating very basic social service provision.

4. There are also signs that resource companies are becoming more interested in operating in Solomon Islands. A major Palm Oil project is in the process of being revived under the management of a Papua New Guinea (PNG) based company that has experience operating in a poor business environment. Moreover, a private sector initiative to restart the Gold Ridge gold mine is being finalised and attempts are being made to make logging more sustainable so it will generate additional government revenue and slow the devastation that excessive logging has brought to Solomon Islands’ forestry resources. However, such initiatives are dependent upon major improvements in infrastructure, the resources for which are scarce, given the government’s budget constraint.

5. Any assistance strategy for Solomon Islands rests on the key assumption that the RAMSI presence will be maintained for a lengthy period - at least 5 years and preferably much longer. However, it also must be recognised that during this time, noticeable benefits to the people of Solomon Islands must occur if the state is not to slip back into anarchy once RAMSI departs. This means that infrastructure and the economy must show substantial improvements. Continued aid in the form of grants and technical assistance is essential, as is a firm commitment from the donor community to coordinate their efforts. A tremendous aid effort is being focused on the country. Indeed, Solomon Islands is a significant test of the potential for aid to revive a country that has gone through a major crisis of governance. However, without a fundamental change in the role of the State in Solomon Islands, the risk of failure is large. Central to this must be the recognition by all levels of Solomon Islands’ public administration that trying to control every part of the framework in which the private sector operates is counterproductive and harms investment.
6. The sections that follow discuss these issues in more detail. The paper commences with an executive summary that provides a two-page overview of the paper and its recommendations. A review of the current state of the economy follows to provide context for the subsequent discussion and analysis of the paper. Since this document is designed to be a “stand-alone” analysis that will be useful to readers who are not very familiar with Solomon Islands, we beg the indulgence of those who have a close familiarity with recent economic developments in the country. A central aim of the paper is to pull together the large quantities of information contained in the many reports that have been written about Solomon Islands in order to analyse the environment for private sector development and identify policy options that will encourage business development and growth.

7. Chapter III sets out the issues that must be faced in encouraging a more vigorous and dynamic private sector in Solomon Islands. Subsequent chapters provide more detailed discussion of the role of the State, infrastructure, the financial sector, land issues, and the legal environment for doing business. The report concludes with recommendations for change to promote the growth of a vigorous private sector.
II. Country Overview

A. Introduction

8. Solomon Islands is a low income country with per capita annual income of some US$500 as of 2003\(^2\), which places it near the bottom when compared with other countries in the Pacific region. Solomon Islands has a population of approximately 460 thousand, the bulk of which (93 percent) are Melanesian\(^3\) and has one of the highest rates of net population growth in the world at approximately 2.6 percent as of 2004\(^4\).

![Figure 1. Comparative Per Capita GDP, 2003](image)

9. The country has a land area of 27,990 square kilometres spread out over hundreds of islands and a tropical climate with monsoons\(^5\). Only 0.6 percent of the land is cultivated though, like several other Pacific Region countries, there is substantial arable land available to expand agriculture. In addition, the country does have many natural resources including fish, timber, gold, bauxite, phosphates, lead, zinc, and nickel.

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\(^2\) Solomon Islands Statistics Internet Site. http://www.spc.int/prism/country/sb/stats/

\(^3\) Solomon Islands Statistics Internet Site. http://www.spc.int/prism/country/sb/stats/Social


\(^5\) World Development Indicators Online Database 2005.
B. Recent Events

10. The bulk of Solomon Islanders (83 percent\(^6\)) live in rural areas. Many communities are dispersed and isolated. Between 1998 and 2003 there was an economic and political crisis (“the Tensions”) because of hostilities between different population groups, primarily those from Guadalcanal and Malaita. The remote areas of the country resented the monopolisation of the country’s resources in the Honiara area by what they perceived as a corrupt government administration intent on retaining the bulk of the revenue for itself. The conflict damaged the private sector, infrastructure, and the administration and facilities of government. Gross Domestic Product (GDP) decreased by 24 percent between 1998 and 2002 as production drastically declined, exports tumbled and the government defaulted on both domestic and foreign debt repayments, including those to the International Finance Institutions (IFIs.) While the military situation stabilised in 2000 with the signing of the Townsville Peace Agreement, effective government was impossible given the general lack of peace and security. Rogue police and ex-militia openly extorted money from government and prominent businesses, basic government services could not be provided because of the security situation and lack of money due to government corruption. Health and education services disappeared, and infrastructure, deteriorated sharply.

11. In April 2003, the Prime Minister, Sir Allan Kemakeza approached the Australian government for assistance. The result was the Regional Assistance Mission to Solomon Islands (RAMSI), which was dispatched in July of the same year and included 300 police officers and 1700 military personnel. With the arrival of RAMSI the security situation immediately improved and more regular forms of government resumed with substantial technical assistance from RAMSI to restore budgetary and fiscal control. The initial results have been positive and RAMSI continues to work with the government to build capacity and introduce other reforms.

\(^6\) World Development Indicators Online Database 2005.
C. Structure of the Economy

12. Analysing issues in Solomon Islands is made difficult by the lack of available data on the economy. There is little detail on what has occurred in various sectors and some information is missing altogether – for example, there is no information on gross capital formation, an important indicator of the level of investment in a country.

13. However, fragmentary data plus anecdotal evidence indicate that recent developments have been dominated by the turmoil in the country, which served to reduce output drastically. There is no doubt that the presence of RAMSI has resulted in a recovery, which some claim began even before it arrived. To obtain a better perspective, however, it is more important to look at the trends developing before the period of the “Tensions.”

![GDP Growth, Annual %](chart)

**Source:** World Development Indicators and Solomon Islands Reserve Bank

1) GDP Growth

14. While Solomon Islands’ GDP growth was mostly positive between independence in 1978 and 1996, it has also been highly variable. This variability is primarily because of the dominance of agriculture in the economy, which is particularly susceptible to world commodity price changes. The initial high growth of the post independence years gradually declined as the quality of governance deteriorated. Furthermore, much of the
positive performance of the previous 2 decades was squandered during the “Tensions”. The upheaval led to a precipitous decline in output, which halved the gains achieved during the previous 20 years. Furthermore, Solomon Islands remains the most impoverished of the Pacific Region countries, with per capital income of only US$500. In order to alleviate the widespread poverty in the country, sustained rapid growth is essential, which makes the task of rebuilding the country even more critical. It is incumbent on both the government and the donors to work together to ensure that the economy does not slip back into stagnation and decline.

**Figure 3. Comparative GDP Per Capita**

![Comparative GDP Per Capita](source: World Development Indicators and Solomon Islands Reserve Bank)

2) **Population Growth and Social Indicators**

15. Resumed rapid GDP growth is critical for poverty reduction – even moderate growth of real GDP will not reduce the number of poor very substantially. Solomon Islands has one of the highest population growth rates in the world – the net reproduction rate has averaged 3.1 percent over the past 30 years. (Population growth was 2.7 percent in 2004.) But, the “Tensions” had a profoundly negative impact on per capita GDP. This situation implies that if growth averages 5 percent annually, it will still take 35 years for per capita GDP to reach US$1000.
16. The picture of poverty in Solomon Islands provided by per capita GDP statistics is mirrored by the social indicators. (See Table 1.) While the medical indicators such as infant mortality and life expectancy are, not surprisingly, poor, statistics on access to sanitation facilities are particularly indicative of the divide between the urban and rural areas. In addition, the human development index statistic is low and compares unfavourably with the rest of the region. This issue will continue to aggravate social tensions between urban and rural areas which, in turn, threatens stability.

### Table 1. Solomon Islands’ Social Indicators

<table>
<thead>
<tr>
<th>Indicator</th>
<th>2000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Human Development Index</td>
<td>0.632 (2001)</td>
</tr>
<tr>
<td>Average Population Growth, 1993 – 2003</td>
<td>2.6</td>
</tr>
<tr>
<td>Number of Malaria Cases per 100,000 people</td>
<td>20,900</td>
</tr>
<tr>
<td>Life expectancy at birth, total (years)</td>
<td>68.6</td>
</tr>
<tr>
<td>Fertility rate (births per woman)</td>
<td>5.3 (2002)</td>
</tr>
<tr>
<td>Infant mortality rate (per 1,000 live births)</td>
<td>20 (2002)</td>
</tr>
<tr>
<td>Under 5 mortality rate (per 1,000 children)</td>
<td>24 (2002)</td>
</tr>
<tr>
<td>Births attended by skilled health staff (% of total)</td>
<td>85 (1999)</td>
</tr>
<tr>
<td>Child immunisation, measles (% under 12 months)</td>
<td>96 (1999)</td>
</tr>
<tr>
<td>Improved sanitation facilities (% of population with access)</td>
<td>34.0</td>
</tr>
<tr>
<td>Improved sanitation facilities, rural (% of rural population with access)</td>
<td>18.0</td>
</tr>
</tbody>
</table>
### Indicator

<table>
<thead>
<tr>
<th>Indicator</th>
<th>2000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Improved sanitation facilities, urban (% of urban population with access)</td>
<td>98.0</td>
</tr>
<tr>
<td>Improved water source (% of population with access)</td>
<td>71.0</td>
</tr>
<tr>
<td>Improved water source, rural (% of rural population with access)</td>
<td>65.0</td>
</tr>
<tr>
<td>Improved water source, urban (% of urban population with access)</td>
<td>94.0</td>
</tr>
</tbody>
</table>

Source: [http://www.spc.int/prism/country/sb/stats](http://www.spc.int/prism/country/sb/stats)

3) **Sectoral Breakdown of the Economy**

17. Solomon Islands’ economy is dominated by agriculture, which makes up nearly 50 percent of output. The stark reality is growth in rural incomes has to occur to achieve poverty alleviation, manageable rural urban migration, and ultimately societal stability. One of the critical challenges in promoting private sector development in Solomon Islands is to encourage the growth of the rural economy.

**Figure 5. GDP by Industrial Origin**

18. Some of the most difficult obstacles facing agricultural development in Solomon Islands include poor transportation infrastructure particularly from some of the more isolated islands. Although there are large tracts of alienated land in some areas, in others land tenure arrangements make customary land difficult to convert to productive uses reliably. Financial services are poor or non-existent in most rural areas. Larger plantation agriculture has suffered because of these problems but was also severely impacted by the unrest. For example, the unrest forced one of the largest plantations -
Solomon Islands Plantation Ltd - to close and its infrastructure was subsequently damaged or destroyed.)

19. The country is endowed with other natural resources such as gold, phosphates, nickel, and zinc but the combination of the unrest, during which the Gold Ridge mine infrastructure was seriously damaged, and uncertain land tenure puts substantial obstacles in the path of extracting the country’s mineral riches. These problems are compounded by an almost complete lack of infrastructure to support even medium scale operations.

4) Trade and the External Sector

20. Solomon Islands’ main export partners include Japan, China, Korea and the Philippines. The dominance of agriculture is seen in Solomon Islands’ trade profile, the top three export commodity’s being timber, fish and copra. The 1990s saw an improvement in Solomon Islands’ production of these commodities but the unrest caused a drop off in production. In 2002 and 2003 exports rose, an indication that output was recovering even before RAMSI arrived.

![Figure 6. Exports by Principal Commodity](source: ADB Key Indicators)

21. Solomon Islands has been a net exporter, which is unusual in a Pacific island country. However, much of the growth in exports has resulted from intensive logging and is not sustainable because of the over-utilisation in the remaining forestry resources.
22. Solomon Islands follows a exchange rate policy based a trade weighted crawling peg consisting of Japanese yen, the Australian dollar, the UK pound, and the US dollar. The government depreciated the exchange rate in 2002 by about 20 per cent to protect its international reserves.
5) Domestic and Foreign Investment

23. The period of unrest had a detrimental effect not only on the economy as a whole but also on the ability of the government to make credible commitments to consistent and cohesive policies. The impact of this is still felt today. There are concerns by many that the situation would degenerate seriously if the RAMSI force were to leave. A central factor in the private sector being able to operate more effectively and efficiently is the restoration of the credibility of the government. Unrest has the obvious result of reducing productive activity. But more insidious and worrying, is the impact on time horizons. Private sector activity depends in the ability of entrepreneurs to commit to investments over extended time periods. If entrepreneurs do not have confidence in the long term, then any investment will be adjusted accordingly – oriented towards larger, short-term rewards - or stopped altogether. Foreign investors, in particular, are looking for countries where they can be assured that their investment will be safe in the long term. Solomon Islands has a long way to go before the expectations arising from the chaos of the “Tensions” are changed. It is critical that the government does everything it can to reinforce their credibility and the viability of Solomon Islands as a long-term investment opportunity. How it can ensure this outcome, will be discussed in greater detail later.

24. It is no surprise that foreign investment in Solomon Islands dropped off drastically during the period of unrest. The extent to which it recovers will depend on whether investor confidence can be restored. A noted Solomon Islands commentator has written:

“It is important to understand the role of uncertainty in determining economic performance [in Solomon Islands]. The climate of fear of 1999-2002 has been replaced, after a brief interlude of relief, by a climate of uncertainty. Long-term growth cannot take place without investment, and uncertainty is the enemy of investment. Uncertainty not only drives away new investment, it increases the perception of risk and requires higher rates of return on existing investments, thus increasing costs and reducing competitiveness. Everything possible should be done to reduce the perceived risks of investing in Solomon Islands, and to shrink the cloud of uncertainty at present shadowing Solomon Islands’ economic future.”

25. This is a succinct exposition of the need to restore investor confidence.

![Figure 9. Foreign Direct Investment](image)

6) Inflation

![Figure 10. Inflation, GDP Deflator (Annual %)](image)

26. Solomon Islands has suffered from relatively high and variable inflation, averaging 11 percent annually since independence. Inflation creates a great deal of uncertainty, adversely affects a businesses’ ability to negotiate contracts, and increases business transactions costs when prices change constantly.
7) **Official Development Assistance**

27. Relative to other countries in the Pacific region, Solomon Islands has not received large amounts of aid per capita, but relative to most developing countries, aid per capita has been substantial. Development assistance has averaged nearly 16 percent of GNI over the period 1992 – 2002. This amount has risen sharply as a result of recent donor assistance and RAMSI.

**Figure 11. Official Development Assistance**

![Bar chart showing aid per capita for different countries in 2002 (current US$).](image)

Source: *World Development Indicators*
III. Private Sector Development Issues

A. Introduction

28. This chapter provides an overview of the barriers and issues that influence private sector development in Solomon Islands. Nevertheless, some topics, such as the role of the state, financial markets, infrastructure, and legal issues and property rights require more comprehensive analysis. Specific chapters on these topics follow the overview. Inevitably there is overlap between the overview and the detailed analysis – the authors beg the indulgence of readers for this.

29. Doing business in Solomon Islands is difficult. The legacy of the “Tensions” remains and the possibility of a return into anarchy raises the rates of return necessary to induce investment. Informal calculations by entrepreneurs interviewed as part of this report indicated that target rates of return had increased by 10 percentage points as a result of political risk.

30. Virtually none of the features of a good business environment are in place. Public goods are weak or non-existent, political uncertainty clouds the future, the already inadequate infrastructure has deteriorated further, income has fallen making a small market even smaller, and corruption is widespread. More specifically:

- The property rights involved in land leases are uncertain and there are many disputes, some of which have resulted in major natural resource investors departing Solomon Islands.

- A good commercial dispute resolution system does not exist and the laws are outdated.

- The machinery of the legal system is weak - registries are inefficient and unreliable and the court processes are slow and uncertain.

- There are reports of endemic corruption in most areas of the economy.

- Local financial markets do not finance investment and entrepreneurship effectively, particularly activities by native Solomon Islanders.
The National Provident Fund has a weak balance sheet because of past non-performing loans to SOEs, and very low rates of return on the portion of its portfolio that is sound.

The regulatory system is burdensome - successful formal businesses cannot concentrate on running their businesses, as they are forced to spend time and effort running the gauntlet of rules, taxes and licenses that do not provide any economic benefit.

A significant portion of the smaller and marginal businesses ignore most rules and pay little tax, which increases the burden on businesses that are taxed and creates an uneven playing field. The tax base needs to be broadened.

Tax rates are high and reduce incentives for success. At the same time, the state of public finances does not allow for any reduction in the overall tax take without significant expenditure cuts - something that is not feasible in the short run without a complete re-evaluation of the role of government in Solomon Islands. Efforts to improve the efficiency of government spending and the social outcomes associated with given levels of public expenditure should also proceed in parallel with those to improve the climate for private sector development.

Public administration is very weak. Staff are under-qualified, there is widespread absenteeism, and the systems of government are poor. And this is in Honiara. Outside the town, the situation is even more dire.

Infrastructure is poor in Honiara and the few provincial towns and virtually nonexistent in the rest of the country.

There are a substantial number of poorly functioning or essentially defunct SOEs that provide poor quality, high cost services and crowd out the private sector.

There are a large number of activities reserved for Solomon Islands nationals for which few if any local skills exist, which means that investment in these activities does not occur at all.

It is noteworthy that the government has budgeted SB$15 million for development spending that is not financed directly by development grants. The effectiveness of
such expenditure, however, depends on the degree to which it is spent on priorities outlined in the following pages.

31. Taken together, these add up to substantial barriers to doing business in Solomon Islands. Many claim that the problems faced by Solomon Islands are an inevitable consequence of the small size of the economy and that the extensive involvement of the State is necessary to make up for the handicaps that remoteness and small size bring. But this view is mistaken. The population of Solomon Islands gives it a much larger potential home market than most of the other countries in the Pacific Region. A theme of this paper is that many of the deficiencies of the economy result from the extent of state involvement rather than any drawbacks arising from the size of the economy. This theme is discussed at greater length in the next section.

**B. Barriers to Doing Business**

1) **Starting a Business; Formality and Informality**

32. Like many aspects of doing business in Solomon Islands, starting a business is an expensive and lengthy task\(^8\) as the following box indicates.

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\(^8\) Data are based on interviews with the Registrars Office and various local legal practitioners.
Box 1. Business Registration

Registering a Company: Costly, Time Consuming and Frustrating

Step 1. The applicant writes a letter to the Registrar requesting approval of the proposed name. The fee for this is SBD$100. The Office does a name search to make sure that the name is available. The process takes one day, although in practice it can take much longer.

Step 2. The Office of the Registrar then submits the name to the Minister of Land for approval. This takes up to 3 weeks. The Office of the Registrar then writes to the applicant, informing them of the approval.

Step 3. The applicant then fills in the standard forms. There is some controversy regarding how these are generated. The Office of the Registrar has not printed any new forms for 6 years because of budget constraints. Some lawyers say that they have tried to use computer-generated forms, but that the Office of the Registrar would not accept them, even though they were virtually identical. The Office of the Acting Registrar maintains that computer generated forms are acceptable, although it acknowledges that when there is no toner, or when the copy machine was not working, there would be delays.

Step 4. The forms plus the Articles of Association of the Company are submitted back to the Office along with a SBD$1700 fee plus Stamp Duty equivalent to 1% of the authorised capital of the company.

Step 5. The Office of the Registrar checks the documents for compliance with the Companies Act and once checked, issues a Certificate of Incorporation. Currently there is a 4 month backlog in issuing certificates.

Step 6. The Office of the Registrar informs the National Provident Fund, the Town Council and the Tax Authority of the registration (in practice, this often does not occur). The newly registered company is supposed to also register with these two bodies, but in practice it often does not happen.

Step 7. After incorporation, there is an Annual Return that must be filed, together with a SBD$50 fee. Many Annual Returns are not filed.

33. The Companies Act is based on the UK Companies Act of 1948 and needs review. In particular, the obligations of officers and directors of the company need to be strengthened. Incorporation is slow and the registration of shelf companies is not permitted. With respect to foreign investors, the process is especially slow. Another problem with the Companies Act is that the Memorandum of Association has to be unnecessarily long with, for example, a full set of objectives. This requires the use of a lawyer, which puts incorporation beyond the reach of the vast majority of Solomon Islanders. Thus the system of registration contains built in biases favouring foreigners.

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9 This is being undertaken as part of ADB RETA 6162 on the legal and commercial environment for private sector development in three Pacific Region countries, including the Solomon Islands.
34. Many of these procedures have no economic rationale and several steps are essentially futile. For example, there are no lawyers in the Office of the Registrar, yet every set of Articles of Association are “checked” even though there is nobody in the Office who has the legal training to ascertain whether they are satisfactory. Even if there were trained personnel, there is no rationale for checking in the first place. The purpose of registering a company is to provide information on who has the legal authority to commit the company to contracts and to specify the legal address of the company for the purpose of serving legal documents. There is no other reason for registering. Modern practice has evolved to the point where the cost and speed of such procedures is low and available to most people who need a corporation as a vehicle to do business. This issue is discussed at greater length in the Chapter on legal reforms.

35. Furthermore, the State reaps very little benefit from the process. For example, inefficiencies between the Registrars Office and the Ministry of Finance waste the potential information for tax collection that is contained in the Registry database. In principle, the Internal Revenue Commission could see information on every registered company in the country and cross check this against tax returns, (and whether tax
returns have been submitted.) However, this is not done and the potential for tax collection is wasted.

Figure 13. Time to Start a Business

![Time to Start a Business (Days)](chart)

(Source: World Bank Doing Business Indicators)

36. In addition to the steps outlined above, firms must navigate formidable additional hurdles. In Honiara, for example, the municipality requires numerous licenses and permits before businesses can operate, a process that adds to the time and expense of starting new ventures. Many of these licenses must be renewed annually. The process is one that almost invites corruption, with many businesses reporting that payoffs are endemic. The cost and time of the registration process pushes many businesses into informality. In principle, this situation means that unregistered firms do not receive the benefits of formality. These benefits include the protection afforded by a limited liability company, access to capital and the ability to engage in legal actions as a corporation rather than as an individual. Formality allows business owners to establish limited liability entities, which reduces personal risk. They can also enter into contracts with other businesses. In practice, however, few of these benefits are available to any but the larger companies. In other words, the benefits of formality are not substantial in Solomon Islands.
37. The World Bank Doing Business Indicators show Solomon Islands as among the costlier countries to establish a formal business. However, these data probably paint Solomon Islands in a more favourable light than is warranted. PSAs done in Fiji, Samoa Vanuatu and Papua New Guinea rank Solomon Islands as the worst of the group even though the World Bank indicators rank it above these countries. In any event, the Doing Business Indicators estimate the cost to be the equivalent of 44 percent of per capita income, making formal registration impossibly expensive for smaller entrepreneurs.

2) Transactions Costs of Running a Business

38. It is costly to engage in business in Solomon Islands. High costs of doing business are exacerbated by policy measures that have led to charges and inefficiencies that substantially raise the expense of commercial activities. Many public services function poorly in Honiara – in the provinces they are virtually non-existent. Attempts to improve these services are hampered by the dire financial situation of the public sector, which has not met its financial obligations since effective government collapsed during the “Tensions”. For example, the government was unable to service its debt to the banking sector, to pay for the utility services that it received and to pay its labour tax obligation to the National Provident Fund, and has been in arrears to suppliers of goods and services. This situation powerfully impacted the efficiencies of the private sector in the economy.

39. Gradually the government is resolving these problems with the assistance of donors, particularly Australia. The debt has been partly renegotiated, payments for current services from the utilities are up-to-date (although backlogs do exist), and the efficiency of services, such as power supply, is improving in Honiara though to a much lesser extent in the Provinces.

40. Nevertheless, many issues are only beginning to be resolved. Furthermore, sustained improvement requires a shift in philosophy on the role of the State in Solomon Islands. One of the themes of this report is that a culture of control of commercial activity by the State continues, which in all countries leads to substantial inefficiencies. When juxtaposed with a public service that has extremely low skill levels it is not surprising
that many activities are not taking place, or occurring completely outside the ambit of formal economic activity. In many areas the possibility exists for supplying the framework for a vigorous private sector. But under present circumstances these will not emanate from the State directly. A new way of delivering such services is necessary – one that pushes the omnipresent public sector into the background and allows the talents of private sector operators to be utilised in supplying them. In some areas this new method will require changes in the law, in others it will require changes in regulation and procedures. In all cases, donor assistance will probably be necessary as well as a unified approach to the resolution of these issues. The following paragraphs highlight some of the specific factors that raise transactions costs and make conducting business in Solomon Islands difficult.

a) Costs of Telecommunications and Utilities

41. Telecommunications costs are among the highest in the Pacific Region due in large part to the long standing monopoly of the telephone company – Solomon Telekom Company Ltd., which was renewed recently over the objections of many. Service covers all but one of the provinces, but reliability is often an issue and problems with land have hindered the establishment of relay stations that would extend coverage further. As in many Pacific Region countries, service to the more remote areas is subsidised by subscribers in Honiara and by raising charges for international services. While the desire of the government to provide service in outlying areas is understandable, the subsidisation raises costs substantially for business and amounts to putting a hidden tax on commercial activity.

42. Electricity supply has improved radically over the past year, although power failures are still common in Honiara. New capacity has recently come on-line in the capital city, which has reduced, although not eliminated, failures and brown outs. Supply, however, does not extend for more than a few kilometres out of the city in each direction. Ironically, the most reliable electricity supply in Solomon Islands currently is in Gizo, where NZAID installed new generator capacity and maintains the equipment as part of
the aid grant\textsuperscript{10}. Service on most of the islands and in all of the rural areas is virtually non-existent except for small scale generators installed as a result of various donor grants. As with most issues connected with the private sector, land availability is a major problem in setting up generating capacity. Most attempts to install hydro-schemes, for example, have foundered on land leasing and ownership issues.

43. The focus on improving the reliability of the power supply and the maintenance of generating facilities has resulted in a deterioration of the distribution infrastructure, which worsened substantially during the “Tensions”, with theft of copper wire a widespread problem. While this situation is gradually being addressed, a large amount remains to be done before service coverage improves.

44. While Solomon Islands’ electricity is not the most costly in the Pacific Region, falling around the middle of the cost distribution, it is still a major expense item for businesses, including the tourism industry and it is certainly among the most unreliable utilities in the Region. The World Bank has committed to assisting Solomon Islands with upgrading the quality of utilities, including electricity. This issue is discussed in more detail in a later section.

\textbf{b) Taxation Issues}

45. Tax administration collapsed during the “Tensions” with the result that government revenues declined sharply, money supply growth accelerated and inflation increased markedly. One of the priorities of RAMSI and the supporting donor community has been to restore order to the government accounts, both on the revenue and expenditure sides. Progress has undoubtedly occurred and some stability is returning to public sector finances. Tax reform is planned through the work of PFTAC, supported by RAMSI and other donors.

46. The following sections elaborate on the most important tax issues at greater length.

\textsuperscript{10} Although there are reports that the maintenance period has come to an end – future reliability must be monitored closely. A later section of this report discusses the effect of fuel charges on incentives to maintain equipment.
I) TAXATION AND PRIVATE SECTOR PERCEPTIONS

47. At meetings with the business community in Solomon Islands, there was intense dissatisfaction with the tax system and its administration. The main reasons were:

- Formal businesses believe that the tax base is so small because of ineffective administration that they are being targeted for compliance while other businesses are able to get away without paying any taxes at all.
- The tax system is cumbersome and imposes high administration costs.
- There appears to be no rationale for the various taxes that must be paid, with cascading taxes resulting in very high rates.
- The system of incentives and drawbacks is almost impossible to understand, either by taxpayers or by tax administrators, so there are often conflicting interpretations of compliance requirements, which results in numerous disputes.
- The formal business community knows of many cases where businesses do not pay tax.
- While the effect of RAMSI on law and order was immediate and welcome, formal businesses have yet to see improved administration of the tax system.

II) A BRIEF OVERVIEW OF PROBLEMS WITH THE EXISTING SYSTEM

48. There is no doubt that private sector perceptions are accurate in many cases. An excellent report from PFTAC outlines the shortcomings of the present system in detail – for the purpose of this analysis, a summary will suffice:

- “PAYE is not a final system and each employee must still lodge an annual income tax return, which is highly time-consuming for tax officials.
- The Company Tax is not a money-making tax and the small hard to tax companies and self-employed are not complying with the bookkeeping requirements, filing their tax returns, or paying the net-profit tax.
- The Goods and Sales Tax is cascading and very complex. Manufacturers and wholesalers are difficult to identify precisely.
- Withholding taxes are numerous and difficult to administer.
○ Exports duties are difficult to control.

○ The administrations of all major taxes lack sufficient enforcement powers and appropriate sanctions to make administration effective and tax collection efficient. This situation is particularly apparent with respect to record keeping, penalties, and powers to collect outstanding tax or to fight against stop filers and late payers.

○ The scope of exemptions is too wide and Solomon Islands urgently needs to reduce them.

○ The incentive regime does not need to be widened.

○ The design of the future Tax system should be such that it is simple, cost effective, and suitable to the level of development in Solomon Islands\textsuperscript{11}.

\section*{III) TAX REFORM}

49. The preconditions for a redesign of the tax system are in place and are expected to proceed in the near future. However, it is important to realise that the PFTAC report analyses tax system shortcomings, so it only covers revenue issues. The reforms that are being proposed do not consider the question of how much revenue should be raised. Within the context of economic reform, however, the role of the State in Solomon Islands is a central issue, particularly when it comes to factors that influence private sector development. Undertaking tax reform without a notion of how much tax has to be raised risks enshrining government functions that may be better left to the private sector. Just as important to the long term growth prospects of the economy, however, is how the tax revenue is spent. Currently, the revenue collected by government excluding grants and aid is expected to amount to the equivalent of some 22 percent of GDP in 2004, with the main sources of revenue being taxes on trade (7.4 percent of GDP), taxes on goods and services (8.1 percent of GDP) and taxes on wages and profits (6.1 percent of GDP)\textsuperscript{12}. Also, the State has additional revenue equivalent to nearly 25 percent of GDP from donor grants (primarily Australia) for developmental and general revenue uses. Although significant portions of the latter income source “leaks” out of


\textsuperscript{12} Revised estimates from IMF Article IV consultation, November, 2004.
the country for payments for various donor-supplied services, the government commands the equivalent of more than 30 percent of GDP.

50. There are two important questions that must be answered in connection with this revenue. First, does Solomon Islands have the capacity to absorb such large inflows and second, and even more importantly, what will this situation lead to in terms of government involvement in the economy? One of the central issues that impacts the long term prospects for private sector development in the country is what is the appropriate share of revenue for the government, and how it should be spent.

51. The State in Solomon Islands is currently unable to provide many vital public services, including those that are the foundation for private sector activity. Simply improving the efficiency of tax collection will not make up for any of the fundamental issues facing the country. Furthermore, it is unrealistic to believe that technical assistance and governance programs can address the shortcomings of the public sector in the foreseeable future, which probably extends at least 5 years hence. A reconsideration of the role of government is therefore warranted and this paper urges strongly that a debate on this issue commence without delay. It is worth noting that when Australia and New Zealand had per capita incomes equal to that of Solomon Islands, government expenditure amounted to less than 8 percent of GDP. This issue is discussed in more detail in the section on the role of the state in Solomon Islands.

52. How would the role of government in the area of private sector development differ from what currently exists? First, the appropriate course of action is to put many of the areas where government is now dominant into the province of the private sector. This would include the provision of many infrastructure services, particularly inter-island transport, small-scale electricity generation, cellular telephone services and so on. In addition, the private sector could assist in the provision of some legal services such as registry operation and private repossession in the event of default on debt.

c) Costs of Transport

53. The quality of all types of transport place substantial barriers in the path of private sector development. Air and sea transport in and out of the country are expensive. Inter-island transport is unreliable and costly. An inadequate road network hampers
road transport – there are only 40 kilometres of paved rural roads in the whole of the country. Inter-island air transport is also reported to be unreliable, and there are reports of weak maintenance of both aircraft and ships that offer inter-island service. Since the neglect of maintenance is long standing, Solomon Islands risks international censure regarding its safety standards, which could have serious implications for inter-island transport.

54. A number of factors hindering the operation and efficiency of all types of transport include:

- The near absence of functional infrastructure;
- The poor quality of maintenance facilities;
- The low incomes of potential users;
- Government interference;
- Taxation.

55. Set against this situation are reports that private sector operators have largely replaced the unreliable provincial shipping services when the latter virtually ceased operation during the “Tensions”. There is a danger that government agencies will attempt to control inter-island shipping, either at the central or provincial government level. The government is considering establishing a National Shipping Authority. There are disturbing signs that some donors are prepared to support such a move. This would be a grave error.

d) Costs of Importing Goods

56. The uncertain and distortionary import regime greatly adds to costs in the economy. The distortions are caused by exemptions, variable duty rates and a surcharge. The exemptions increase opportunities for evasion and penalise those businesses that attempt to act honestly within the system. The 30 percent surcharge on imports that is supposedly imposed for “profit”, has no sound analytical basis. It merely raises the
amount of duty paid, imposing further costs in an economy that must import most manufactured and capital goods\textsuperscript{13}.

3) Foreign Investment

57. Recently, a local economist described the process of foreign investment in Solomon Islands:

“At the same time successive governments were making a famous mess of the arrangements for promoting and monitoring foreign direct investment in SI. The process was heavily politicised from the start, with ministerial and prime ministerial involvement in interviewing and selection of investors and devising of investment conditions, with some of the more important and personal conditions apparently not being recorded. This long-winded and corruption-prone process has had a deterrent effect on a number of genuine would-be investors, some of whom have made their feelings known in Honiara. Conversely, it has also encouraged some obvious con-artists to try hijacking parts of the economy. Amazing statistics have periodically appeared about the number and value of incoming investments approved, but there has never been any serious attempt to follow up to see what actually happened and publish the information.”\textsuperscript{14}

58. The analysis and review undertaken as part of the background to this paper supports these observations. There is comprehensive control and review of foreign investments in Solomon Islands that brings no benefits and imposes substantial costs. Although all applications by foreign investors have to pass through the Foreign Investment Board (FIB), in practice other senior government officials vet applications personally. The process is ostensibly to ensure that the prospective investors are “genuine” and to keep out shady characters that are notorious in the Pacific Region, namely the iniquitous “two dollar investors”, who are reputed to take advantage of well meaning countries and then flee with the proceeds of their nefarious activities\textsuperscript{15}. In addition, there are

\textsuperscript{13} Examples of evasion and abuse are widespread. For example, outboard motors can be imported under bond, and duty paid when the motors are sold. According to customs records, there should be over 600 motors held under bond in Honiara – the actual number is a tiny fraction of this figure.


\textsuperscript{15} In practice, under transparent circumstances and processes, a review found no instances where investors had defrauded any countries in the Region. All reported cases of fraud involved instances where investors had managed to persuade governments to provide special favours and incentives.
myriad licenses and permits to be obtained as well as checks to make sure that there is no encroachment into activities reserved for Solomon Islanders. Investors are often required to lodge a deposit with one of the local banks while the approval process takes place. In principle, at least, the deposit can be forfeited if actual investment is delayed once approval has been granted.

59. In spite of the extensive review of foreign investment applications the process functions poorly. It is time consuming, expensive and fraught with delays – decisions take months, or even years. It is not effective in keeping out investors of dubious repute. There are many examples of the review failing to filter out rogues. The most recent include people claiming to represent Cornell University in the United States and Kings College in the United Kingdom, both of whom obtained investment approval and opened “campuses” in hotels in Solomon Islands to defraud unwary students who have registered with them. Both universities have repudiated these imitators. The review process merely discourages genuine investors who have many places to choose from in placing their investments.

60. The list of activities reserved for Solomon Islanders runs to nearly 8 pages, and includes any business employing less than 10 people. In many cases the list is arbitrary, leaving much to the interpretation of those approving the investment, and providing substantial opportunities for corruption. Justification for reserving certain activities for citizens is based on the conception that there is a limited number of jobs available in Solomon Islands and that if foreigners are allowed to engage in these sectors, they will be taking work or opportunity away from Solomon Islanders. This misconception is known as the “lump of labour fallacy” and has been proven to be incorrect everywhere. The more investment that occurs, the larger the number of jobs available for local people. The effect of this list is not to “protect” Solomon Islanders, but rather to discourage small business formation by foreigners who have skills that local people do not.

61. Parts of the Government recognise well the problems that the current foreign investment regime poses. A recent document of the Investment Division of the Department of Commerce, Industries and Employment clearly establishes some of the barriers that the current process erects to foreign investment. The document outlines
reform recommendations, many of which would lead to substantial improvements. It also recommends revising the list of proscribed activities and suggests:

“The total number of activities included on the list would be kept small as possible in order to promote competition and maximise benefits for businesses and consumers. Any activity included on the List would meet the following criteria:

- Should not be dominated by an individual or a small number of people or businesses;
- Should not produce products or services that are important inputs into the operations of many other sectors of the business community;
- Should be described in a clear and understandable way to enable easy comparison against activities that are listed in foreign investors’ applications.”

62. This text is ambiguous – if it means that activities included on the list would not allow foreign investors to produce items that are important inputs into the local economy, this paper takes strong exception to the recommendation. Similarly, there is no reason why a relatively small number of investors, whether they be foreign or domestic should not produce a major proportion of local output.

63. More generally, the rationale supporting a reserved list of activities is faulty. The optimum policy is to abolish the reserved list altogether. The recommendation is based on the following premises. Implicit in the justification for a reserved list are the notions that Solomon Islanders cannot compete with foreigners because they lack skills; they suffer from inherent disadvantages, such as access to finance; there are hordes of foreigners waiting to push Solomon Islanders out of these activities; and there is some fundamental reason why foreigners should not engage in certain activities.

64. But, none of these rationalisations have any economic justification for the following reasons:

- If foreigners have superior skills in certain areas, they will pass these on to Solomon Islanders who, if willing, will learn them and use them to start their own businesses. Without these skills, Solomon Islanders who engage in these activities are likely to end up bankrupt. The reason why Solomon Islanders and others in the Pacific
Region have not benefited as much as they should have from the effects of foreign investment is the dysfunctional business environment that puts so many barriers in the path of local businesses.

○ In any country, investors with more capital have an advantage over those with less capital. This is as true in the U.S. as it is in Solomon Islands. However, this is not a reason to prohibit those with more capital engaging in particular activities. Successful investments benefit the economy as a whole, as well as the individual investor by raising the overall level of prosperity. Keeping those with capital away from activities in which they could invest successfully harms many Solomon Islanders. However, it is true that the system of property rights and collateral severely disadvantages entrepreneurs in Solomon Islands, especially those without capital. This is an argument for reforming the collateral system, however, not for proscribing certain activities.

○ Getting genuine foreign investors and entrepreneurs to invest in Solomon Islands is difficult. It is highly unlikely that there are investors who would push Solomon Islanders out of investment opportunities. Far more plausible is the danger that the difficulty foreign investors face in investing will result in them sending their capital and skills elsewhere.

○ There may be some activities that should be performed by Solomon Islanders only, on religious or cultural grounds. In such a case, however, it is inconceivable that foreigners would either desire to or be able to engage in these activities.

65. The conclusion of this analysis and the recommendation of this paper is therefore that the proscribed list not be reformed, but that it be abolished on the grounds that not only does it serve no purpose but it is most definitely harming the citizens and residents of Solomon Islands. A review of the foreign investment regime, supported by the Foreign Investment Advisory Service (FIAS) of the World Bank Group, has been finalised that identifies many problems described above – steps to improve the process are getting underway.
4) **Investment Incentives**

66. Solomon Islands has a system of incentives revolving around the granting of tax holidays for investment. These are available to both local and foreign investors and provide for a tax holiday of up to 5 years [or, in some cases substantially longer] for approved investments. Such incentives are counterproductive. They create two classes of businesses – those that have incentives and those that do not, and effectively penalise smaller, indigenously owned businesses as well as those that have continued to operate in Solomon Islands during the worst of the “Tensions”. Furthermore, there is little evidence that incentives of this type create long lasting investment and, rather, encourage “incentive shopping” around the Pacific. A much preferable strategy is to have no incentives but a sharply lower company tax rate.

5) **World Bank “Doing Business” Indicators**

67. Additional information on problems faced by firms in Solomon Islands is provided by the World Bank “Doing Business Indicators,” which reinforce the conclusions of the preceding analysis - that Solomon Islands is one of the most difficult places in the Pacific Region for entrepreneurs to operate. Across the board, the indicators are poor. While not necessarily always the worst in the Pacific, they are also not favourable for business, particularly when compared with those countries that are best in class.

a) **Time and Cost to Enforce a Contract**

68. One of the elements that is important to the business environment includes contract enforcement – the time and cost to enforce a contract. In Solomon Islands, the time and cost are prohibitive and the highest in the Pacific by far. It takes 455 days to enforce a contract and 141.0 percent of per capita income.
69. Contract enforcement is important to business. Without enforcement, contracts can only be entered into between people who know each other well and as a result businesses cannot move beyond their immediate circle – which reduces economic efficiency and business opportunities. Contracting also allows longer time horizons. When it is difficult to enforce a contract, contracting tends to be between much smaller numbers of people, which concentrates economic power in the elite. It makes entry by newcomers more difficult and inevitably reduces entrepreneurial dynamism.
b) **Insolvency**

70. It is not only important that it is easy for entrepreneurs to start and register a business. It is also important that the process for shutting a business down is smooth and happens as quickly as possible. When a business exists, its resources are wrapped up in the activity of that business. When a decision is made to close the business, it is important that those resources can be deployed to more productive uses as quickly as possible so efficiency can be maintained and growth stimulated. It is also important that when a business closes, any creditors can get the money owed to them out of the business once it is closed. If they are unable to do so, the incentive to lend is reduced and lending costs for others are increased by the increased risk to lenders. (The return on any investment has to be that much higher in the future.)
Figure 16. Time to Go Through Insolvency

Time To Go Through Insolvency (Years)


Source: World Bank Doing Business Indicators

Figure 17. Recovery Rate in Insolvency (Cents on the US$)

Recovery Rate in Insolvency (Cents on the Dollar)


Source: World Bank Doing Business Indicators
71. In Solomon Islands, the ability to get resources out is greatly hindered by the bankruptcy process, which, according to the Doing Business indicators, takes close to 4 years with a recovery rate of only 24 cents on the US dollar. In practice, the situation may be even worse than these statistics show, since most bankruptcies do not even enter the process.
C. The Rural Sector

1) The Importance of Rural Development

72. National policymakers, governments, and donors frequently overlook rural based economic activity. Furthermore, there is a tendency to view the development of rural areas as a problem in agriculture. While it is true that agriculture, fishing, logging and mining play a substantial role in the rural economy, neglecting services associated with supplying rural producers and distributing their output is a major element of rural business development. High service costs and poor transport currently consume a large proportion of the potential gains from engaging in economic activity in rural areas. Many aspects of the rural economy remain underdeveloped. With the wide range of climatic conditions that exist in Solomon Islands, there are substantial opportunities for many different types of agriculturally based activities – agriculture in Hawaii is an example of how small island states can develop agricultural activities.

73. With a large majority of the population still living outside urban areas, the stark choice in Solomon Islands is between encouraging rural business, or emigration by the rural population to urban areas, particularly Honiara, which was the original flash point for the “Tensions”. Ironically, there is a risk that the influx of donors and donor support, combined with the substantial immediate stimulus of the economy from RAMSI, gives incentives for Malaitans and outer islanders to resume their migration to Honiara, carrying with it the risk of a resumption of interracial strife. While trends worldwide indicate the it is impossible to stop urban/rural migration because of greater opportunity in towns and cities, if rural opportunities are non-existent, this movement will be greatly magnified.

74. For the rural economy to bring prosperity, it must become a source of employment and private entrepreneurship for large numbers of Solomon Islanders. It will not happen, however, under the present circumstances – the issues of the dysfunctional business environment discussed in the preceding sections are greatly magnified in rural areas. Furthermore, even urban centres that are remote from Honiara can benefit from greater business activity in rural areas. If growth can be widespread, geographically, its benefits will contribute to poverty reduction over a wider area.
75. Promoting rural development and growth requires the formulation of a rural private sector development strategy in its own right. A rural private sector development strategy has the potential to enhance greatly the effectiveness of a broader rural development strategy and increase its effectiveness in reducing poverty and promoting country wide prosperity. This would make a substantial contribution to promoting alternatives to migrating to Honiara, as well as attenuating the rivalries between different areas of the country.

2) Main Elements of a Rural Development Strategy

a) Rural Infrastructure

76. What are the main elements of a rural development strategy? First and foremost, rural development requires substantial improvement and upgrading of infrastructure. Currently local roads, local ports, electricity and water supply, shipping services, air communications and telecom connections hamper severely all private sector activity in rural areas. Unless there is improvement in these vital services, there is little possibility of promoting rural development. In this, rural development policy is strikingly similar to more general interventions to promote private sector development, illustrating the extent to which business environment issues span the whole spectrum of reform measures. A later section outlines ways in which upgrading infrastructure can add to the prosperity of rural areas through local and community-based implementation. This in turn necessitates better performance on the part of the central government.

b) Legal and Financial Reform

77. Development of the legal and financial system will promote rural development. The interest of the Central Bank in microcredit systems is to be welcomed – combined with effective secured transactions reform that will promote, for example, the securitisation of microfinance portfolios - has the potential to provide monetisation and finance in areas where it currently does not exist. Furthermore, there is a symbiotic relationship between rural infrastructure and the developing of branch banking and mobile banking networks that can further promote rural development.
c) Assistance to Rural Smallholders and Agricultural Communities

78. There is substantial potential for smallholders to promote agriculture as a driver of economic development in rural areas, but sectoral performance is limited by mis-oriented or non-existent research and extension that does not emphasize smallholders, an inadequate focus on traditional crops, fragmented institutional responsibility for agriculture, and an absence of mechanisms to resolve competing land claims. These issues need to be addressed.

79. Regardless of how successful the initial reforms are, once producers have good property rights and incentives, and once exchange is being facilitated by functioning institutions, sustained rises in productivity will depend on investments in agricultural research, extension, and other infrastructure projects, such as investments in water control and roads, that individual farmers will not be able to finance by themselves. In the long run, agricultural growth will suffer if such investments are ignored during transition. When nations reach the point where they face these longer-run problems, in fact, reform may be close to an end and transition problems may be evolving into more traditional development problems.

3) Land Reform

a) Property Rights in Land

80. At independence, the land holdings of all non-Solomon Islanders moved to 75-year leases. Many problems surround land rights and land holdings in Solomon Islands. These include:

- The process of allocating land is said to be very non-transparent. Until recently, it was not unheard of for government land that was earmarked for development to be transferred to Government Ministers or particularly powerful wontoks for little or no payment\(^{16}\) and without publicity.

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\(^{16}\) An example is the recent case of Kennedy Island, which was sold to a minister for US$1000. The island is low lying and is threatened by flooding - it was given to the minister on the grounds that he is the only one who could put walls around it. Another island was allocated to a Canadian expatriate for the nominal cost of SB$4000 plus SB$48 per year in rent.
• Government at all levels not knowing what land it owns accentuates the non-transparency of the process.

• There is also a problem with land valuation. Land rents are very low. Lease payments are calculated on the basis of 5 per cent of the unimproved capital value of the land. The current Land Act only provides for the adjustment of lease payments every 20 years. In many cases the difference between the valuation and the actual land value is 2000 per cent.

• In addition to problems of land valuation, there are also problems of collecting payments on land leases. There are estimates that government is collecting only a small portion of the rents due – even in Honiara, the Town Council is only collecting less than 20 per cent of what is owed.

• Under the existing land law, there is no requirement that leaseholders give lessees notice of non-renewal.

• The Australian Defence Force remapped the whole country over the past two years and this information can be used to promote land reform.

• In Honiara, 25 per cent of the people are living in areas without any tenure - yet they are developing their properties. These are recent arrivals. Observers in the Land Office estimate that there is about SB$100 million in housing stock in these areas - they are suburbs in their own right with schools and clinics.

81. There is currently an AusAID financed land administration project that has produced its own street maps of Honiara - there are no addresses - and this is being used to determine what land the government is actually holding. An aim of the project is to introduce standard procedures for the granting of leases and the transfer of land. In addition, there is a new proposal to update valuations every 7 years. At the end of the lease, all improvements revert to the government.

82. There is a new land law that is currently stalled in the legislature. In the existing law, there is no provision for giving notice on the intention to renew or terminate leases. Any new law should require lessors, including the government, to give long term notice of their intention to renew or terminate - say 10 years. However, enforcing adherence to
these procedures is a major challenge. In total, the government is collecting SB$1.7 million in lease rents throughout the country.

b) A Proposal for Land Reform

83. Some observers in Solomon Islands maintain that land reform is not the insuperable problem that many claim it to be. At least partly, many indigenous people would like to find a way that would allow leasing, as long as land lease rents reflect land valuation and can be adjusted on a more regular basis. The problem of group ownership remains but there are ways around this, according to some local observers. One intriguing suggestion made by a land administrator is to base land reform on the pattern of a corporation. This reform would require four distinct steps.

- Determine through genealogy family ownership. This would require expert assistance from genealogists.
- Provide for binding arbitration in the case of disputes.
- Fix the boundaries of the property through surveys and maps.
- Develop an ownership vehicle based on a corporate structure. This would involve an organisation akin to a corporation, where each family or group owner in a particular piece of land would receive a predefined share based on their genealogical rights. The agreement in terms of which this would be held would determine how large a share any individual or family owned as well as the rules of succession - for example the rights of those who have married into a landholding group and how their children’s rights should be treated. The “corporation” would be managed by a combination of heredity chiefs plus people elected by the landowners to represent them. The corporation would also produce sets of accounts, with distributions of the proceeds of any leases that it might have.

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17 Based on conversations with Rod Little, AusAID Land Administration Project, Honiara.
D. Is the Small Size of the Economy a Handicap?

84. Small Island economies like Solomon Islands face disadvantage resulting from their size and isolation. The most important of these are:

85. Remoteness. All of the island countries of the Pacific are located far from major markets and are often a geographically dispersed collection of small atolls, which raises transport costs – the long distance to markets and small cargo volumes, make economies of scale difficult to achieve. In turn, freight carriers may have a monopoly position, which generally leads to higher costs as well. The result? Business faces a de facto tax on exports and imports, which makes it more difficult for island nations to compete with larger, less remote economies.

86. Susceptibility to Natural Disasters. Most countries in the Pacific, including Solomon Islands, are subject to adverse climatic and natural events including cyclones, floods, earthquakes, tsunamis, droughts, and volcanoes. These events serve to decrease income and increase investment risk and at times can threaten an islands’ a very existence – in the case of volcanic eruptions, tsunamis, and global warming – as the recent events in the Indian Ocean Rim have so dramatically and tragically demonstrated.

87. Limited Institutional Capacity. Providing public goods and services in small economies inevitably implies that fixed costs are high so it is difficult for the government to capture the economies of scale needed to provide public services effectively, including regulation and a well functioning judiciary. These costs increase even further in countries such as Solomon Islands that are geographically dispersed. The institutional capacity of the public sector is further limited by the failure to fill many government vacancies. There is anecdotal evidence of the availability of qualified and motivated personnel who could adequately fill vacancies, but delays abound.

88. Limited Diversification. The small market size and a generally limited resource base imply that production possibilities are narrow as well. The potential for manufacturing industry is limited and small economies generally rely on a limited number of income

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earning activities, such as natural resources, tourism, services, agriculture and fishing. Even though a majority of the population of most Pacific Region countries are engaged in agriculture, however, it primarily takes the form of subsistence production, even though many countries, like Solomon Islands, have climates and soils that could be harnessed to supply specialty and seasonal products to industrial country markets. Concentrated production of limited products exposes Pacific Region countries to income volatility because fluctuations in world prices have an inordinate influence on GDP.

89. **Access to external capital and investment.** Private capital markets generally regard the island nations of the Pacific as being risky. The result is high interest rate spreads and difficult access to capital. The high interest rate spreads result from financial institutions needing to recover their fixed costs, which are the same for small loans as they are for large ones. For those islands with high levels of public and private indebtedness, including Solomon Islands, commercial borrowing is virtually precluded, and even those with low levels of external debt find commercial borrowing difficult. While some small states receive significant inflows of FDI, an important source of new technology and expertise, most Pacific island economies receive less per capita than average.

90. Small states are at a disadvantage in attracting FDI. This disadvantage exists for the same reasons that commercial lenders reject lending to small states even when those states have open economies and good investment policies – the risks are higher and the returns not commensurate. For this reason, the IFIs have a role to ensure that market information is made available to potential investors.

91. While all of these factors may present a pessimistic view of the prospects for Solomon Islands, many small economies have overcome the inherent disadvantage of size. Easterly and Kraay\(^{19}\), analysed small developing economies around the world. They found that states with a population of less than one million have higher per capita GDP, higher productivity growth rates, and worldwide have been able to achieve more rapid growth than larger countries, although they do have greater income volatility. They concluded that economic policies in small states should not differ in any material way.

from those in larger states. Winters and Martins support this conclusion, although they are less sanguine about the prospects for the very smallest economies.\textsuperscript{20} [They conclude, for example, that manufacturing is probably not viable in the small economies of the Pacific Region, except in limited and specialised form for local markets].

92. Both studies emphasize the need for policies that promote flexibility in the face of uncertain external events, both economic shocks and natural disasters. Although neither discusses domestic policies in detail, the conclusion of both studies is that small economies require government policies that offset rather than exacerbate the disadvantages of small size and remoteness. Unfortunately other work has concluded that policy in most Pacific Region economies has had the opposite effect.\textsuperscript{21} State ownership of essential services, excessive bureaucracy, a failure to supply public goods such as property rights and a well functioning legal system, combined with a “Culture of Control” has dramatically raised the costs of doing business in the Pacific. In this, Solomon Islands is no exception.

93. Rather than promoting flexibility policies have been implemented that have the opposite effect. Implicitly or explicitly, remoteness and size have been regarded as a form of market failure, which in turn has been used to justify government intervention in virtually every sector of the economy. In spite of the highest per capita aid of any region in the world, the results have been high costs, the emigration of a substantial proportion of the population, and stagnant or declining per capita incomes. Solomon Islands has implemented policies that have led to the stagnation of the private sector. There is a great deal of control of economic activity, which combined with extremely limited competence in the public sector has reduced the ability of the economy to cope with fast changing events in the outside world and has stifled investment and entrepreneurship at home. At the same time, a heavy public hand has resulted in centralised decision making and resource concentration, contributing to the “Tensions”. The combined effect has been a marked decline in per capita GDP over the past several years and a dimming of growth prospects in the future.


IV. The Role of the State

94. This chapter discusses the role and functions of the State in Solomon Islands and the implications for government and donor policy to promote private sector development.

A. Strengthening the Public Sector

95. From the perspective of investors and entrepreneurs in the private sector in Solomon Islands, the public sector is a substantial barrier to doing business. The authors conducted extensive interviews with the business community - there is a universally held feeling that the State puts many barriers in the way of doing business, while providing none of the foundations for private sector activity that are essential for a modern competitive economy operating in a globalised environment. Property rights are weak, the legal system provides a poor foundation for contracting and dispute resolution, government owned sectors of the economy do not function effectively, tax rates are high, and interference is pervasive.

96. There are extremely competent people in the public sector. They are the exception rather than the rule, however. In general, levels of education, training, and competence are below what is needed for the public sector to function at even a minimum level of effectiveness – several people interviewed who have extensive international experience described the public administration of Solomon Islands as the weakest that they had ever seen.

97. The capacity to promote change in government through learning and the sufficiency of its resources to exert leverage, are all issues that are fundamental to policy makers intent on improving the investment climate. Realism dictates that whilst there is the necessity to embark on a program for improving the efficiency of the public sector through training and governance programs, they are not likely to bear substantial fruit in the immediate future. This is an issue that both reformers in government and donors must confront in formulating a strategy to promote growth in the economy. International experience is not encouraging in this regard. The need for change is urgent, while the prospect for a significantly improved public service is far in the future. It is hard to say
how distant is the horizon which will bring better functioning civil service, but it is safe to say that nothing fundamental will be achieved soon.

98. In the view of the authors of this report, cooperation between the small number of serious reformers in government and donors intent on promoting the transformation of Solomon Islands’ economy do have the potential to promote long lasting and vigorous growth but only by changing radically the role of the State in the economy. This requires re-orienting their intellectual framework (learning), applying what they learn to operations (particularly regarding credible commitment), and exploring ways of increasing their leverage. This requires further understanding of:

- The idea of the centrality of credible commitment to private-sector development – entrepreneurs and investors must become convinced that the country will not relapse into chaos, and that any change in the rules governing private sector activity will not be reversed.

- A tested and refined link between credible commitment and political rules and structures.

99. The issue of credible commitment must be central to realistic institutional assessments of the viability of specific donor operations to promote private-sector development. Often, donor agencies, through staff turnover or changes in strategic priorities, are unable to maintain their own commitment over time to a project or to the policy changes it requires. Donors should ensure that they have the proper long-term instruments and procedures to assist in implementing the necessary change.

100. Donors can also promote good political practice in small ways. For instance, policies made under transparent conditions (for example, pre-publication of laws, consultation) are more likely to be durable than policies made rapidly and behind closed doors. Donors can increase their potential leverage in two possible ways. The first is to seek ways of the donors working closely together (in this the Australian Government, the ADB, the World Bank and the IMF have a central role) – in other countries this has been easier said than done.
B. Undertaking and Building Support for Reform

101. Reforms that visibly and tangibly benefit large numbers of people or firms may create their own political momentum. Real-property-rights reforms, for instance, can benefit large numbers of people who then become a pressure group seeking to ensure that the reforms are not reversed. Building feedback mechanisms into projects may help ensure that their benefits are well-disseminated. Donors have a central role to play in the rebuilding of Solomon Islands’ economy and in assisting the country develop a foundation for future growth. Developing a strategy to address Solomon Islands’ private sector development requires a common and consistent long-term vision of the country’s priorities and ways to address them by all donors. The Economic Reform Unit has taken strong initial steps to ensure that this is occurring. The vision needs to be holistic in that it must address: the macroeconomic issues critical in providing an environment conducive for the private sector, sectoral issues such as tariffs and customs procedures, inter-sectoral linkages such as utility costs, and small rural enterprise concerns. The government needs to consult with civil society and external donors to build consensus on the way forward. However, the lack of effective government in many areas is a major impediment to private sector development. Without a strong government commitment, private sector business activity will continue to be hampered.

C. Guidelines for Reform

102. Pay systematic attention to the nature of prospective winners and losers from institutional reform. Be aware of the main cleavages – regional, sectoral, social, etc. – that appear to separate such winners and losers. Monitor closely the nature and intensity of support or opposition as manifested by public opinion polls, proclamations of interest groups, public demonstrations, and the like.

103. Empowering the beneficiaries is good policy and smart politics. Give beneficiaries “voice”, for instance by allowing greater parent participation in school management or by protecting community rights.

104. Providing choice to beneficiaries is also good policy and smart politics. Allow citizens a say in how infrastructure programs should be targeted and implemented.
105. **Public-information campaigns should be part and parcel of reform efforts.** Potential interest groups – the poor, notably – may be inactive because they lack information. Information campaigns are particularly important where the poor have a vote.

106. **Pay careful attention to the political support for prospective reforms at the intermediate level, particularly among key political leaders and political party organisations.** Assess the possibilities for “deals” and tradeoffs among them. Be particularly aware of the “political cycle” – i.e., how windows of opportunity for institutional change might open (or close), depending upon impending elections.

107. **Have a clear understanding of the constitutional – i.e. formal/governmental – facilitators and obstacles to institutional change and reform.** With a clear understanding of the constitutional forces in play, and of their close relationship to partisan forces particularly in the legislature, think creatively about how to exploit the opportunities and overcome the constraints.

108. **Reforming incentive structures is good policy and smart politics.** Perhaps the politically most difficult reforms to complete are those that aim to change or reduce public employment. Consequently, public organisation reforms should focus on incentive structures rather than changing personnel or installing the latest technology.

109. The realities of the region suggest that broad frontal reforms in typical Pacific Region countries are often unrealistic. Picking out policy enclaves (for instance in tax administration and infrastructure regulation) is an alternative approach, which is not popular with policy purists, in large part because it undermines the integrity of the public sector. But in reality there are not too many alternatives. Policy enclaves also suffer from a problem of credible commitment, precisely because they are often not as well anchored in the public administration as mainstream agencies, relying instead on the personal authority of a president.

**D. Extending Credible Commitment from One Government to the Next**

110. To extend credible commitment to specific policies or institutional change, the following steps are possible:

- Donors need to remember that a project is a contract. They should insist that a project contract be fulfilled both by the present administration and the next. To do
this, donors will have to be disciplined (and eschew the pressure to disburse.) Unless the recipient country, in this case Solomon Islands, fully complies with the terms and conditions of loan and technical assistance programs, disbursement can be counterproductive. While no donors are currently lending in Solomon Islands in the short to medium term, once the loan program recommences, strict adherence to conditionality is necessary to promote long term reform commitment.

- Building pro-reform stakeholder groups will also help. Donors can provide direct support to such groups (e.g. community groups, exporters’ associations, residents’ associations.) They can also build mandatory information provision, service standards, and service-quality surveys into the services their projects support. Publicising the aims, amounts and implementers of loans and grants can bring a degree of community involvement and control to increase support and participation. Donors can also implement courses for journalists on the benefits of the specific reform might help, for example.

- Donors should encourage pre-publication of, and consultation on, new laws and policies underlying the reforms it supports.

- Donors can seek to enshrine a policy or institutional change they support into a more formal national commitment. This could be, as suggested above, a treaty commitment or a summit declaration. Striking up alliances with other donors to provide joint public support for reforms will help cement national commitment (especially if this alliance can co-sign a policy letter with the government).

- To create credible commitment for a general political mechanism, the following steps are possible (to the extent donors can become involved in political issues):
  a. Take measures that support greater checks and balances in government, such as legal changes and capacity building that strengthen the non-executive branches (legislatures, courts, external auditors, ombudsman).
  b. Support the general provision of information and pre-publication of, and public consultation for, draft laws and new policies.
  c. Take measures to strengthen political parties, pro-reform interest groups, and the media.
V. Infrastructure Issues

A. Introduction

111. Given Solomon Islands’ geographic reality – several large islands surrounded by many small islands spread out over a large area – providing infrastructure services efficiently requires creative solutions different from the traditional means of infrastructure provision. The quality of existing infrastructure was low even before the “Tensions”. It has now reached a point where the most basic levels of infrastructure service provision are absent over a large area of the country. Electricity, water, transport and communications are conspicuous by their absence for a large percentage of the population. Of the 1500 kilometres of roads in Solomon Islands, less than 40 kilometres are paved, making road transport uncertain or unavailable over large areas of the country. Only 16 percent of the population has access to electricity. Inter-island sea transport is unreliable, as are air links, and both are said to be unsafe. Telecommunication services are more widely available, but prices are extremely high.

112. Providing infrastructure in Solomon Islands, however, is a particular challenge. Even abstracting from the weaknesses of the State and of public administration, supplying even basic services to numerous islands spread over a wide geographic area is difficult. Any program to improve infrastructure service provision must face this reality. In Solomon Islands, therefore, the gap may be wide between technically efficient solutions and providing answers to the lack of infrastructure that are feasible economically. An optimal technical solution in the electricity sector, for example, dictates low cost power provision through large generator facilities. In Solomon Islands this is not economically efficient because of the lack of roads, the remoteness of many villages and the inability of large scale power providers to administer effectively a widespread network.

113. Although the geographic realities may raise costs in one dimension, however, in another it provides an opportunity for the introduction of distributed infrastructure services and competition, as well as the possibility of experimenting with different forms of

22 Australian Government. 2004. Solomon Islands, Rebuilding an Island Economy. Department of Foreign Affairs and Trade Economic Analytical Unit. p. 60
supplying telecom services, electricity, inter-island sea and air transport as well as local roads and even ports. This theme is developed at greater length in the sections that follow.

B. Current Infrastructure Services

1) Electricity and Water

114. Electricity service is characterised by regular disruptions, although reliability is increasing, especially in Gizo, where NZAID installed new generation capacity, and in Honiara, where the focus of the Solomon Islands Electricity Authority (SIEA) has been on maintenance of supply. As a result, power is available more regularly, although brown-outs are not uncommon, especially in Honiara. However, the distribution network is in a parlous state. SIEA has suffered extreme financial difficulties in recent years, primarily because of the backlog in payments from the government to the company. In addition, it has had problems collecting debts and power theft and theft of wire from the distribution network is not uncommon. Given the difficulties of operation, the management of SIEA have had to overcome substantial obstacles to operation. In addition, funds for investment in new facilities are in short supply as is the technical expertise to service the facilities effectively. The World Bank is about to embark on a program to assist the Government in the improvement of the operation of utilities.

115. The cost of electricity in Solomon Islands is about at the midpoint of costs in the Pacific Region. The setting of tariffs is based on a fixed charge plus a fuel allowance. In the current rate setting cost structure, about 65 per cent of the price is based on the fuel cost, and only some 8 per cent is allowed maintenance. But, prices can only be changed by going through a tortuous process. There is a requirement that consultants be hired to study the cost structure and make recommendations for change. This analysis must then be submitted to Cabinet for approval, something that does not occur quickly. Management reported that it takes about 2 years to obtain approval for a change in price under the current system. In a world where oil prices, the cost of capital, and the exchange rate are changing constantly, such delays guarantee problems for electricity suppliers.
116. The payment position of SIEA is improving, even though it is still owed SB$20 million by the Government and SB$18 million by the Water Authority. Nevertheless, it is not uncommon for it to have to buy fuel on a daily basis for cash. In the past SIEA was unable to service its debt fully – the Solomon Islands National Provident Fund foreclosed on property owned by SIEA to pay off some of the arrears. In turn, SIEA is suing the Water Authority for the recovery of its debt.

117. The government has indicated that it might be interested in privatising the management of the Authority to a private company, but nothing has happened so far. The crucial question is what form any such privatisation should take. Management of SIEA has indicated that it would issue licenses to generate to anybody who wished to do so, although there is no thought out structure for the terms of such concessions. Although there is large potential for small scale hydro power provision, land disputes have so far made this untenable, at least as far as SIEA is concerned.

![Table 2. Electricity Rates in the Pacific](image)

118. The Solomon Islands Water Authority is the state owned enterprise responsible for water provision in urban areas. Service is poor. The agency is in a parlous financial state in part because they deliver water without collecting fees. It has a large debt to SIEA and poor water quality is a problem. Rural areas are served inadequately. The Rural Water Supply Service of the Ministry of Health has responsibility for water provision in
rural communities, but where the jurisdiction of the two organisations is set is unclear. Any additional rural producers would face potential conflict between the two

2) Telecoms

119. Telephone service is of better quality, but is costly. Internet and cellular service are also available in Honiara. Sol Telekom has a 15 year exclusive license to supply all telephone services in Solomon Islands. It is 7.1 per cent government owned, 51 per cent NPF and 41.9 per cent Cable and Wireless. Service extends over all but one of the provinces and dial up Internet service is available wherever there is a land line telephone. Land issues for relay stations are a significant problem for telecom service expansion because of land disputes. Sol Telekom has taken the attitude that without registration, they will not establish relay stations.

120. Sol Telekom loses about SB$10 million per year through subsidising outer island telephone services, which it is required to do under the terms of its exclusive license arrangement. The company recoups these subsidies through extra charges to users in Honiara and for international calls. Such cross subsidisation is common among countries in the Pacific Region – this does not mean, however, that it is an efficient way to provide telephone services to low income users. The World Bank has found that in most cases, cross subsidies rarely help low income users, but rather are inefficient and uneconomic. In the case of the Pacific Region countries, this instrument raises costs for one of the most important links with the outside world. The use of cross subsidies places countries like Solomon Islands at a competitive disadvantage greatly raising the costs of links with the global economy, on which the prosperity of the country depends. Instead of being an effective means of bringing communications to remote communities, it has the perverse effect of lowering the income of the country as a whole, and thereby penalising the very communities that were the object of aid.

121. The current Telecom Act dates from 1940 – executives of Sol Telekom complained that the fines under the Act were not sufficient to close potential competitors, although they could seize their equipment, but there were lengthy delays in doing so. The main

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23 Sol Telekom used to pay a management fee to Cable & Wireless. However, there is an ongoing dispute as to how these payments should be taxed, so currently no management fee is being paid.

problems with the Act, however, is that it views available technology as that which existed over 60 years ago, and has no allowance for alternative forms of voice and data transmission. The result is that potential opportunities for competition are lost.

122. In the view of the authors of this paper, the whole matter of providing telecom services should be revisited. Even though the population of Solomon Islands is relatively small, the experience in other countries, such as Samoa and Tonga, shows that better service through competition has the potential to greatly benefit the country and the economy.

<table>
<thead>
<tr>
<th>COUNTRY</th>
<th>TELEPHONE CALL TO US (US$/MINUTE)</th>
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<tbody>
<tr>
<td>Australia</td>
<td>~0.16</td>
</tr>
<tr>
<td>Micronesia</td>
<td>0.60 – 1.20</td>
</tr>
<tr>
<td>Tonga</td>
<td>0.75 – 0.80</td>
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<tr>
<td>Palau</td>
<td>1.15 – 1.50</td>
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<tr>
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<tr>
<td>Vanuatu</td>
<td>1.56 – 2.00</td>
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<tr>
<td><strong>Solomon Islands</strong></td>
<td><strong>1.65 – 2.96</strong></td>
</tr>
<tr>
<td>Samoa</td>
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<tr>
<td>Marshall Islands</td>
<td>2.00</td>
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<tr>
<td>Cook Islands</td>
<td>2.06</td>
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<tr>
<td>Kiribati</td>
<td>2.42 – 3.03</td>
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<tr>
<td>Tuvalu</td>
<td>4.00</td>
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**NOTES:**
Rates are for October 2004, using the exchange rate on November 4th, 2004 to convert to US Dollars. If a range is provided, it is for off-peak (Weekends and Evenings) and Peak Times. (Except for Tuvalu and the Marshall Islands for which recent information was not readily available.)

**SOURCES:**
FSM Telecommunications Corporation [http://telecom.fm/phones/international.htm](http://telecom.fm/phones/international.htm)
Tonga Communications Corporation [http://www.tcc.to/rates_new.html](http://www.tcc.to/rates_new.html)
Solomon Telekom Company Ltd. Email correspondence with customer service
SamoaTel. Rates include 12.5% VAGST [http://www.samoatel.ws/call_plan_international.asp](http://www.samoatel.ws/call_plan_international.asp)
Telecom Cook Islands Ltd [http://www.telecom.co.ck/rates.htm](http://www.telecom.co.ck/rates.htm)
Telecom Services Kiribati Ltd [http://www.tskl.net.ki/idd.html](http://www.tskl.net.ki/idd.html)

3) **Sea and Air Transport**

123. Shipping and air communications between the islands is uncertain and costly. In particular, outer island development has suffered from unreliable service at the hands of provincially owned ships that often do not arrive, or arrive very late. In addition, IMO
and ICAO respectively have documented that the maintenance of both vessels and aircraft is unsatisfactory which could result in safety problems.

124. Inter-island mixed passenger/cargo ships have been run partly by Provincial Governments and partly by private sector operators. In many cases, the provision of such services has been at below cost, [plus the fact that the crews on government owned vessels often allow wontok relationships to affect how much they charge for transport] thereby making private service provision intolerable. Nevertheless, there are widespread reports of private sector run cargo vessels plying between the islands, a trend that emerged during the “Tensions”.

125. There are several initiatives to strengthen both infrastructure and shipping, including several ADB funded Technical Assistance projects to undertake diagnostic assessments of the shipping and aviation industries, prepare a National Transport Plan, set up a Transport Development Trust Fund and design and implement policy and regulatory reforms. There is also an EU proposal to provide a short term subsidy for services to several islands – the subsidy will be available to both private and publicly provided services. There are also potential initiatives by bilateral donors to support provincial shipping lines. The authors of this paper oppose in the strongest terms any donor or government sponsored initiative to restart the provincial shipping lines or any other state-owned shipping entities. We therefore strongly support the ADB initiative to explore ways in which the private shipping industry can be encouraged to restart.

4) The Regulation of Infrastructure

126. The extent to which regulation is needed in Solomon Islands depends on the types of service provision. For example, if the telecom monopoly is maintained, there is a clear need for regulation. However, a far more preferable arrangement would be the introduction of competition. Effective regulation in Solomon Islands is unlikely. Even in the most developed economies, the regulation of infrastructure is complicated and technically demanding, with skilled regulators in short supply. It is therefore unrealistic to expect that even with the most intensive training local regulation capabilities will emerge any time soon in Solomon Islands. This has several implications for infrastructure provision:
Wherever possible, competition should be encouraged. For example, an open seas policy reduces the need for regulation of routes and rates. Similarly, an open skies policy encourages competition in air traffic.

The decentralised provision of infrastructure with competing suppliers, perhaps using competing technologies, also carries with it a reduced need for regulation. This arrangement might require safety regulation that pays due attention to the state of economic development of Solomon Islands.

In cases where regulation is essential, scarce regulatory resources can be handled by a central regulatory agency, perhaps for the region. Realistically this will initially be staffed by expatriates and funded by donors. Over time, regional expertise can be built.

C. Infrastructure Lessons From Post Conflict Countries

127. Studies of infrastructure service provision in other countries emerging from conflict and crisis have some interesting lessons for policymakers and donors in Solomon Islands. Since the fiscal imbalances of Solomon Islands’ government preclude any infrastructure investment that is not supported or provided by donors, a partnership is essential to identify infrastructure priorities and formulate and implement a comprehensive timetable and plan for upgrade and improvement.

1) Communications

128. One of the striking features of countries emerging from conflict is how quickly some infrastructure services can be established. In particular, telecommunications services emerge quickly if allowed to do so. Most of these are in the form of cellular service, which, does not need large markets to be profitable, something that the experience of Tonga and Samoa confirms – even though the economies are small, there are several service providers and competition has brought a sharp reduction in rates.

2) **Shipping**

Even while the “Tensions” were at their height, there were private shipping services between the islands. With the cessation of conflict, these have increased. Again, the services have sprung up in the absence of government, rather than with the encouragement of the state. This is consistent with what has been observed in other countries that have emerged from conflict. The policy implication is that where they exist, (primarily in the form of non-issuance of licenses) barriers to the operation of inter-island shipping should be eliminated and that there should be no attempt to revive provincial shipping lines. While the issue of passenger transport is a politically sensitive one, it can be handled through the auction of subsidies, rather than through the subsidisation of government or provincially owned ships.

3) **Electricity**

A similar pattern has been observed in the provision of electricity by small scale private providers in post conflict countries, although this does not occur as rapidly as with telecoms. For example, in Cambodia, there are more than 600 small private power providers, serving as many people as are served by the national power company. They average about 200 customers each and metre them in the same way as does any functioning power supplier. This example illustrates powerfully just how small scale such operations can be. Notably, these small-scale providers started up because state-owned utilities could not supply electricity in the more remote areas as a result of the conflict. In Solomon Islands, there is great potential for such services to spread to remote areas – the following sections discuss ways in which these might be encouraged. One of the key findings is that government should stay out of attempting to bring such services under its regulatory control or to attempt to re-establish the hegemony of State-owned centralised providers with a monopoly – when countries did attempt to do so, provision of infrastructure services declined.

### D. New Ways to Provide Infrastructure Services

The cumulative impact of neglect that has resulted from the period surrounding the “Tensions” has exacted an enormous toll on infrastructure maintenance in a country
where infrastructure supply was always scarce. Attempting to upgrade and restore all types of infrastructure present government and donors with an overwhelming task if they attempt to follow the traditional channels of project identification, evaluation, consultation with government and then procurement and implementation. To restore and upgrade infrastructure quickly, something that is needed urgently, new ways of provision will have to be utilised with private sector and community based delivery assuming the dominant role. How this might be done is sketched out in the sections that follow.

1) Integrated Project Design

132. In Solomon Islands, there is an urgent need for analysis, prioritisation, and additional inputs that go beyond traditional cost benefit and rate of return analysis. Traditionally, good analysis of infrastructure projects includes an array of technical designs, an estimate of cost/benefit ratios or rates of return from different designs, and a discussion of project choice. The additional analysis must incorporate the key features of Solomon Islands’ problems: the enormous need for infrastructure improvement that is totally beyond the current capabilities of the public sector.

133. In Solomon Islands, a well-designed infrastructure upgrade project must consider from the outset the lack of an effective regulatory system, what are the legal implications and what modifications to the law might be necessary, and whether competitive market forces can replace regulation. At the limit, it is necessary to evaluate the overall efficiency of the system. It is inappropriate, for example, to allow a single service provider on the grounds that a centralised supply is technically more efficient, if the effect of that change is to deliver the population into the hands of a monopolist who delivers those services at monopolistic prices thereby reducing the economy’s overall efficiency. In this case, technical efficiency considerations are overwhelmed by economic efficiency considerations, the geographic realities of Solomon Islands and the problems of effective implementation.

2) Choice of Infrastructure Provision

134. There are many technically feasible ways to meet infrastructure needs. Because wages and interest rates differ among countries, different countries will often choose different
techniques. A key issue for infrastructure lies in understanding how the technique relates to the cost and the regulatory structure of the country. Typically, smaller scale technologies permit more diffused supply, which tends to favour competitive supply. Indeed, in Solomon Islands, where the population is widely scattered, it is not necessary (or even possible) to have a large centralised supplier with widely scattered distribution. In the case of electricity generation, outside Honiara small scale supply is the only option. Furthermore, there is no reason why a single provider should own all the generating facilities. If the government cannot regulate it, then several smaller providers with small generating facilities may produce a more efficient result even if the underlying cost of production is higher. Any project evaluation, therefore, must include an assessment of feasible regulatory frameworks, including competitive supply. Competition is well nigh impossible without private participation. Some large countries have succeeded in getting the benefits of competition by having state agencies compete. But this arrangement would be difficult for a country of Solomon Islands’ size. Alternatives must therefore be found. Importantly, these solutions include determining land rights (so that infrastructure transactions with fixed capital components have lower risks) and extending the use of collateral for loans outside of Honiara.

3) Improve Access to Financing

135. More general financial market issues are discussed in the following chapter. Financial issues related to infrastructure are discussed in the following paragraphs.

136. Private participation is difficult without private financing. Obviously, as a matter of public policy, the government cannot disengage itself very far from infrastructure projects whose financing it provides or that it guarantees. When the government itself executes the project, then the provision of a sovereign guarantee is typically implicit but this does not carry much credibility in Solomon Islands, given the recent default on the country’s debt. Essentially, in Solomon Islands, the only recourse to financing is for private suppliers who can offer adequate collateral, or donors. Given that the current collateral framework is inadequate, donor financing is probably the only way that infrastructure services can be provided in the short term, pending reform of the collateral framework. Since most donors typically deal with governments, the natural tendency would be for them to assist the government of Solomon Islands to establish
additional infrastructure services. This would be a mistake. There are many options available to introduce competition into the infrastructure sector that does not involve provision by the State. Furthermore, in many sectors, costs would be relatively low and could be covered by grants rather than by loans.

137. With sufficient opening up, different types of providers could enter the market. Not only could companies supply infrastructure services, but communities could as well – for example, power generation could be provided by cooperatives that are community based. Furthermore, once the collateral system has been reformed\textsuperscript{26} several new financing options open up. Small-scale electricity generation could pledge accounts receivable to obtain financing. Inter-island shipping companies could pledge future revenues as well as their vessels as collateral. Donors could assist further by granting small maintenance contracts to private companies. In all of these activities, there is no reason why government could not finance provision, without providing the actual supply. Under this arrangement, supply contracts with private providers could be undertaken with government supply.

4) Improve Procurement

138. Typically donor infrastructure projects are biased strongly toward large companies. This bias can be explicit -- by requiring minimum size and experience to do business. Or, the bias can be implicit -- requiring conformity to the same audit, performance, and record keeping requirements for contracts of all sizes\textsuperscript{27}. Reforms can rectify this imbalance. But rather than enabling a government road agency to do business with small-scale contractors through reforms, program designers could utilise an independent contract management agency outside the government – a preferable arrangement. The agency could be selected based on competitive bidding, which could reoccur at fixed intervals to ensure that there is a strong incentive for effective monitoring. Initially, it might be necessary for donors to assist such companies to enter the market – as opportunities

\textsuperscript{26} Reform of the secured transactions framework is being assisted by an ADB TA to prepare for collateral reform.

\textsuperscript{27} For a discussion of these issues and ways to deal with the bias against small companies, see The Enterprise Research Institute 1998. SMEs and Public Procurement: Lowering Transaction Costs to Increase Participation. Paper Prepared for the UNCTAD Workshop on Procurement, Geneva.
present themselves and profits are evident, others might then put themselves forward to supply services in this way.

139. The private agency model permits two important efficiencies:

- Unlike a government road agency, a private agency can pay its employees higher salaries and therefore attract well-motivated, high-calibre staff and streamline procedures for payment and procurement – thereby avoiding many of the problems faced by government agencies.
- While donors and IFIs are not well equipped to audit many small contractors, monitoring a private agent on a quarterly or even bimonthly basis is quite feasible. Such an agency can also handle the burden of administering and monitoring many small contracts.

140. It therefore can allow government to finance such projects without getting involved in provision, but it should not involve lending or financing capital equipment of working capital of private sector suppliers. Unlike many supply-driven programs that have sought to promote small-scale contracting through training, the agency model has a demand-driven approach. It creates a market for small firms by "freeing up" procurement by dividing works into many small contracts and providing prompt payments for work completed. Firms could gain access to training based on successful tendering. While such an agency can expand competition and reduce the burden on the regulatory authority, program design should take care of monopoly everywhere, even in the choice of the agency. More than one private agency competing for the right to handle work with smaller contractors is, therefore, advisable. Such a system is especially suited to Solomon Islands, with its widely scattered islands and difficult access making the administration of a centrally run government department especially difficult. In the past, Solomon Islands’ government has in practice not supplied services to a large portion of the country. But, the private agent model has the potential to gradually extend infrastructure across the country. Initially, donors could contract with outside firms to do this, with a training component that advances the abilities of local firms to take over eventually.
5) **Improve the Operation and Maintenance of Infrastructure**

141. Access to basic public services remains limited in Solomon Islands and service provision is low. Like many developing countries with ample access to donor support for new projects, existing assets are not maintained and the allocations for operations are inadequate. The typical action of donors in the provision of infrastructure is to supply funding for the capital outlays required for the infrastructure project and perhaps a limited amount of maintenance. The recipients are then supposed to maintain the infrastructure out of current budgeted funds. The incentives inherent in this approach do not lead to the desired outcome, which is the gradual improvement of the recipient country’s infrastructure network. Rather, experience has shown the recipient countries that even if they do not maintain infrastructure adequately, after a while there is usually another donor prepared to replace the same piece of depreciated capital stock, whether it be roads, power plants or transportation equipment. Unfortunately, the “build and deteriorate” model of donor infrastructure provision is the rule rather than the exception in the developing world.

142. Because of political and social pressures to spread the benefits of donor support, departments and agencies are overstaffed. Similar pressures undercut cost recovery efforts and aggravate the problems of funding operation and maintenance (O&M). O&M, however, is the only way that services are provided on an ongoing basis. The inappropriate incentives created by donor support, however, means that O&M is neglected. Recommending the privatisation of O&M can be a small step toward remediying this problem. Privatisation creates a domestic interest group with a stake in O&M. This interest will be stronger and more effective than the interest of state-run O&M agencies in lobbying for more funds. This change would be a step in the right direction, though it is not clear that it would entirely end the practices described above.

**E. Conclusion**

143. Decentralising Solomon Islands’ infrastructure efforts is a huge task, but it is essential both because it may be the only feasible way to supply such services outside the main areas and because decentralisation has become a major policy thrust. Decentralisation and privatisation present an excellent opportunity for moving forward on Solomon
Islands’ infrastructure problems. For example, one simple plan would set standards for infrastructure supply -- say quality of roads-- and make block payments from a central government fund established by donors contingent on meeting such standards. Nevertheless, without careful management, decentralisation could bog down reform efforts even further. The issue of a lack of qualified personnel at the central government level applies even more strongly at the local government level. The suggestions that appear above require careful donor involvement and implementation on a pilot basis to identify and iron out initial problems, as well as to test the overall feasibility of the recommendation.

144. In addition, privatisation can only occur if there is serious investor interest. Without this interest, any form of private sector involvement – build operate transfer, public private partnerships, management contracts, or full privatisation - will not have the substantial impact that is needed. In addition, the public sector should not involve itself in areas where it is not currently engaged.

145. Given the history of a lack of transparency in the use of funds, innovative methods would be required to ensure that they were employed for the purpose for which they were intended. One option that has been used with great success in Africa is the announcement to the community of the amount of funds allocated, the various uses to which they could be put and the options that are available for implementation. Thus the community could decide whether a particular grant should be used to build a schoolhouse, a clinic, a small dock, upgrade or build a road, and so on. The community could also decide whether government, customary, or private providers did the work. The infrastructure fund would disburse payments based on the localities meeting the quality standards. The central government could then privatise the process for monitoring these standards. In practice, donors might want to insist, initially, that they set the standards and do the monitoring while local expertise is developed.

146. Such a plan would provide an additional benefit. The stream of block payments could be used as collateral for local government guarantees of local private contractors. Such a guarantee would then have value to a formal sector lender because of the ability to take a security interest against the stream of block payments. It would provide security both for the contractor, who could borrow using future payments as collateral and for
the central government who could take the block grant as collateral against the work being performed adequately. Naturally, localities would need to have a great deal of confidence in their customary methods of enforcing debt repayment.
VI. The Financial Sector

A. Overview

147. The financial sector of Solomon Islands consists of three commercial banks, a development bank and the National Provident Fund of Solomon Islands [SINPF], plus a number of smaller financial institutions, such as credit unions and housing schemes. The commercial banks are financially sound – which is not the case with some the other financial institutions in Solomon Islands. For example, the SINPF holds a large amount of non-performing government debt in its portfolio as well as loans to government entities, such as the Solomon Islands Electricity Corporation, large parts of which are non-performing or under-performing. The Development Bank of Solomon Islands (DBSI), which is owned by the government, is now bankrupt and has ceased lending, the result of what the IMF describes as a “poor credit culture” – unsecured loans made on political grounds. The Central Bank of Solomon Islands has been appointed as the provisional manager for DBSI.

148. The financial sector of Solomon Islands is severely underdeveloped. Although recently there has been an increase in credit to the private sector, many potential investors cannot finance projects. The banks are still suffering from the fallout resulting from the “Tensions”, when government and SOEs stopped paying their debt obligations and many private businesses failed. While a recovery is underway as a result of RAMSI, the banks are understandably cautious regarding further lending. Two additional problems represent major constraints on financing private sector development: unclear land rights and the systemic difficulties in using all types of collateral for loans.

149. The land rights system requires a careful analysis to determine exactly how a chain of rights can be built that serves key economic ends. Those economic ends are the use of real property, probably through a leasehold system, for the purpose of investment and taking collateral. Simply imposing conventional western country land tenure patterns cannot solve this problem. Existing studies of land rights, though often thoughtful and

28 SINPF recovered some of the debt of Solomon Islands Electricity by foreclosing and selling some properties in Honiara.
sophisticated, have not focused clearly on these two objectives. The immediate need is for such a diagnostic study and the action plan it would propose.

150. In addition, the legal framework for secured lending needs to be modernised\(^9\). The new system must mesh closely with the system of land rights and permit more of Solomon Islands' movable property to serve as collateral. This requires a diagnostic study and the preparation of a draft law to focus discussion of the issues. Developing a consensus is a necessary part of the process and will take time. It needs to commence now.

**B. Credit and Interest Rates**

151. The private sector in Solomon Islands has extremely constrained access to credit. The ratio of private sector credit to GDP is little more than 10 per cent, the lowest in the Pacific Region and much lower than the average for low income countries. In high income countries with well developed financial markets, credit to the private sector is at least the equivalent of 100 percent of GDP.

152. Financial underdevelopment is not surprising given the degree of unrest the country has experienced until recently, the uncertain land ownership situation, and the inability to pledge collateral effectively. Nevertheless, the lack of access to finance is a severe constraint to growth and private sector activity. For rural communities that could produce cash crops, the total unavailability of rural finance perpetuates underdevelopment. Options for the development of microfinance require urgent exploration. Interesting examples already exist in the Pacific Region, particularly in nearby Vanuatu, where a successful microfinance pilot project is being extended to several additional areas. The Central Bank is planning a review of various microfinance options with a view to evaluating the possible policy options for making microfinance available, an initiative that the authors of this paper welcome.

153. A severe constraint to developing microfinance through credit unions arises from the interest ceiling applied to credit union loans, which is capped at one per cent per month. Given general lending rates and the risks involved means that the ceiling effectively

\(^9\) The ADB is undertaking a regional technical assistance initiative to prepare collateral reform projects in 4 countries, one of which is Solomon Islands.
precludes credit unions from making loans. Work elsewhere shows that if microfinance institutions lend at rates below 30 per cent per annum, they will not be commercially viable\textsuperscript{30}. The interest ceiling in Solomon Islands is damaging the prospects for microlending and should be abolished.

154. Without finance, businesses cannot grow, which constrains expansion to the reinvestment of retained earnings or to the financial endowments of owners. In particular, those without private wealth or those who have assets that cannot be mobilised – for example, land owners in Solomon Islands – are reliant on business financing. It allows the business to increase its income by providing capital for projects whose business owners could not enter into otherwise. Credit in Solomon Islands, however, is at a premium and available only to those who are well known to the banks. The banks complain that there are a limited number of bankable projects and the private sector complains that they cannot get credit. The commercial banks rightly point to problems that they had with doubtful debts during the “Tensions”, when they peaked at 15 percent – they are now down to 5 percent, but this is a recent reduction.

\textbf{Figure 18. Comparative Domestic Credit to the Private Sector}

![Figure 18. Comparative Domestic Credit to the Private Sector](image)

\textit{Source: World Development Indicators Database}

155. Interest rate spreads in Solomon Islands, are around 10 per cent in real terms although they are beginning to decline. Nevertheless, spreads are among the highest in the region.
Figure 21. Comparative Regional Interest Rate Spreads

156. These high interest rates – rates that the entrepreneurs think are expensive and the bankers think reflect the risk they see in lending to businesses - tend to attract riskier projects and create problems of adverse selection. To minimise default risk, banks generally lend only to larger businesses and to those they know. This reduces the efficiency of the financial market to disburse funds to those who should receive them given that the decision to lend is based on personal connections rather than the validity of the business proposition. Furthermore, the banks had to restructure government debts – jointly they were owed approximately SB$150 million. At one point the government was not even paying interest. In terms of the settlement, the banks have written off 60 per cent of the accrued interest arrears and have restructured repayments over 14 years at 2.25 per cent interest. Essentially this gives the banks’ balance sheet a dual structure with what amounts to subsidy to the government in terms of the long term loan and then much higher short term loans.

157. A further issue that contributes to financial underdevelopment is the very limited network of branch banks that exists within the country, which is the result of several factors.

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31 This is a phenomenon that occurs when banks only finance very high rate of return projects, which are inherently riskier – banks portfolios then become filled with high risk projects, or they do not lend at all.
○ The extremely limited network of roads places severe geographical constraints on where branches can be located.

○ The unreliability of shipping precludes the banks from offering mobile banking services similar to those that exist in The Marshall Islands, where the largest bank provides monthly service on a ship to the more remote islands. Since many studies have indicated that access to banking facilities is at least as important as access to credit for many poorer rural dwellers, unreliable infrastructure is also holding back financial market development.

○ There is no clearing mechanism outside Honiara – the banks have to bring financial instruments to the Central Bank themselves. This is done mainly by air, but insurance is not available, with a concomitant increase in risk.

158. Collateral issues clearly are among the most pressing in holding back financial market development. They are discussed in greater detail in the next section. However, a number of other problems also raise costs and risks of financial institutions. The most important of these are:

○ Security. This remains a concern, although the situation has improved markedly with the arrival of RAMSI. International private security companies are not allowed in Solomon Islands. This presents the banks with a major problem - in most other countries in the world private police are hired to protect the premises of financial institutions as well as the transportation of cash. There is understandable reluctance regarding local security companies, given recent history. While the banks feel that to some degree this is understandable as a result of what happened during the “Tensions”, it is now holding back further expansion because of the greater risk of crime. A PNG security company applied to start a local policing firm but its application was denied. Furthermore, local police are not allowed to work as security guards in their spare time.

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32 NBSI used to run operate a ship to provide such services. Nevertheless, it was unprofitable. The services offered by ANZ in Fiji indicate that profitability is not out of the question.

○ **Political Risk.** All the banks supported enthusiastically the presence of RAMSI, and indicated that a long term commitment by the governments involved was essential for the recovery of the economy and the prospects for long term growth. Nevertheless, they also said that realism demanded that an element of political risk be built into their lending rates. Ironically, the combination of political risk premia, low interest long term loans to the government, and higher interest rates to private sector borrowers, raises the overall risk within the financial system – adverse selection results in the financing of higher return/higher risk projects. This conclusion is supported by observations from interviews with private sector entrepreneurs who indicated that the political risk element had raised target rates of return on investment by 10 percentage points.

### C. Collateral Issues

159. In industrial countries, effective systems of collateral have played a central role in financial market development. Interest rate structures of lenders demonstrate conclusively that loans secured by collateral carry lower rates and longer terms the better they are secured. Such systems of effective pledging of collateral as security are missing in the Pacific Region, including in Solomon Islands.

1) **Characteristics of an Effective Collateral System**

160. The economic usefulness of a legal system for security interests will depend on how well that system fulfils certain key requirements:

○ The law must provide for creating an enforceable security interest against all economically important property – both tangible and intangible.

○ It must apply to all important transactions in which security interests are created.

○ The cost of creating such a security interest must be low relative to the value of the property.

○ Enforcing the security interest must be inexpensive relative to the value of the property.
The law and the institutions that implement the law must allow the lender to determine before the loan is made, with certainty and at little cost relative to the value of the property, whether any other lender has a superior claim to the collateral.

The secured lender must be protected from hidden claims of third parties, including secured and unsecured creditors, a trustee in bankruptcy, or some purchasers of the collateral.

161. Often the features that cause problems in a secured transactions framework have no obvious justification in public policy. And even where they do have a public policy objective, the means of achieving the objective (tax collection, or protection of workers, debtors, and tenants) can impose a high cost on the country’s economy by reducing access to credit. In addition, and most importantly, it is possible to use other policy measures to achieve these worthy objectives without compromising a country’s access to credit.

2) Using the Collateral Framework

162. To understand what is necessary for establishing a framework for secured transactions, it is essential to understand the four economically important stages of being able to pledge collateral that can be used to secure loans. Those stages are:

- **Creation.** The process by which the creditor establishes a security interest in specific property (the collateral.)

- **Priority.** The process by which the lender establishes the priority of the security interest. This step ensures that the collateral has not been pledged to anyone else. It requires the lender knowing whether any other security interest might have been filed and when the filing occurred. In the most modern systems, the date of filing is recorded along with the time. In Solomon Islands, a company charge is only effective when it is entered in the company file in the Company Registry. Delays are such that it can take several months for a security interest to be registered. Some attorneys go so far as to say that unscrupulous borrowers could challenge the validity of any collateral, which has a powerful effect on the willingness of financial institutions to lend. Furthermore, when a security interest is discharged, it needs to
be noted in the company file in the registry. There are many examples of security interests not having been discharged, even 10 or more years after the event. Notwithstanding this, company files often contain further registrations of security interests. It is not surprising that lenders ask for collateral that has a value several times that of the loan.

- **Publicity.** The process that makes public the priority of the security interest. This ensures that other potential lenders are aware of the security interest, thereby minimising the possibility of disputes over the ownership of the collateral. Given the delays in recording security interests, publicity is ineffective in Solomon Islands.

- **Enforcement.** The process by which, upon the debtor's default, the creditor will seize and sell the collateral to satisfy his claim. The cheaper this procedure, the more value can be placed on collateral. In modern systems, this process only takes days, which means that lenders can realise a high percentage of the value of the collateral that they hold. In systems that do not work well, it can take months or even years. Such delays greatly degrade the value of movable property as collateral. In Solomon Islands, enforcement of judgments is slow and difficult. An order must be obtained from the court, which in itself is not quick. Once judgment is obtained, the winning lawyer must write to the Sheriff requesting a time for enforcement. Typically, it takes 4 to 6 months to receive an answer. The reply usually states that the Sheriff will take action “within a few weeks”. Thereafter, the Sheriff must serve the judgment and seize the collateral in question. However, the Sheriff has other duties – he is the chauffeur for the High Court Judges and also the Admiralty Marshall. He has no vehicle himself, however. Observers state that if the judgment has to be enforced outside Honiara, it often does not happen at all. The net result is that lenders are forced to hold collateral many times the value of their loans. This raises the risks to borrowers as well – they stand to lose much more than the value of the loan.

163. To work effectively, each of these stages must be effective before the secured transactions framework can be used reliably as security for lending. Although there are forms of collateral instruments available in Solomon Islands – for example, the creation of security interests operates under the UK Sales of Goods Act – it is rudimentary and
not easy to use, raising the costs of creating security interests. The UK Law of Bailment that predated 1961 is the law that governs warehousing in the country. This law, however, is outdated, and not suitable for modern practices. Similarly, ships mortgages, commodities bills of sale, crop liens, back to back financing are available under outdated English Common Law structures. However, they require lawyers to draw up individual instruments and examine the law to ascertain what is permissible. As in many other Pacific Region countries, high quality legal expertise is expensive, so the cost of creating security interests is high.

164. A further problem is that sole proprietors have little access to pledging collateral other than using Bills of Sale financing. Lenders indicated that they generally were not prepared to accept significant exposure under this instrument. In practice, therefore, the majority of businesses in Solomon Islands are excluded because they are sole proprietors.

165. Under a new regional Technical Assistance, ADB is preparing diagnoses for, and reform implementation plans for, collateral reform in 4 Pacific Region countries, one of which is Solomon Islands. The authors support this initiative strongly – a better functioning secured transactions framework is one of the important building blocks to promote financial market development in Solomon Islands.
VII. Legal and Property Rights Issues

166. The legal system in Solomon Islands does not provide an effective foundation for long-term contracting. Many laws are outdated or are not suited for the reality of doing business in Solomon Islands, where the machinery of the legal system functions poorly or not at all, especially outside the capital, Honiara. The sections that follow summarise the most important issues.

A. Overview of the Legal Framework

167. At Independence in 1978, Solomon Islands adopted in its Constitution, the United Kingdom’s Acts of Parliament, dating from January 1, 1961, subject to Solomon Islands’ Constitutions’ provisions and Acts. English common law prior to 7th July, 1978 also applies in Solomon Islands. However, this body of law and subsidiary regulations creates a high transaction cost business environment and contains many gaps that case

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34 This Chapter is based on work done under ADB TA 6162-REG: Improving the Legal Business Environment in the Pacific Region performed by ERI and the Center for the Economic Analysis of Law
35 Schedule 3 to the Constitution states as follows: Application of Laws
1. Subject to this Constitution and to any Act of Parliament, the Acts of the Parliament of the United Kingdom of general application and in force on 1st January 1961 shall have effect as part of the law of Solomon Islands, with such changes to names, titles, offices, persons and institutions, and as to such other formal and non-substantive matters, as may be necessary to facilitate their application to the circumstances of Solomon Islands from time to time.
2. (a) Subject to this paragraph, the principles and rules of the common law and equity shall have effect as part of the law of Solomon Islands, save in so far as:- (i) they are inconsistent with this Constitution or any Act of Parliament; (ii) they are inapplicable to or inappropriate in the circumstances of Solomon Islands from time to time; or (iii) in their application to any particular matter, they are inconsistent with customary law applying in respect of that matter.
(b) The principles and rules of the common law and equity shall so have effect notwithstanding any revision of them by any Act of the Parliament of the United Kingdom that does not have effect as part of the law of Solomon Islands.
3. (a) Subject to this paragraph, customary law shall have effect as part of the law of Solomon Islands.
(b) The preceding subparagraph shall not apply in respect of any customary law that is, and to the extent that it is, inconsistent with this Constitution or an Act of Parliament.
(c) An Act of Parliament may:- (i) provide for the proof and pleading of customary law of any purpose; (ii) regulate the matter in which or the purposes for which customary law may be recognized; and (iii) provide for the resolution of conflicts of customary law.
4. (a) No court of Solomon Islands shall be bound by any decision of a foreign court given on or after 7th July 1978.
(b) Subject to the preceding provisions of this Schedule or any provision in that regard made by Parliament, the operation in Solomon Islands of the doctrine of judicial precedent shall be regulated by practice directions given by the Chief Justice.
5. The provisions of this Schedule are without prejudice to the provisions of section 5 of the Order to which the Constitution is scheduled.
law has not filled. These breaches increase transaction costs because they intensify business contract enforcement risks since English decisions post-1978, which make new law, do not become part of Solomon Islands’ law. As a result, many contract law issues have no binding relevant case law or legislation because no local case law has developed since the cut off date. For example, unfair contract terms, consumer credit, and some fair trading legislation are lacking. The absence of these laws inhibits the evolution of arms length contracting and the development of consumer credit information, among other factors.

168. Additionally, Solomon Islands’ laws provide an inadequate foundation for economic development as they rely on institutions that do not exist or function poorly. In a country where law enforcement is problematic, the laws themselves create enforcement problems because they do not clearly resolve key business issues. Local legislation specifies enforcement mechanisms that rely on poorly functioning, publicly-run, institutions that add costs, often not envisioned in the original model of the laws. The issues that require consideration when examining any country’s legal framework include:

- Do the legal requirements meet a clear public policy objective?
- Do its benefits outweigh its cost to society?
- If not, should it be derogated, or can the same benefits be achieved by different requirements that are less costly?

169. Unfortunately, the Solomon Island's business laws create the exact conditions for a slow and uncertain bureaucracy that hurts businesses at every turn. First, the legal system requires a broad range of costly licenses and registrations, particularly at the local level, that have no compensating public policy objective and severely raise the uncertainty for investors. Second, the legal procedures for obtaining many licenses and registrations typically require the “discretionary” authority of a public official. Some legal procedures are unnecessarily stringent and all are subject to judicial review. The law sets out almost no clear legal automatic standards under which the government must grant licenses and process registrations. This situation exacerbates the problem of corruption in Solomon Islands and increases transaction costs.
1) **Pervasive Non-Legal Institutions**

170. The markets in Solomon Islands rest partly on a formal legal foundation but also on a non-legal foundation of extra-legal and, sometimes, illegal, customs and usage. While not formalised, these legal and non-legal foundations directly affect business operation. Non-legal solutions do have power in local situations where personal relationships replace formal law and enforcement. But, they collapse outside the local orbit and these geographic and associational limitations on non-legal solutions serve to undermine private sector development. Private sector development is undermined because the business laws that create competitive and efficient markets and bring those with savings together with those with the best investments are lacking. (In other words, those with the best investments may not always be the saver's neighbours, relatives, or members of the same religious sect, caste, or tribe.)

2) **Availability of Legal Information**

171. In addition, only some of Solomon Islands’ laws and case law are publicly available online at the University of the South Pacific Institute of Justice and Legal Studies (IJALS) website. But most are not available and are often unavailable even at the printing office in Solomon Islands. The economic problems of any legal system are obviously compounded when business (or any citizen) cannot even determine the law. Any substantial business transaction requires a legal opinion but that legal opinion is risky because the lawyers cannot cite the law authoritatively.

**B. Problems in Business Entry and Operation**

1) **Business Licensing**

172. The legal framework that shapes business entry and operation is relevant because if it creates difficulties and high costs for business, fewer firms will enter the market and competition is reduced. If the rules governing the process are not written down in a way that a business owner can clearly see the necessary steps, how they link together, and the criteria determining how an application is evaluated then the transaction costs are increased and the opportunity for corruption exists.
173. In Solomon Islands, the Honiara City Council and the provincial governments can levy business license fees on business operations. Fee levels vary from business to business and from province to province. Some try to impose excessive fees and this has resulted in the High Court being asked to rule on the issue. Most provinces and the Honiara City Council rely on business license fees as a major source of income and, as a result, fees tend to be higher than they should be. For example, by section 40 of the Local Government Act Cap 117, a Council may charge fees for any license issued.

174. This legal framework for business licensing and registration leads to bribery and corruption problems because it is based on the discretionary power of the executive. The laws do not specify objective criteria by which the license is automatically granted. Thereby, the system reinforces opportunities for corruption. The law extends this approach to all licenses and all cases. One can find few exceptions in acts where the law states that the Registrar, ‘shall register”. Rather, a registrar assesses compliance with the guidelines. But since Solomon Islands is using licensing as a revenue generator, they are self-defeating. It is not advisable to use business licensing as a revenue source since it limits growth of business and the tax base. An income tax or VAT is preferable. But, where licenses are used to raise revenues, an automatic process is best.

175. In the United States, for example, the Federal Communications Commission has created a registration system for persons wishing to obtain licenses for specific radio frequencies. The applicant fills out the form and pays the fee online. Upon completion, the Web site software generates a license certificate that the applicant may save and print from his desktop, to carry and display. Under such a system, there are no opportunities for corruption or bribery in obtaining the license, and the process takes less than 10 minutes.

176. By contrast, under Solomon Islands’ legal framework, a license application must be submitted in writing to a public official, which under the law must exercise his/her discretionary powers to grant or not grant the license. This approach puts too much power in the administration without any balance to this power, inviting corruption and

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37 Should Solomon Islands become a federal system the Provinces will become States with greater powers to tax and raise revenue. Business license fees may therefore continue to be an important source of revenue.
bribery. In addition, there are costs and inconvenience imposed by non-issuance of licenses or their frivolous cancellation by corrupt or overzealous state officials.

2) **Company Registration**

177. In Solomon Islands, the Companies Act [Cap 175] is based on the UK Act of 1948 and is seriously outdated. Here, the procedure for incorporation is slow and complicated and it is impossible to create and register shelf companies due to stipulations in the Foreign Investment Laws.\(^{38}\) The incorporation procedures are also expensive for most small and midsize businesses. This cost arises in part from high filing fees, but also from the process itself, which is costly because of paper filing and appearances, the legal documentation fees, on-site presentation of documents, and unnecessary legal requirements.

178. Although there have been calls for an overhaul of the Investment Act to attract much needed foreign investment into Solomon Islands, the main problem lies with the Companies Registry, the national registry where companies must publicly file their status. The registry is in Honiara and all records are in hard-copy form. The state of these files is haphazard and disorganised. It is no surprise, therefore, that interviewees indicated long search delays. Another obstacle facing the Registry is outdated files, given qualified staff shortages and inadequate funding. The Registry is under the responsibility of the Registrar General who also supervises the Land Registry and other matters.

179. Most modern laws governing incorporation, such as in the U.S. state of Delaware, do not require such detailed filing and these jurisdictions usually have the lowest annual fees as well as the most efficient registries. It is no surprise, therefore, that they are the jurisdiction with the largest number of corporate filings in the world. Solomon Islands must strike a balance between the legally required information and the necessary information to find the company and its representatives. Delaware only requires one-page articles of incorporation with minimum information, which suffices to identify the legal entity, its basic structure, and list of officers and directors that can bind the entity. The requirements of Solomon Islands’ law only serve to increase the costs of

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\(^{38}\) However, local business may do so.
registration, the responsibilities of the Registrar's office, and the cost and complexity of the required computer and ancillary equipment.

180. Solomon Islands’ Registry needs to be computerised. But, instead of capturing information digitally, paper documents must be submitted. However, applying technology to paper documents requires more expensive scanning and image management, which are many times more expensive than technical systems. In addition, applying technology in this fashion would only be digitising a costly, inefficient and damaging process, as opposed to overhauling company registration fundamentally. Instead, the law should allow minimal essential information to be entered into an online database, which would then allow the public to search for information on the important aspects of the corporation. As noted earlier, an Internet-based company filing system has enormous potential advantage in Solomon Islands.

181. Any proposal to introduce new company legislation will also need to address the institutional structure of the Registrar-General’s office. The bureaucracy of managing the office is cumbersome and does not lend itself to modern company registry administration. For this reason, a private and competitively run administration may be more appropriate.

C. Enforcement of Business Transactions

182. As in many other countries in the Pacific Region, enforcement of business property rights is a serious issue for the private sector. Time and again the fact-finding mission was told that provisions against undesirable behaviour existed but were not enforced. This section sets out the issues involved in the enforcement of the law governing business transactions in Solomon Islands.

1) Enforcement of Business Property Law

183. Business property rights can be transferred either consensually or non-consensually. When it is non-consensual, it is generally through either theft or corruption. Consensual transfer generally occurs through a business transaction such as the sale of goods. These transfers are relevant because they impact business property rights and enforcement is necessary to ensure those rights are respected.
- **Enforcement of Business Property Rights in the Event of Non-consensual Transfer.** Loss from theft and corruption represents a fundamental threat to property rights and, thereby, to private sector development. Two constraints prevent Solomon Islands’ government from taking more action to protect property: insufficient police resources and insufficient public prosecutor resources for crime prosecution. In most countries, the police problem is partly addressed by the use of private police. But, the laws governing such police must balance their effectiveness with civil liberty protections. The public prosecutor problem is addressed by permitting private citizens to bring criminal charges before a court. Private crime prosecution is also a potentially important step for curbing corruption, where the government itself may limit the public prosecution of corrupt officials.

- **Enforcement of Business Property Rights in the Event of Default on Consensual Transfer.** When property is transferred by consensual agreement there are more options for enforcing these agreements. Enforcement becomes relevant in the event of default by one of the parties to the agreement. Private options are generally more effective and efficient. But a private police act could accommodate some key aspects of enforcing property rights, regulating self-help repossession, consumer protection, and the seizure of property without court action when the property right is not disputed. Particular provisions should address the most common transactions in warehousing, ships, aircraft, automobiles, and intellectual property rights.

2) **Arbitration**

184. Merchants and business operators have settled disputes privately for more than a thousand years with good results. Arbitration is one modern version of this system. For all the ink spilled about the rule of law and contract enforcement, this is a simple system for settling disputes within voluntary agreements. It is a system that allows dispute resolution outside of the developing world’s notoriously inefficient and costly courts. In Solomon Islands, the Arbitration Act [Cap 2] establishes an arbitration framework.

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39 Private police outnumber public police in many industrial countries, including [the] United States. The Asian Development Bank, the International Monetary Fund, and the World Bank are all patrolled internally by private police.
Moreover, the law, Section 5, creates broad options for parties applying to the court to stay the court proceedings when there is an agreed to an arbitration clause. In addition, in some arbitration cases, a party can apply for injunctive orders, restraining the other party from dealing with goods in its possession or control. Parties can create written agreements to submit present or future differences to arbitration and such agreements are irrevocable, except by leave of the High Court. Arbitrators are given express power to administer oaths or affirmations, to state a case for the opinion of the High Court, and to correct any clerical mistake in an award.

185. However, there are still issues with arbitration in Solomon Islands:

- An arbitration award is enforced by leave of the High Court in the same way as a High Court judgment or order.
- The grounds for appeal are very broad.
- Any legal question arising from an award may be appealed in the High Court.

186. It seems that few used arbitration prior to 1999, probably because of the lack of skilled and experienced arbitrators. But since 1999, social, economic, and commercial conditions have not been conducive for arbitration.

187. How the law treats the enforcement of arbitral awards can severely limit the economic usefulness of arbitration. Of particular importance is whether broad grounds exist for reviewing an arbitral award in the courts. When the arbitral court itself can order the use of force, or if a judge must automatically give orders to enforce arbitral rulings, with limited rights to review them, then arbitration can be fast and efficient. When arbitration law requires court intervention, and thus the need to hire a lawyer, to enforce the arbitral decisions, arbitration will have no effect. Knowledgeable litigants will bypass arbitration and go straight to the courts. However, our prime concern is to increase the use of arbitration to resolve disputes in Solomon Islands. Therefore, the legal framework needs to change.

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40 A recent study on project financing confirms these types of obstacles in using arbitration to resolve disputes involving independent power projects, in spite of arbitration provisions in contracts. The study explains how the law permits local or national courts to intervene and overrule arbitration. The article reviews the experience of three independent power projects in Indonesia, two in Pakistan, and one in India. The Journal of Structured and Project Finance, Institutional Investor 8 (3): pp. 42-57, Fall 2002.
188. What is missing is an arbitration system available to smaller businesses and transactions; a system that follows customary dispute resolution mechanisms with formal legal standing and enforceability outside a closed community network. A solution to this situation possibly includes creating arbitration centres that could be operated online and via email. Other tribunals could be localised and arbitrators could travel to the place of business of the parties for all transactions. The aim: to reduce litigation costs in the event of contract default. In the long run, online arbitration systems are likely to cost effective for Solomon Islands even though the initial set-up costs may be high. This is an area that could benefit both from donor funding and technical assistance and has enormous potential to increase the availability of public goods in Solomon Islands.

189. An example to follow is the Civil Procedure Rules (2002) of Vanuatu that has extensive provisions on mediation, which if adopted by the parties, may go a long way in minimising commercial or transaction costs. Parties are empowered to opt for arbitration or the Court can order mediation where it will better serve justice. In addition, an independent arbiter conducts the mediation processes. The gains from this approach go a long way in minimising the cost of commercial litigation and the bitterness that often accompanies the end of an adversarial proceeding.

**D. Problems in Business Exit - Bankruptcy**

190. For an economy to be efficient, firms must not only be able to enter the market but also exit – or go through bankruptcy. Through bankruptcy, resources that were tied up in an inefficient firm can be released to more efficient purposes. Thereby, economic dynamism is increased and private sector growth stimulated. In general, legislation dealing with bankruptcies can be classified into two categories:

- Those affecting natural persons.
- Those governing the insolvency of entities, particularly companies.

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41 Bankruptcy is distinct from secured lending because it serves a different economic purpose and social end. Bankruptcy cancels debt collection and replaces other penalty systems for defaulting debtors, including debtors’ prison, and transportation. Secured lending, on the other hand, facilitates debt collection. It works by improving security and information. Borrowers can then more readily prove their creditworthiness. Lenders can make loans with less risk and collect them more easily.
191. In Solomon Islands, Part V of the Companies Act Cap 175 covers insolvency of companies. Section 203 prescribes three modes of “winding up” companies including:

- By the court.
- Voluntarily, where the creditors could be involved.
- By court supervision, primarily based on the just and equitable rule.

192. These modes of winding up entail complicated procedures and extensive court processes. A court order is required to validate winding up decisions taken by the company or its shareholders, which is time consuming, costly, and requires substantial legal expertise to handle. The effect on SMEs is enormous. The property of the bankrupt vests in the trustee immediately on a debtor being adjudged bankrupt. The court, however, has broad discretion in granting a stay of execution. But these aspects of the process that are now administered by the courts could be more efficient if administered by the creditors.

E. Consumer Protection

193. In Solomon Islands, there is the Consumer Protection Act Cap 63 (No. 2) of 1995. In addition, the English Hire Purchase Act of 1938, which provided protection for consumers purchasing on hire purchase, is believed to be in force in Solomon Islands, although it has been repealed in England. There may be some serious gaps in the protection the Act offers, although the common law may provide some protection:

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42 A recent decision (Tori v Morris [2001] SBHC 39; HC-CAC No 007 of 2001. 28th June, 2001), stated: “It is now known that special circumstances must be shown by evidence by the party applying for stay of execution before the Court may grant a staying order. This is because of the principle that a successful party should enjoy the fruits of his success. However, there can be exceptions being special circumstances that must be proven by evidence. In the Annot Lyle case cited above, the application was refused because there was no affidavit evidence to support the application. Examples of special circumstances are given in footnote 2 at page 272 of 17 Halsbury Laws of England, 4th Edition, some of which were successful and others were not. Footnote 2 above includes instances of special circumstances cases as mentioned in paragraph 455 of 17 Halsbury Laws of England above. Paragraph 455 states --“The court has an absolute and unfettered discretion as to the granting or refusing of a stay, and as to the terms upon which it will grant it, and will, as a rule, only grant a stay if there are special circumstances, which must be deposed to on affidavit unless the application is made at the hearing...”In this case, I can find no evidence of special circumstances warranting an order for stay of execution. Mr. Tori's affidavit filed on 1st June 2001 falls short of evidence showing a case of special circumstances. In paragraph 3 of his affidavit, he is asking for the proceedings in the High Court Civil Case No. 37 of 2001 to be stayed. He is not asking for the stay of execution of my judgment delivered on 23rd May 2001. In my view, the Appellants have failed to make out a case for stay of my judgment. I must therefore dismiss their application. Costs be in the appeal.”
First, all of these provisions are directed toward sellers of goods. They do not provide protection for the abuse of consumers, particularly related to credit provision. Other legislation may cover this, such as the banking code, but a rigorous search did not reveal any provisions.

Second, information disclosure is not seriously used in Solomon Islands as a vehicle for promoting competition or comparison-shopping. This gap exists despite a concerted effort to regulate the veracity of what information is disclosed through misleading advertising provisions and it seems to apply to the sale of goods and credit transactions. While it is important to both, it is especially important in credit transactions because of the consumer’s well-known reluctance to treat consumer borrowing as a business transaction and comparison-shop among creditors.

Third, within the credit transaction, known abuses exist that may need creditor regulation. These include discrimination based on race, creed, sex, etc., abusive collection practices, and a range of issues concerning credit and debit cards. As to the latter, there are problems arising out of the unauthorised use of a card, billing errors by the card issuer, and who bears the risk of the merchant who does not ship goods ordered and charged to a card.

Fourth, the effect of Solomon Islands’ consumer protection legislation depends heavily on the quality of its enforcement provisions. Enforcement provisions rely primarily (but not exclusively) on enforcement by and through public officials. Most systems of consumer protection in industrial countries do have such provisions, but also have provisions that grant speedy and effective enforcement powers to the aggrieved consumers themselves to seek effective loss restitution. Solomon Islands’ statutes, however, seem to require long and expensive civil action. This situation is probably because public officials fail to recognise or understand an abuse, and governmental agencies are always subject to “capture” by the industry they regulate.

Finally, many new consumer protection issues arise with E-Commerce and Internet shopping. They range from the effectiveness of “click wrap” agreements and terms (and regulation of their disclosure), to choice of law clauses that select foreign law, to what law is applicable to the sale of downloaded software, to issues concerning payment over the Internet. Some nations in the South Pacific possess legislation that
seems to facilitate E-Commerce (e.g., Vanuatu E-Business Act of 2000, and Electronic Transactions Act of 2000), but such acts do not provide the necessary consumer protection provisions for this new environment.

194. What is obvious in Solomon Islands is also the difficulties surrounding enforcement as well as structural failings. These include staffing shortages, lack of expertise, and inadequate funding.

F. Reform Recommendations

1) Make Legal Information Available

195. To ensure legality, regulations in Solomon Islands must be published in the Gazette and made available to the general public. But presently, this is not occurring. In recent years the Government’s serious financial situation has prevented the Gazettes from being printed, or if so, then not making them widely available. As a result, it is often difficult to ascertain the law or chargeable fees. This situation needs to change so that business costs and risks are reduced and more importantly, so the status of the law cannot be challenged. Hopefully, the RAMSI intervention will address this problem.

2) Reform the National Licensing Law and Corporations Act

196. Solomon Islands must revise the corporation and other business laws that establish the requirements for entering the formal business sector. The provisions should match the expected costs and benefits of achieving the public policy objectives, and derogate all provisions that do not do so. The result would most likely include:

- A new National Business Licensing Law, applicable to the general business license (any person that does business.)
- A new Corporations Law, applicable to incorporated entities.

197. The guiding principle for those licenses that would remain is to keep costs at a minimum to avoid making the license a tax. In addition, given that license reform may remove some sources of revenue for state/local government, a program to raise and enforce less distortional taxes, such as income taxes or the value-added tax, should accompany this program.
198. In Solomon Islands, taxation is a prerogative of the national government. Two important issues then arise: first, if business licenses, as set up now in the localities, are shown a tax, they would be deemed unconstitutional. Second, the national government could approach licenses as a disguised taxation system, and enact a national law that derogates all local licensing laws, and provides for a new general framework. The proposed new national licensing law could meet this later approach.

3) Establish a Company and Business Licensing Registry

199. The revision of the company and business licensing laws should establish a stand alone corporation and business licensing registry under a competitive framework, including giving private operators the opportunity to run it. The legal structure for the registry should include three basic elements:

- **Private, Competitive Registry Operation.** The revised laws should establish the possibility and standards for private operators to manage the registry. Private operators could include chambers of commerce, an association of banks, and other associations of trade and industries, as well as any person that meets a standard criterion and provides bond or insurance, such as lawyers and accountants.

- **Operating Regulations.** Regulations should accompany the laws that establish the registry archive’s technical elements – an unique database mounted on an Internet server that is freely available to the public. The regulations should also ensure competitive pricing for filing services charged by the licensed private operators. For example, ensuring that many operators can be licensed under basic standards, and not collude on prices.

- **Establish an Internet-based Archive.** To ensure consistency, Solomon Islands should concurrently create an Internet-based archive system. The registry project should establish a working Internet-based archive system that private operators will only need a personal computer and password to provide filing services. The archive could operate on rented servers to avoid local set-up costs and technical personnel costs. Once Solomon Islands licenses several operators, the regulations could

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43 The rental cost would be US$250 to US$300 per month, considerably less than setting up a local server.
provide that the registry archive’s maintenance and administration be given to an association of these operators. Thus, minimal recurring government supervision of the system would be necessary.\footnote{Arguably, the entire registry could be operated by only one or two staff.}

### 4) Create a Legal Framework for Business Property Rights Enforcement

200. Solomon Islands’ should create a legal framework for business property rights enforcement through private policing. In designing the laws there are key public policy issues to consider including:

- **Low costs and ease of seizure.** Enforcement must balance low costs and ease of seizure and the potential for system abuse. Therefore, consumer protection legislation reform must establish the minimum information that a contract should contain: the true costs and other terms of the contract, and a clear definition of what constitutes default. Given this information, sellers or lessors will be liable for violations and purchasers or lessees will be liable for resisting a lawful repossession.

- **Liability – the Balancing Act.** A successful law will set an amount of liability for initiating illegal repossessions that is high enough that the parties have the incentive to invest time and resources to try to prevent this from happening, but not so high that the resulting transactions costs cause financial market efficiency to be reduced by making enforcement too risky.

- **Ensure Incentives are Set Appropriately by the Legal Structure.** The use of private police to execute repossessions needs to be supported by the tort law. In any system using private policing, careful thought must be given to managing the incentives to use violence. The actions that constitute default should be made as clear as possible to all parties. This may be very difficult when a party is more familiar with the customary system than a common law system introduced in the colonial era. However, it is possible. Any new legal system using private enforcement mechanisms or private police to increase economic efficiency should contain incentives to prevent being derailed by an invitation to increase the level of violence.
And arbitration is one of these, particularly if mechanisms are established to assist the poorer and less educated members of the community.

- **Compensation.** Another important consideration is the compensation of private enforcers of property rights. The incentives for such private enforcement must be balanced in ways that induce private enforcers to supply the socially optimal balance between failing to enforce contracts that should be enforced and enforcing actions that should not be enforced.

### 5) Revise the Arbitration Act and its Enforcement

201. In countries like Solomon Islands where courts are overloaded, or do not operate effectively, arbitration can facilitate speedy contract enforcement and its expanded use can also reduce case loads in congested courts, which makes the task of judicial reform more manageable. Some elements that are objectively critical to arbitration include:

- **Permitting Binding Arbitration.** Once parties elect to use arbitration, they must be bound by the outcome. Otherwise, arbitration would not provide a path to resolution outside Solomon Islands’ court system.

- **Enforcing Awards Automatically or Privately.** Society’s saving from private parties’ agreeing to arbitrate is lost or minimised if the evidence must be presented in court for enforcement. Therefore, the courts must enforce awards automatically or, even better, licensed private agents enforce them.

### 6) Revise the Bankruptcy Act

202. Maximising economic value is the central economic policy objective of bankruptcy, and is consistent with enforcing private contracts as well as equity and fairness. Economic efficiency is best served when the law leads to a company’s financial reorganisation, if that restructuring increases the assets’ market value. Bankruptcy may also lead to liquidation, if the parts are worth more than their value together. These public policy objectives should guide the provisions of a revised Bankruptcy Act. A central policy concern should also be whether government appointed agents take charge of this reorganisation or, rather, a creditor syndicate.
7) Reform Consumer Protection Legislation

203. Any legislation Solomon Islands enacts should be drafted with the aim to achieve the same economic impact given its particular political preferences and economic constraints. There are a number of models on which such legislation may be based, and each is quite different. Important models to consider include current English legislation, EU Directives and Regulations, Commonwealth nation legislation, U.S. state and federal legislative approaches, and UNICITRAL and OECD international models. Legal strengthening mechanisms, capacity building programs, and civic awareness programs for information dissemination through radio and chiefs also increases effectiveness.
VIII. Conclusions

204. This paper has argued that the private sector business environment in Solomon Islands is essentially dysfunctional. That is not to say that there will be no growth in the coming years. If RAMSI stays in the country and donors continue to offer technical assistance and grants thereby ensuring that law and order is maintained and that macroeconomic probity is brought into the budget process, the rebound from the darkest days of the “Tensions” will continue. Furthermore, the presence of RAMSI will encourage foreign investors in natural resources to step back into the country, especially those that have experience in dealing in the region, and with similarly difficult circumstances, such as for instance in PNG. The impact of such investment will make a positive contribution to growth, the effects of which could continue for a number of years. In addition, the prospect of stability will provide further impetus for the recovery of domestic investment, although the three month notice arrangement for the pull out of RAMSI does not promote investing for the long term and could, perhaps, be reconsidered and replaced by something more long term.

205. Nevertheless, RAMSI’s presence will not be sufficient to turn Solomon Islands into a robust, rapidly growing economy. The speed with which natural resource investors can come and go is amply illustrated by Solomon Islands’ history over the past 3 decades. Reformers are facing a public sector whose natural impulse is to attempt to control most economic activity, but which is greatly lacking in trained personnel and processes that function effectively. Currently, the rules and procedures that apply to most phases of private sector activity are labyrinth, discretionary, often contradictory and opaque.

206. Yet what is a reformer to do? One answer might be to attempt to improve the capacity of employees of the public sector, yet this is an extremely long term task and the results of governance capacity building in other developing countries has not necessarily been encouraging, at least not in the short and medium term. This applies even more strongly to provincial administrations in Solomon Islands. Furthermore, the instability of the country and the need for shorter term results requires that actions that have reasonable prospects for visible success in the short term be implemented. Therefore, this paper
recommends a radical shift in the roles of government and the private sector in Solomon Islands, in terms of which government overseas private sector activity, but steps back from attempts to supply services and implement regulations.

A. The Priorities for Reform Efforts

1) Donors and the Disbursement of Aid

207. Analysis of other states emerging from crisis indicates that the capacity of government to absorb aid is weakest in the immediate post conflict years and only gradually rises, due to a combination of political and administrative constraints. This implies that the amount of aid should rise concomitantly as reconstruction proceeds. However, this is not how donors operate—they typically provide a large initial burst of aid in support of peace and initial reconstruction, followed by a gradual decline in aid. Therefore, experience in other countries emerging from crisis point to the importance of matching the obvious long-term commitment of donors to the capacity of Solomon Islands to absorb donor funds and assistance. Currently, aid should not exceed the capacity of the country to absorb it and, importantly, plans for ratcheting up funding should be ready.

208. Many of the suggestions of this paper are directed at speeding up the ability to absorb aid by reducing the role of government and carving out a larger sphere for private sector and community-based supply of essential services and functions, including roads, clinics, ports, schools, power generation, telecoms, airlines and shipping. Donor support and coordination in achieving these aims are vital for their success. Technical assistance work is underway in several areas, something that the authors support strongly.

209. Inevitably, donors will initially perform many activities. However, this can be done in a way that prepares Solomon Islanders to take over, especially if the private agent model of supervision and supply is used. The ideal would be to have a combination of international and local agents competing and combining to offer a range of services for implementation and supervision.
2) **Focus on Infrastructure**

210. Upgrading of infrastructure throughout the country is central to the future development of Solomon Islands. The chapter on infrastructure pointed out that the traditional means used by donors to upgrade infrastructure services may not achieve the rapid results that are necessary to increase quickly the prosperity of a substantial portion of the population. New methods to deliver and install infrastructure of all types are required. No blueprint exists regarding how to do this, but heavy private sector and community level involvement is necessary. One suggestion contained in this paper is to use private sector and community based agents in the areas of power generation, shipping, road building, schools and clinics construction, and the construction of small ports. Donors have exciting potential to experiment with alternative forms of infrastructure design and delivery, within the central guiding principle of ensuring that the stultifying hand of the state at both the central and local government level does not delay, or interfere with delivery. For example, the paper describes how the lack of rural infrastructure hampers severely the possibility of developing the rural economy and suggested ways in which it might be supplied using community based efforts. Part of providing infrastructure in rural areas involves ensuring that what is supplied matches community needs – this could be accomplished by block grants that leave the determination of what is built to the community. Widely publicising the amounts involved and the process by which the funds will be spent could increase transparency. Communities could also decide not only on the project, but also on how it might be implemented – local suppliers, community work, or outside contractors. While such procedures will not necessarily eliminate the ability of chiefs and “big men” to garnish most of the benefits of community projects, they could well be a move in the right direction if they are implemented with the assistance of on-the-ground donor support.

211. There is also a large need for the State to provide funding in areas where markets fail, but delivery should occur through private sector and community based suppliers. Wherever possible, competition can take the place of regulation. Where it cannot, using external or regional regulators is the only feasible course of action. Developing local regulatory capability will take many years and is of questionable feasibility.
212. Donor support and financing will be central to the success of these endeavours. Fortunately, individual initiatives do not require large sums and in many cases could be handled by grants that would not need to total more than a few hundred thousand US dollars. Furthermore, it might be possible to have communities competing for grants through submitting imaginative proposals that include local inputs, part local financing and so on. Such competition will be enhanced by reform of the collateral framework, which would allow the pledging of future streams of income to partly finance such projects.

3) Refocusing Government

213. This paper has described how the public sector places substantial barriers to private sector development, both through what it does and what it does not do. Examples of pervasive attempts to control private sector activity through licensing, the presence of monopolies of State Owned Enterprises, and reservation of activities for Solomon Islanders abound. At the same time, many of the fundamental pillars for the support of private sector development are missing – reliable property rights, a financial system that functions, and a legal system that supports contracting and the settlement of disputes. A current government initiative, supported by FIAS, is addressing some of the barriers and regulations surrounding investment including approvals and reserved activities. These are most welcome. In addition, we recommend the following measures:

- Closing down those government owned entities that serve no obvious policy objective to be in public hands, and improving those entities that will in the medium term remain in public ownership through private sector participation. Caution is necessary to ensure that genuine investor interest exists in order to prevent rent seeking in this process, however.

- Opening activities that are traditionally under the purview of the State to private and community based suppliers.

- Reforming the collateral system and passing legislation to modernise the legal structure underlying commercial activity so that lending by the financial sector at all levels could increase.
Pressing ahead with land reforms to improve access and use of land, thereby allowing Solomon Islanders to mobilise their most valuable resource;

4) Tax Reform

214. The paper has described the chaotic system of taxes, preferences, duties and surcharges that currently exists in Solomon Islands. Excellent proposals for reform have been put forward by PFTAC for the rationalisation and reform of the tax system. Furthermore, there are recommendations in this paper that overlap with improving the efficiency of the system – for example, using the Company Registry as an instrument to ensure that tax returns have been filed. However, a word of caution in necessary both for tax reform and for attempting to obtain new revenues from existing companies. Without rationalising government expenditures, simply raising more revenue will put an even greater burden on the private sector.

5) Financial Market Reform

215. Currently, financial markets in Solomon Islands are still recovering from the impact of the “Tensions” on business [with associated bankruptcies] and the default by the government on loans. The latter have been rescheduled over an extended period at a low interest rate and the banks have written down bad debts so that their balance sheets are much stronger. This experience, however, has left them justifiably conservative in their lending policies. Furthermore, by any measure, Solomon Islands is still a high-risk business environment, which makes it a risky lending environment, something that interest rates and interest rate spreads reflect.

216. Some of the recommendations contained in this paper will help to reduce lending risk by lowering systemic risk factors and by improving the potential to pledge collateral. Furthermore, better infrastructure will enhance the banks’ ability to extend their services into more remote locations, either through the establishment of branches, or by providing mobile banking. Furthermore, the ability to hire private security guards will also assist the financial institutions in supplying wider services.

217. Microfinance will need to be promoted if financial services are to reach out to rural areas. To be sustainable, microfinance initiatives will need to be market based and not
subsidised. The Central Bank’s current initiative to raise the level of discussion of options for improving access to rural finance is certainly an important first step.

6) Rural Development and Land Reform

218. This paper has pointed out the importance of rural development for the growth of Solomon Islands’ economy. However, achieving effective rural economic growth will not be simple. Solomon Islands is a country of numerous ethnic groupings and languages, scattered widely over more than 70 islands. Loyalties to village, clan and chief compete with the concept of common citizenship of a nation state. This has implications for policies and investments. Approval of an investment or a donor project at the national level does not imply that it will be accepted at the local level. There are often reports, for example, that projects that have been approved at the central levels of government do not proceed or fail because local support is not forthcoming. In order to maintain community support in rural projects or investments, and this includes mining, logging and large scale agriculture, more local education regarding the benefits of these projects is necessary. This in turn requires less central government “ownership” and more local community engagement in the decision process. If a community has a strong flow of benefits, it acquires a vested interest in the project flourishing and continuing - investors and donors should keep in mind the incentives at different levels of Solomon Islands society. Just as dissemination of the benefits of a private sector strategy are essential for it to be incorporated into government policy, dissemination, consultation and the appropriate structuring of incentives is essential at the local level. Investing in rural infrastructure would increase the ability of a large portion of the population to generate cash income. This income in turn would improve their living standards and reduce pressures to move to urban areas with its concomitant rise in ethnic “Tensions”.

7) Legal Reform

219. The report makes a number of legal reform recommendations that summarise much more extensive analysis contained in a paper produced as part of an ADB RETA (TA 6162 – REG; Improving the Legal Business Environment in the Pacific Region). The main recommendations are:

- Reform the National Licensing and Corporations Act.
o Establish a Company and Business Licensing Registry.

o Create a legal framework for collateral and business property rights enforcement.

o Revise the Arbitration Act and its Enforcement.

o Revise the Bankruptcy Law.

o Reform Consumer Protection Legislation.

o Start on creating stable, verifiable, property rights in real estate.

220. Moreover, considering that security is an overriding concern for investors, there is a need to plan beyond RAMSI—options to introduce private security should be assessed. Even in the current environment, financial institutions complain that they cannot supply private guards. While the authors are well aware of the sensitivities of the issue given experience with self styled private police and armies, this issue needs to be confronted. Some method of licensing private security companies needs to be found to allow the private sector to supply this much needed service.

B. Last Word

221. A vigorous campaign of persuasion, mobilising public opinion, and identifying and nursing reformers should be embarked upon without delay. This is the best prospect for promoting self-sustaining reform and prosperity. If this cannot be mobilised, what alternatives are there? For reform minded individuals within government, the only prospect is to “work under the radar” and attempt to improve the functioning and services of the limited areas at their disposal. For example, encouraging the market based provision of microcredit. For donors, the alternative is to support these individuals while continuing to promote macroeconomic stability, providing infrastructure and maintenance, and encouraging the development of enclave projects especially in rural areas.

222. Promoting growth in Solomon Islands is synonymous with promoting private sector development. Prospects for better social indicators and poverty alleviation cannot improve without the extensive upgrading of infrastructure. This too rests on the implementation of a private sector development strategy that promotes the provision of currently non-existent infrastructure services and facilities. Running through this paper
is the theme that innovative and sometimes radical solutions are needed to create a business friendly environment. Business as usual, whether by the government or by donors, will achieve little in the short and medium term. Unfortunately, short term failure could lead to long term instability. A vast effort, therefore, by both local and international partners is underway to assist in the recovery and development of Solomon Islands. This paper highlights opportunities for reform and ways in which interventions can occur that have the potential to accelerate the process.
IX. Bibliography


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