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Productive Capacity and Trade in the Solomon Islands

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ABSTRACT

Economic growth, environmental sustainability and human development in the Solomon Islands have lagged much of the Pacific region since independence in 1978. Trade contributes insufficiently to development, partly because of the dominance of the logging industry but also due to the lack of emphasis on building productive capacities with a view to economic transformation toward higher productivity activities. Targeted soft industrial policies may help address these shortcomings, in the form of sectoral prioritisation; linkages policies; joint government-donor support to build appropriate infrastructure; and the development of human resources in specific areas. Government institutional capacity will only be allowed to improve if policymakers are permitted true ownership over policies and if they are allowed to make mistakes.

Keywords: Solomon Islands, productive capacity, trade, least developed countries, industrial policy.

JEL Classification: F13, F14, F35, F63, O1, O2, O11, O14, O24, O25, O56

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Acronyms

ADB	Asian Development Bank
EIF	Enhanced Integrated Framework
EPA	Economic Partnership Agreement
ERU	Economic Reform Unit
GDP	Gross domestic product
GNI	Gross national income
GFCF	Gross fixed capital formation
HDI	Human Development Index
ICT	Information and communications technology
IMF	International Monetary Fund
LDCs	Least developed countries
MDG	Millennium Development Goals
MFN	Most-favoured nation
MSG	Melanesian Spearhead Group
PACER	Pacific Agreement on Closer Economic Relations
PICTA	Pacific Island Countries Trade Agreement
RAMSI	Regional Assistance Mission to Solomon Islands
SPARTECA	South Pacific Regional Trade and Economic Co-operation Agreement
UNESCAP	United Nations Economic and Social Commission for Asia and the Pacific
WTO	World Trade Organization

Productive Capacity and Trade in the Solomon Islands

1 Introduction

The economic and human development performance of the Solomon Islands since independence in 1978 has been mixed, often lagging the Pacific island region in the dimensions of sustainable development – environmental, social and economic – but in recent years achieving some stability.

Several inherent characteristics have inhibited development: the country is small, decentralised and distant from major markets.[1] But this paper argues that there also are a number of interconnected, policy-dependent explanations for the country's mixed development performance. Trade has not contributed as much as it could. In part this is due to the low development of productive capacities: production is insufficiently dynamic for export development or for import replacement, while until now policies have failed to promote diversification.[2] The result has been the absence of economic transformation into higher-productivity activities. Underpinning these shortcomings is the dominance of the logging industry; a long history of underinvestment; and the combined international and national institutional framework for trade policymaking. Policy implications therefore include the need to actively promote diversification and technological development, to improve institutional capacity and to stimulate investment, particularly in trade-related infrastructure.

2 Background

The Solomon Islands economy is recorded as having grown at approximately 4.5 percent per annum for the first decade after independence, slightly lower than the 5 percent average recorded during the previous 10-year period (Gay 2009:23).[3] Annual growth declined further in the 1990s to around 3.5 percent, little higher than the rapid annual population growth of 2.9 percent. Per capita gross domestic product (GDP) shrank by a third in constant Solomon Islands dollars from 1995 to 2002 and only recovered its 1990 level by 2007.

Framing this economic context is the fact that the Solomon Islands is the only Pacific island nation to have featured a civil war leading to the arguable failure of the state. A period from 1999 to 2002 known as "the Tensions" was partly linked to control of logging revenues and the gains from dwindling economic growth by a particular group perceived as having an ethnic identity. In 1998 a militant force known as the Guadalcanal Revolutionary Army, later renamed the Isatabu Freedom Fighters, began a violent campaign against people from the island of Malaita with the aim of removing them from Guadalcanal. In retaliation the Malaitan Eagle Force, a militant group made up of disenfranchised

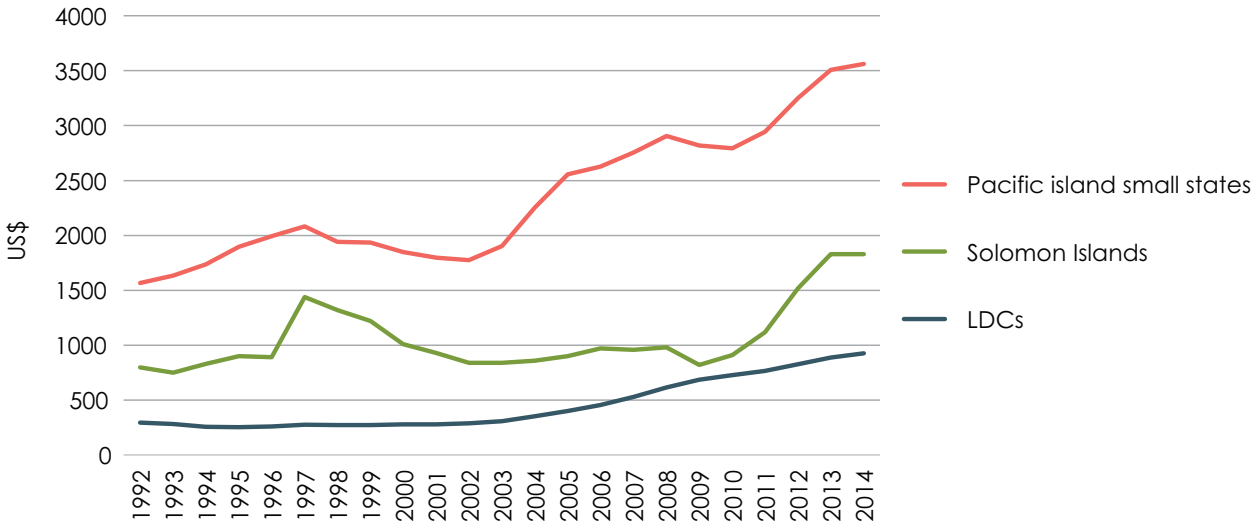
1 The population is 561,231 and the country comprises around 1,000 islands across an area of 28,400 km^2.

2 The paper understands productive capacity as the productive resources, entrepreneurial capabilities and production linkages which together determine the capacity of a country to produce goods and services and enable it to grow and develop sustainably. Productive capacity encompasses more than just manufacturing – it includes resource production, services and agriculture, which are more relevant in many LDCs. Economic transformation occurs when economic activity shifts from low to high productivity activities – traditionally from agriculture to manufacturing. See Hirschman (1958); Kaldor (1967, 1981); Kalecki (1969); the UNCTAD LDC reports (2006-14); and Ocampo (2005).

3 National income statistics may be unreliable, especially from the 1980s and the 1990s.

Figure 1

GNI per capita, Atlas method, current US$, 1992-2014



Source: World Development Indicators

Malaitans in partnership with the police paramilitary force, reacted violently, overrunning the capital Honiara, which, along with other parts of Guadalcanal, became lawless and unstable.

The economy shrank by a quarter, with a drastic effect on many livelihoods. During the conflict an estimated 20,000 or more people were displaced and up to 200 killed (UNDP 2004). As revenue collection dwindled and the currency devalued by 20 percent, the Government defaulted on domestic and foreign debt and became unable to finance its operations. An Australian-led Regional Assistance Mission to the Solomon Islands (RAMSI) assembled by regional neighbours and donors aimed at stabilising security and the political and economic situation. Development aid under RAMSI totalled A$2.6 billion from 2003-13, equivalent to a third of GDP and higher than government spending over the decade.[4] The macroeconomic impact of this aid accounts for a considerable proportion of economic growth over the period.

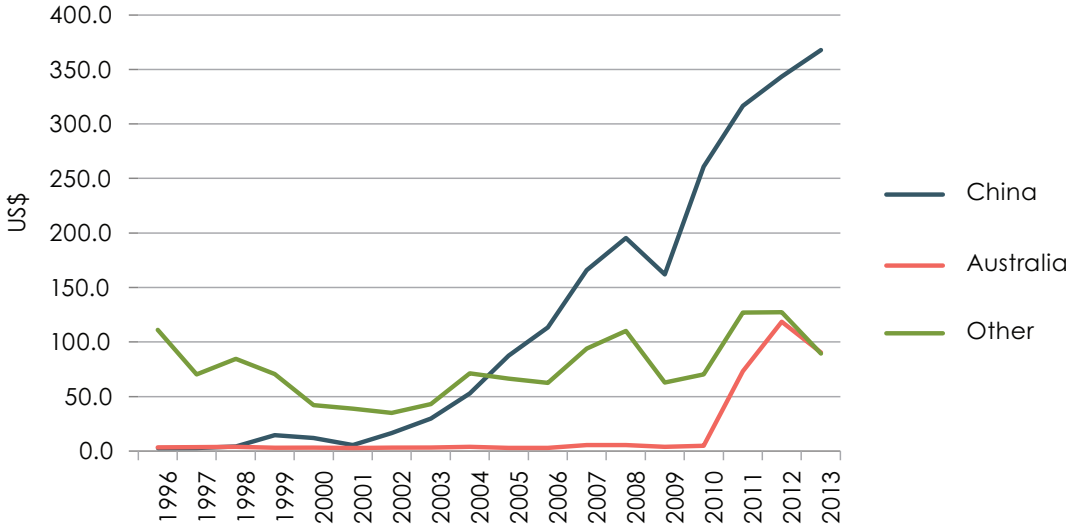
The Tensions came at the same time as a general upturn in economic performance and human development in several other Pacific island economies, with the result that the Solomon Islands lost ground on the region at a critical period. It has not since closed the gap (see figure 1), despite an improvement in the security and political situation after 2003. GNI per capita remains higher than the mean level for LDCs but it is around half the regional average.

The Solomon Islands's human development performance has been similarly lacklustre. The absolute Human Development Index (HDI) value (of which per capita GNI is one of three components) increased slightly in the last two Human Development Reports but at a lower rate than the regional average. The country's relative international ranking has deteriorated. In 2008 the Solomon Islands ranked 128th out of the 177 countries on the HDI, classifying the country as having medium human development. The Solomon Islands ranked above Papua New Guinea (which was in 139th place) but below Melanesian neighbours Vanuatu (119th) and Fiji (90th). Although the criteria for measurement of the index changed, and more countries were added to the list, by 2014 the Solomon Islands was classified as having low human development, at 157th out of 187 countries, equal with Papua New Guinea

4 http://www.lowyinterpreter.org/post/2014/05/23/RAMSI-How-to-blow-$26-billion-in-a-decade.aspx

Figure 2

Solomon Islands exports, US$ million



Source: Asian Development Bank

and well below Vanuatu (131st) and Fiji (88th).[5] The Solomon Islands was considered unlikely to meet many of its Millennium Development Goal targets.

As a result of a recent upturn in income per capita and longer-term performance in human assets, the country is now on course for possible LDC graduation on all three main criteria. Of the main human development-related indicators on the list of LDC criteria, the Solomon Islands performs relatively well on human assets, with an under-5 mortality rate of 30.1. 12.5 percent of the population is undernourished; the gross secondary school enrolment ratio is 48.4; and the adult literacy rate 76.6. The Solomon Islands also exceeds the criterion for graduation on the economic vulnerability index and has a per capita income above the threshold for graduation of $1,242.[6] It is therefore possible that the country may be recommended for LDC graduation at the 2018 triennial review of the Committee for Development Policy, paving the way for graduation in 2021.

Table 1

Human Asset Index Solomon Islands 2015

Indicator	Value
Under-5 mortality rate	30.1
Percentage of population undernourished	12.5
Gross secondary school enrolment ratio	48.4
Adult literacy rate	76.6
Human Asset Index	71.7

3 Reasons for economic and human development underperformance

3.1 Trade

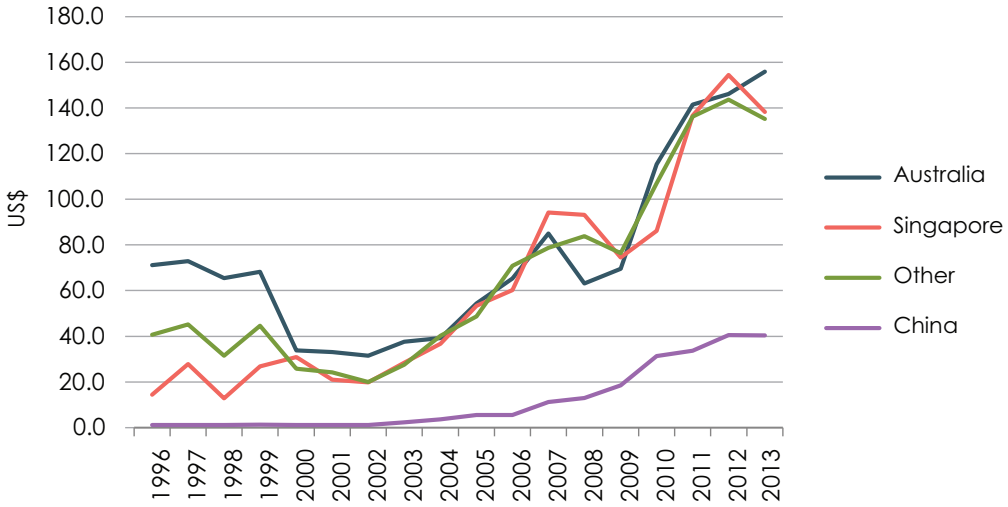
As a small island state the Solomon Islands economy is very open. The country imports most consumer goods, while resource exports, as will be shown below, have formed the basis of economic growth since independence. As summarised in Gay (2008), good education and health services are prerequisites for successful economic development; and revenues from trade are needed to fund investment in human

5 http://hdr.undp.org/en/data

6 Source for all data: 2015 triennial review http://www.un.org/en/development/desa/policy/cdp/ldc/ldc_data.shtml

Figure 3

Solomon Islands imports, US$ million



Source: Asian Development Bank

development. In the Solomon Islands trade has the potential to play a more dynamic and useful a role in development.

Trade is undiversified both by sector and destination, with the Herfindahl-Hirschman index having risen from 0.12 in 2002 to 0.51 in 2014, signalling high and increasing export concentration.[7] Imports have risen owing to a recovery in domestic demand over recent years, although exports of goods and services as a proportion of GDP fell from to 56.4 percent in 2013 from its peak of 62 percent in 2012.[8] The country has run a goods trade deficit every year since 2000, with the deficit partially offset by a surplus in net transfers, mostly official development assistance. Services trade was in deficit from 2000 until 2012, when services imports fell. Although incoming direct investment has been volatile, it has risen in recent years, with projects in tourism, mining and agriculture.[9]

Most logs are shipped to China, which is the Solomon Islands' top export partner, accounting for half of exports. Australia ranked a distant second at 13.6 percent of the total in 2013, mostly gold, before the closure of the Goldridge mine. The next main export destinations are Thailand and Italy, mostly processed and unprocessed fish. The main outstanding export trend has been a major shift toward China over the past decade or more. Gold exports to Australia rose rapidly from 2010 to 2012 but have since fallen.

Imports are more diversified. Singapore and developing Asia have accounted for an increasing proportion of imports over the previous 15 years. Imports from Australia are the second largest by individual country, at 27 percent in 2013. Singapore now accounts for a quarter of all imports (mostly re-exports including mineral fuels), followed by China at 7 percent. Developing Asia accounts for a third of imports.

The Solomon Islands has been a World Trade Organization (WTO) member since 1995 but has enacted unilateral decisions and taken part in trade negotiations in recent years which have taken it beyond its WTO tariff commitments. Few active measures have been taken to promote trade diversification, with trade policy focused on trade agreements and liberalisation. Although the majority of most-favoured

7 World Integrated Trade Solution, http://wits.worldbank.org/CountryProfile/Country/SLB/StartYear/2010/EndYear/2014/Indicator/HH-MKT-CNCNTRTN-NDX

8 World Integrated Trade Solution, http://wits.worldbank.org/CountryProfile/Country/SLB/StartYear/2010/EndYear/2014/Indicator/NE-EXP-GNFS-ZS

9 See annex 1 for the full balance of payments data from 2000.

nation (MFN) tariffs are bound at 80 percent, applied tariffs have fallen significantly over the past decade. The simple average applied MFN tariff rate in 2008 was 9.1 percent, while the average effective tariff rate was 5.7 percent in 2007. About 82 percent of ad valorem tariff lines have a rate of an applied tariff of 10 percent; 17 percent of items have a rate of 5 percent; 33 items are duty free; and 6 items have a rate of 15 percent.

As an LDC the Solomon Islands has duty and quota-free access to markets including the European Union and United States, as well as a number of developing country markets. Exporters have not fully utilised preferences except logging exports to China, fisheries exports to Italy, and periodic shipments to Australia. Margins of preference are, in any case, small and eroding.

Under the Pacific Island Countries Trade Agreement (PICTA), signed in 2001, the Solomon Islands has made reciprocal commitments on trade in goods to the 14 other Forum Island Country members. The Solomon Islands must eliminate tariffs on almost all products from other Forum Island Countries by 2021. Implementation, however, has proven difficult, and within the Pacific island region, the Solomon Islands conducts very little trade with non-Melanesian countries.

Under the Melanesian Spearhead Group (MSG) Trade Agreement, a regional bloc consisting of Papua New Guinea, the Solomon Islands, Vanuatu and Fiji, the Solomon Islands in 2017 will provide and receive duty free access to and from all but a few exempt products from MSG countries. The plan to extend the coverage of the MSG Trade Agreement to trade in services, investment and labour mobility may have a greater impact.

The South Pacific Area Regional trade Agreement (SPARTECA) gives Pacific island nations including the Solomon Islands duty and quota-free access to Australia and New Zealand. The Solomon Islands is engaged in negotiations toward a reciprocal trade agreement with Australia and New Zealand which may supersede this arrangement, the Pacific Agreement on Closer Economic Relations (PACER Plus). Labour mobility is a key offensive interest in negotiations, while additional development assistance has been raised as a possible benefit.

With the other Pacific members of the Group of African Caribbean and Pacific States, the Solomon Islands is negotiating an Economic Partnership Agreement (EPA) with the European Union. At a time when revenue from mining or logging activities may be reduced, this agreement may have implications for the fisheries industry and for tax revenues.

The pursuit of trade liberalisation via these various trade agreements has not resulted in trade-led development. Rather than Government actively promoting diversification and the development of the supply-side through the promotion of areas of possible dynamic comparative advantage, selective trade policies have been considered off the agenda. Export growth was seen as lying in improved market access; that is, it was expected that domestic supply would respond automatically to international market demand given a reduction in trade taxes or domestic distortions. The assumption, grounded in mainstream theory, was that increased exposure to international market prices alongside domestic factor market liberalisation would automatically lead to trade and economic development, facilitating the country's specialisation in its comparative advantage.

As we have seen, this approach fell short of its objectives. Domestic capital and labour markets are undeveloped, and for linguistic and cultural reasons (not to mention cultural tensions), and due to a lack of financial development, domestic factor mobility is extremely limited. People and investment do not move readily from one part of the archipelago to others. Large parts of the country remain excluded from the cash economy and from formal employment. The concept of economic flexibility has proven inappropriate: attempts to achieve it have failed. In the small number of areas where labour or capital market flexibility has been achieved, the results have been disappointing or counterproductive. Trade liberalisation has similarly failed.

Some economists have, in contrast, argued that for small island economies, "comparative advantage is not enough", owing to the costs associated with diseconomies of scale and with distance (Winters and Martins 2004). While the Solomon Islands has a comparative advantage in logging, this will not last and the industry has had a detrimental effect on the environment, governance and in many cases, livelihoods.

Instead of trade policy being in effect about trade agreements, it should have been as much about building the domestic economic engine and a move away from logging. Strategic measures by Government are required to stimulate production for trade. Particularly in small economies, trade is a supply issue as much as it is an issue of international demand.

3.2 Productive capacity and economic transformation

The increased concentration of trade and the persistent trade deficit, alongside the limited growth in trade, are partly a result of the lack of development of productive capacities, which is manifested in the absence of economic transformation. In the Solomon Islands there is indeed some evidence of reverse transformation, with a move into lower-productivity areas.

The development of productive capacity is critical to poverty reduction among other things because it helps move the unemployed and underemployed into more productive and expanding economic activities; it increases the likelihood that wage goods will fall and stabilise in price, making them more accessible to the wider population; and it helps raise government revenues and hence the provision of health and education (UNCTAD 2006).

One of the main reasons for the lack of development of productive capacity and economic transformation was the dominance of the logging industry. The Solomon Islands bears many of the hallmarks of the resource curse. Logging comprises 60 percent of exports, 15 percent of government revenue and 32 percent of foreign exchange earnings. It is also the largest source of formal employment other than the Government, providing nearly 5,000 jobs (Solomon Islands Government 2015). Whilst logging did not lead to Dutch disease via currency appreciation, as a readily-available source of economic activity the industry reduced the incentives for diversification and value-addition. Taxes on log exports (currently 2.5 percent) were a reliable fiscal revenue independent of direct and indirect taxes on citizens. Rather than reform and diversify, it was easier for Government to persist with a readily available fiscal revenue stream than to diversify into new products and to impose new and potentially controversial forms of taxation. Broadening the tax base would have presented challenges in a predominantly subsistence society.

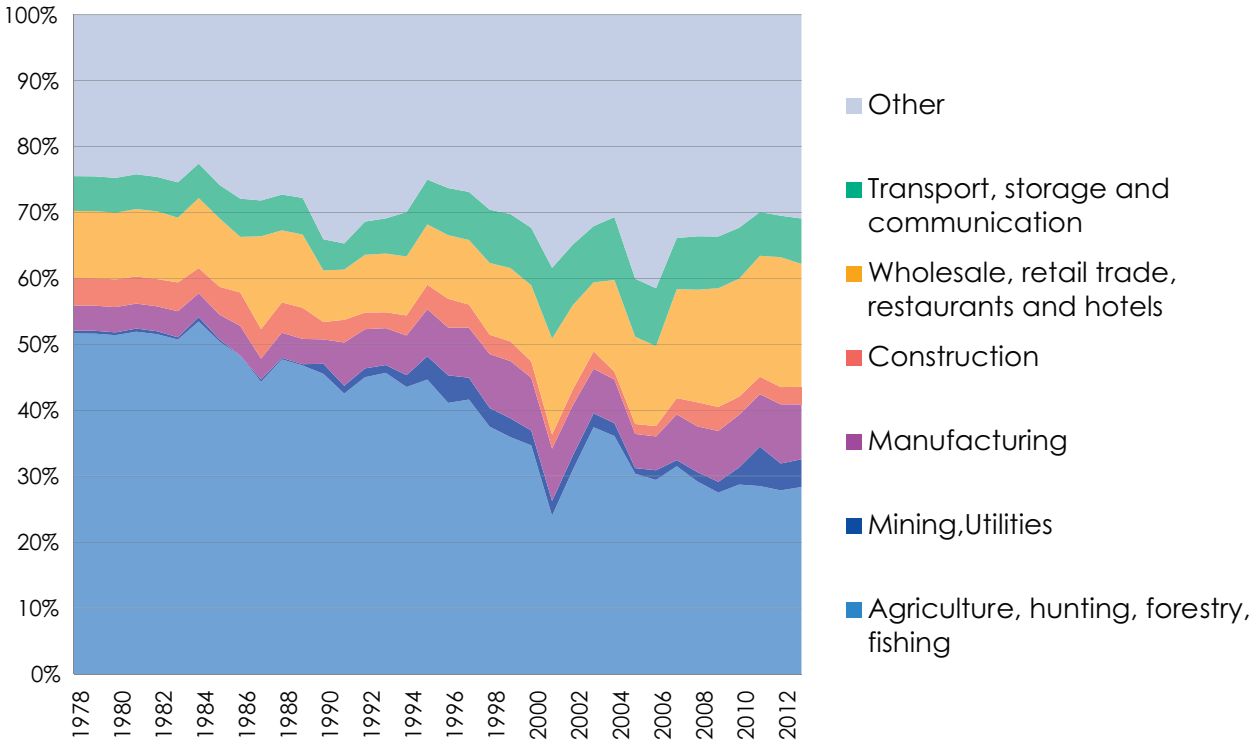
Allegations of a lack of transparency, illegality, abuse and a lack of environmental controls have long surrounded the industry. According to the Pacific Islands Millennium Development Goals (MDG) progress report: "Environmental degradation [is a] very significant problem due to rapidly accelerating land use, logging and the effects of global environmental change on seascapes and terrestrial landscapes. Logging activities [are] unsustainable, [and] cause siltation problems for reefs in coastal areas downstream of them."[10] There have been reports of the exploitation of women and girls on logging camps (Herbert 2007). Backward and forward linkages remain minimal, and most logs are exported unprocessed.

Weak political accountability meant that government funds were often misspent or misappropriated rather than used to build infrastructure or to invest in the productive sectors. While assessments of governance are difficult and often subjective, an Asian Development Bank and Commonwealth Secretariat study (2005) found that poor governance cost the country around US$2.8 billion in lost growth between 1978 and 2003, equivalent to 11.4 times the value of GDP in 2003. The economic challenge is simultaneously

10 Pacific Islands Secretariat (2013) "2013 Pacific Islands MDG Tracking Report" http://www.forumsec.org/resources/uploads/attachments/documents/2013_Pac_Regional_MDGs_Tracking_Report_FINAL.pdf

Figure 4

Value added by economic activity, percent



Source: UNSD National Accounts Main Aggregates Database

an environmental crisis, in that unsustainable logging has damaged the environment and removed the major source of economic growth. Natural forest resources are now close to exhaustion after being logged almost unchecked since independence. Some estimates suggest that logging will cease entirely within the next 5-10 years.

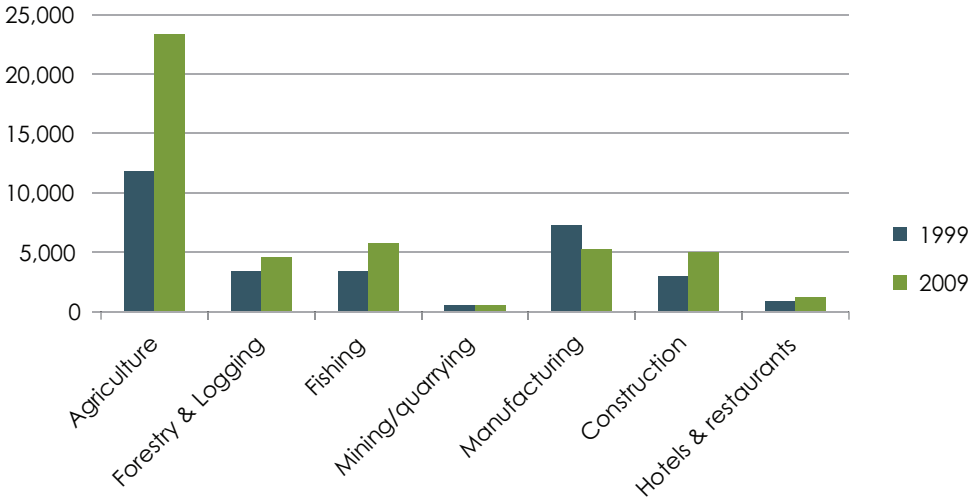
Figure 4, outlining the evolution of economic structure from independence to 2014, confirms the absence of economic transformation toward higher productivity activities. Services have grown to 55-60 percent of value-added, while agriculture has fallen to a quarter, manufacturing expanded slightly to 8 percent and mining to 5 percent. Although most services are domestic, non-traded activities, tourism has grown in recent years and has considerable potential owing to the country's attractive natural environment. Infrastructure is one of the main challenges, including telecoms, electrification (blackouts are still common and many in the outer islands continue to rely on generators), hotels and resorts beyond the main island, as well as roads and inter-island transport by boat and aeroplane. Many smaller tourism companies report being unable to readily access finance for expansion.

Agriculture has fallen from around half of value-added at independence, with the main agricultural export earnings from cocoa, palm oil, copra and coconut oil. As in several other industries value-addition is low and linkages are weak, with limited supply to the tourism sector and minimal processing. Infrastructure is poor, particularly feeder roads to agricultural areas. The Solomon Islands has the lowest number of kilometres of roads per square kilometre in the Pacific Islands. Fewer roads are paved than in any other country in the region, at 2.4 percent of the length of the total network.

Some growth has been seen in the manufacturing sector, mostly low-level processing and activities

Figure 5

Employment by sector, 1999 and 2009



Source: Solomon Islands National Statistical Office, 2009

such as water bottling, beer and food preparation. Technological progress and innovation have been very limited. Whilst data on most indicators of technological progress do not exist, the evidence suggests that very little is spent on research and development and that the labour force faces shortages of engineers and technical personnel. Potential exists for the promotion of light industry as a means of import replacement (Lin and Dinh 2014).

Mining revenues have increased slightly, and the industry has the potential to be the major contributor to foreign exchange and government revenues, possibly replacing the logging industry as the mainstay of the economy. Deposits of gold, bauxite and nickel in several parts of the archipelago have yet to be fully exploited. Extraction has, however, been limited due to land ownership problems, a lack of policy guidance and delays in the approval of licences. Linkages in the mining industry are notoriously limited, while the capital-intensive nature of production means that employment can be low. Many worry that similarly to logging, the industry will be affected by environmental mismanagement and a lack of transparency.

The fishing industry (within the category other in figure 4) has seen some growth in recent years after years of stagnation. The Western Central Pacific Ocean area, which includes the Solomon Islands and which is the world's last major unexploited tuna fishing ground, produced a record high of 2.6 million tons of tuna in 2012, representing over 60 percent of the world's tuna catch. Of the total catch in the Solomon Islands' Exclusive Economic Zone some 11 percent (24,000 tonnes) is processed in-country. This processing generates 1,795 jobs with a potential value-added of US$16 million and exports valued at US$59 million (Solomon Islands Government 2015). A small proportion of the catch is sold domestically, both canned and uncanned. Given the Solomon Islands's Generalised System of Preferences access to most major markets, constraints to growth lie principally on the supply-side in the form of sourcing increased volumes of fish for processing, and access to land and finance for the expansion of existing premises.

Figure 4 shows that the Tensions affected every sector equally, whilst the 2008 global economic crisis had a slightly larger impact on services – due to a decline in tourism – than on agriculture, mining and manufacturing.

Data on the labour market from the last census confirm the absence of economic transformation and the move in some cases toward lower productivity activities. From 1999 to 2009 there was a major shift in employment away from manufacturing and toward agriculture. Employment increased in both fisheries and forestry and logging, as well as the construction industry. Fewer workers were employed in manufacturing at the end of the decade than at the start. Although there is no official data on labour productivity, together with the observation that manufacturing has grown slightly this suggests that productivity in manufacturing may have increased. In agriculture, however, the opposite is true. Employment has significantly increased but the output share has fallen.

Human resource constraints are a particular drag on productive capacity, despite the country's relatively solid performance in human assets compared with other LDCs, particularly in literacy. Data from the 2014 Human Development Report show that the mean number of years of schooling is 4.5, just above the average of 4.4 for low income countries. The expected years of schooling were 9.2 years, slightly higher than the average of 9.0 for low-income countries. Expenditure on education was 7.3 percent of GDP in 2014, an increase on the 5.9 percent seen in 2007 but below the peak of 8.0 percent in 2009. This rate is comparatively high but may not reflect the true quality of education and its relevance to the productive sectors.

According to the Diagnostic Trade Integration Study (DTIS) skills levels are generally low, particularly in managerial and technical areas, which means that many professional positions are filled by expatriates (Gay 2009). Donor support has helped to pay teachers and improve and maintain facilities, including a network of rural training centres and vocational training institutions owned and operated by both the church and Government. Most of these institutions lack quality instructors, are under-resourced and regularly experience management problems. According to the Labour Commission, vocational training is strong in the electrical, carpentry, mechanics and plumbing trades. However there is still a shortage of skilled workers in areas such as tourism, information and communications technology (ICT), accounting, human resource management and personal services.

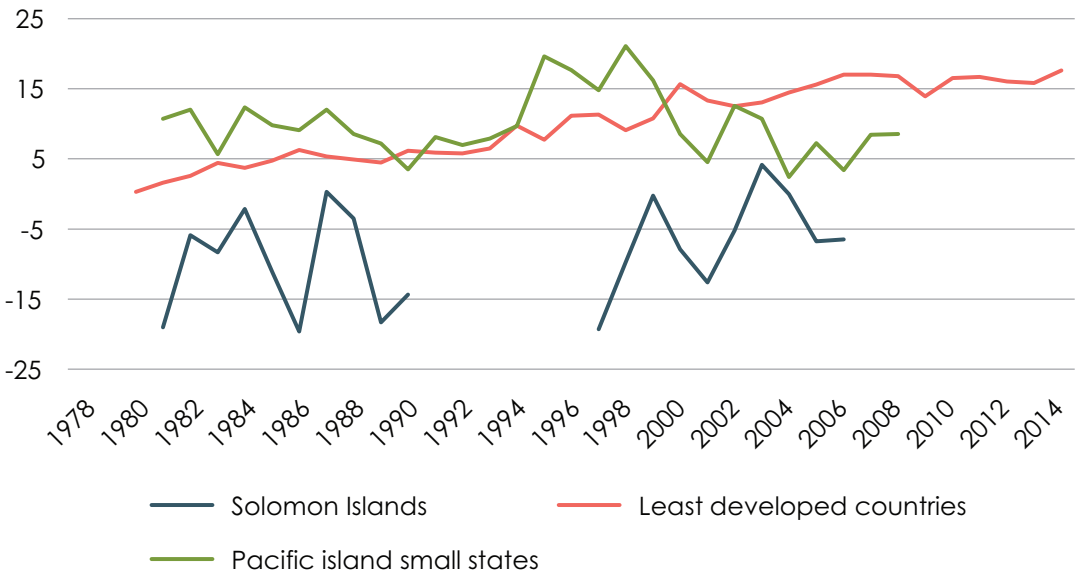
Shortages in local training facilities mean that students must often go overseas for training, funded by government and donor scholarships. The DTIS states that training and human resource development priorities should include developing technical skills and entrepreneurship in support of agricultural processing and diversification; a renewed focus on certification; and conducting labour market surveys on a regular basis. In such a small country, however, and until new economic activities become better-established, the suggestion is not to build new training facilities but to use others within the region, such as the Vanuatu tourism training school.

3.3 Underinvestment

Following recovery from the Tensions after 2003 a long-term investment programme should have been put in place, aimed at stimulating demand, building infrastructure and developing human resources. This could have been possible given the large sums of incoming aid, concessional borrowing and with a reasonable degree of fiscal space. Alongside policies of progressive trade liberalisation, however, fiscal policy has progressively tightened. This fiscal conservatism is partly due to policies enacted as part of the bail-out following the Tensions in 2003, but almost a decade later, fiscal conditions remained very tight. The government budget has been in surplus since 2009, recording large surpluses of 8.3 percent of GDP in 2010 and 6.4 percent of GDP in 2011. The United Nations Economic and Social Commission for Asia and the Pacific (UNESCAP) ranked the Solomon Islands as having the biggest fiscal surplus of any of the 30 Asia-Pacific states during those years.[11] Government expenditure was reported by the Asian Development Bank (ADB) as 44 percent of GDP in 2013, reasonably high by global standards

11 http://www.unescap.org/stat/data/syb2013/ESCAP-syb2013.pdf

Figure 6
Percentage of GDP



Source: World Bank

but among the bottom half of the 12 Pacific island states for which data is available.

Public debt had declined to the very low level of 13.6 percent of GDP by 2015 according to the International Monetary Fund (IMF), one of the lowest rates in the world, after which the rate was projected to climb to the mandated debt limit of 25 percent of GDP following the installation of an internet cable and the construction of a hydropower project on Guadalcanal. This rate is still extremely low, especially given that the rate of return is likely to be well in excess of cost of borrowing and that lending is on concessional terms.

A reduction in the Government's involvement in the economy was supposed to minimise "crowding out" and lead to a flourishing of market forces, among other things encouraging investment. However investment remained low. Unsurprisingly the Solomon Islands economy features a negative savings rate. Gross domestic savings shrank by an annual average of 6.4 percent between 1997 and 2006 (the latest data available, although it is likely that the savings rate has since remained negative). This contrasts with LDCs, where the savings rate has gradually increased, and with the rest of the Pacific region, which features a volatile but positive rate.

The negative savings rate in the Solomon Islands is partly a reflection of the large size of the subsistence sector, which results in relatively high inequality. The Gini coefficient based on the most recent household income and expenditure survey is 0.45, slightly higher than the average for the Pacific region (the closer to 1, the more unequal).[12] A fifth of adults of working age are not involved in the cash economy. Whilst subsistence has a number of advantages including food security; as in many LDCs the associated inequality and the relatively small size of the cash economy reduces potential demand. The subsistence poor, who would otherwise spend a higher proportion of their income on consumption, cannot afford even basic goods and services and

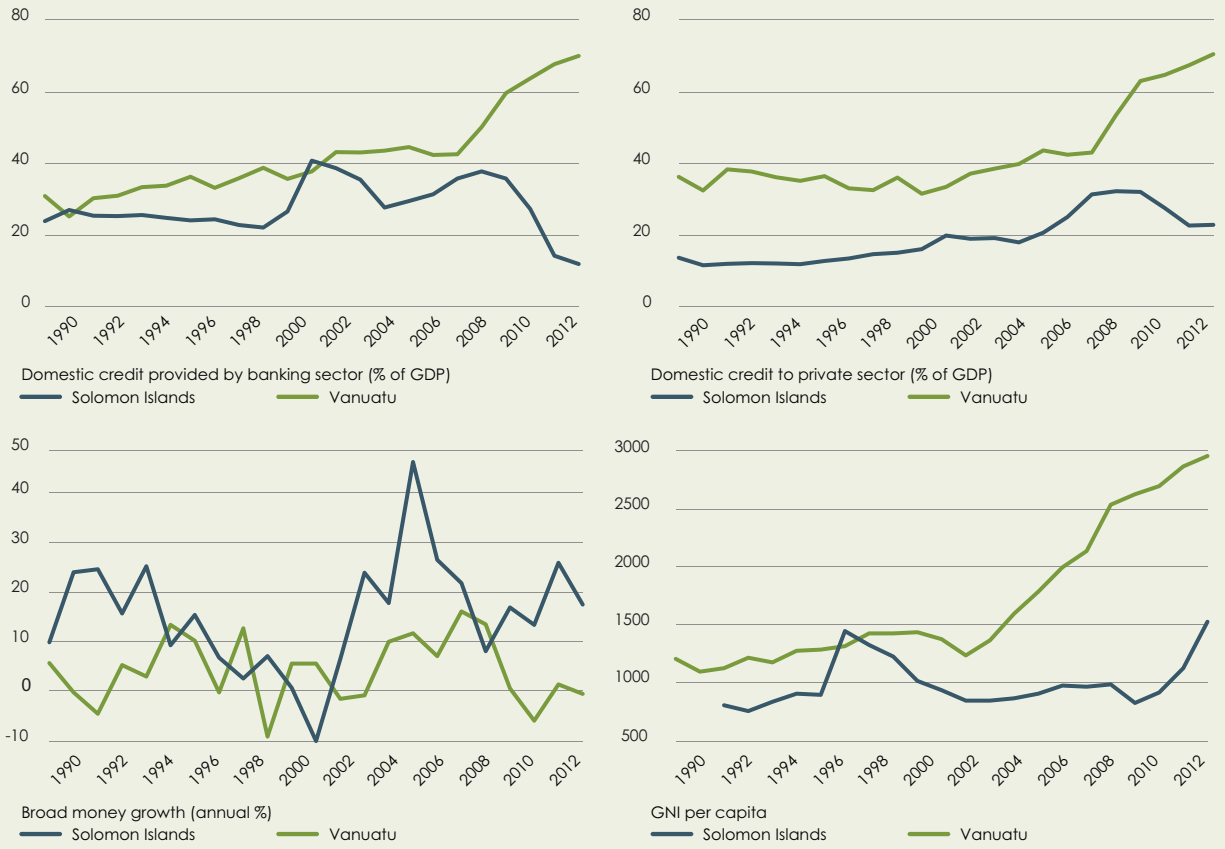
12 This aggregate measure hides other manifestations of inequality such as power, access to government services and the divide between men and women. More than 80 percent of people earn less than half of average national income while the richest 20 percent earn ten times the poorest 20 percent. Sources: http://www.adb.org/sites/default/files/publication/43030/ki2014_0.pdf; http://www.undppc.org.fj/_resources/article/files/solomon percent20report percent20final percent20LOW.pdf

Vanuatu and Solomon Islands

Neighbouring Vanuatu, a country with a similar population size, history and cultural characteristics, is a useful comparator. The Vanuatu economy has attracted higher levels of incoming foreign investment, while policies have been directed much more at the development of productive capacity (in tourism) and capital accumulation. As a result one of the key points of divergence has been the rate of investment. The Vanuatu economy, after following a similar trajectory in per capita GNI until 2002 albeit at a slightly higher level, subsequently significantly outperformed that of the Solomon Islands (see figure 9 below) and has been recommended for LDC graduation in 2017. As the figure shows, in recent years there has been a marked divergence in the two countries between domestic credit provided by the banking sector, although overall domestic credit to the private sector in the Solomon Islands has long lagged that of Vanuatu, and the divergence has increased in recent years. Broad money supply growth in both countries has been more similar, although Vanuatu has registered a lower rate in recent years, adding to evidence of poor financial services development in the Solomon Islands. Vanuatu, as a tax haven, has a larger and more competitive banking sector. Overall, liquidity in Solomon Islands have been as high or higher than in Vanuatu but in the Solomon Islands savings are not being converted into productive private investment. Domestic investment is significantly lower in the Solomon Islands, with Vanuatu's rate of gross fixed capital formation reaching 40 percent of GDP in 2008 compared with the last known rate of 21 percent for the Solomon Islands.

Figure 7

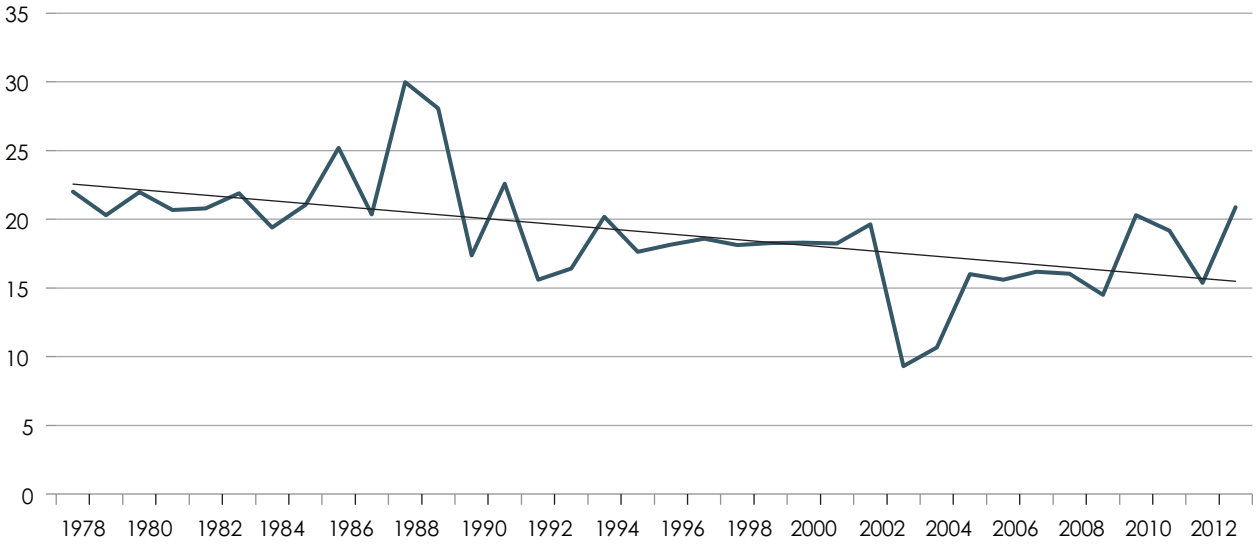
Selected indicators, Vanuatu and the Solomon Islands, 1990-2011



Source: World Bank

Figure 8

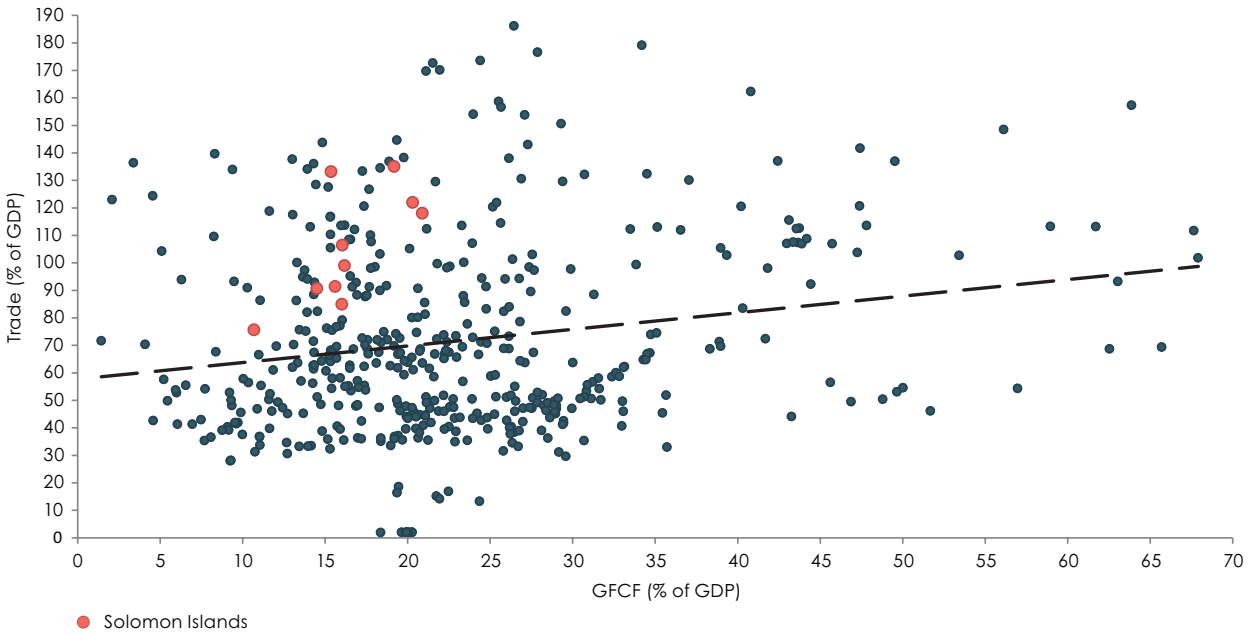
Solomon Islands, gross fixed capital formation, percent GDP



Source: UNSD National Accounts Main Aggregates Database

Figure 9

Trade and GFCF, LDCs, 2004-13



Source: UNSD National Accounts Main Aggregates Database; author's calculations

Note: Ten years' worth of data are used for all LDCs, with each data point representing one year for an individual LDC.

therefore contribute less than they otherwise would to consumption, further reducing domestic business opportunities. There is also a clear impact on productive capacity in the reduction in the potential human resource pool. Rebei (2014) suggests that there is a link between inequality and high interest rate spreads, in that the latter hinder the private sector's access to credit, which is an impediment to inclusive growth. Spreads, at 10 percent or more, are higher in the Solomon Islands than in other Pacific Island countries

A further reason why the reduction of government expenditure was unlikely to lead to an increase in private-sector investment was that returns on savings are low, which in turn results from the weakness of the banking sector and from the poor provision of financial services[13]. Banks are risk-averse and ration credit. Rebei (2014) shows that there is evidence of abnormally high banking profits, partly a result of collusion in a small and uncompetitive sector. With average commercial bank rates of up to 15 percent, tight monetary policy has contributed to the lack of development of productive capacity. Other reasons for the low rate of lending include the difficulties in ascertaining land ownership and the associated lack of collateral. Financial exclusion and the associated absence of lending history contribute to the absence of information about borrowers.

Measures have been taken to make the country more attractive to foreign investors including attempts to create a one-stop-shop for foreign investors and a new, more open investment policy drafted with World Bank assistance. Yet most incoming projects are concentrated in a small number of areas including hotels, and resource-seeking investments such as mining. Technology transfer has been limited or non-existent and incoming capital is not always converted into productive and sustainable investment.

One of the upshots is that gross fixed capital formation (GFCF) as a proportion of GDP has been in a state of long-term decline since independence and, although there has been a recent upturn, as recently as 2009 was only 15 percent, particularly low for developing countries, which tend to invest more during the catch-up phase. Chang (2014) argues that no country has achieved rapid economic transformation with an investment rate of lower than 25 percent. Ideally, he argues, the rate should be at least 30 percent.

Further evidence of the links between the rate of investment and trade growth in LDCs can be seen in figure 8, which plots gross fixed capital formation against imports and exports as a proportion of GDP for all 48 LDCs over 10 years. Whilst it would be wrong to read too much into the data, causality could run either way, and other factors could be of greater explanatory importance, a link appears to exist between the two variables over the years in question. Relative to other LDCs, the Solomon Islands appears to be a low-investment, high-trade country.

3.4 The domestic and international context for trade-related policymaking

The Solomon Islands is one of the highest recipients of official development assistance (ODA) in the world, at US$513 per capita in 2013, a more than eightfold expansion from a decade earlier and ten times the LDC average.[14] There has thus been no shortage of incoming development funds, and it should be possible for the country to use these funds for investment in the supply side. To some extent, this has been the case. The country has benefited from a number of Aid for Trade initiatives. These include at the regional level the Pacific Trade and Development Facility established by the Pacific Islands Forum Secretariat; the Pacific Regional Economic Integration Programme and its successor programme funded by the EU; and the now expired Regional Trade Facilitation Programme established under the Pacific Agreement on Closer Economic Relations (PACER). The Solomon Islands is a member of the Enhanced

13 See Solomon Islands Diagnostic Trade Integration Study pp. 82-99.

14 Source: World Bank World Development Indicators

Table 2
Aid for Trade in the Solomon Islands (ODA receipts in US$ million)

Sector	2006	2007	2008	2009	2010	2011
1. Transport & Storage	24.907	0.013	8.430	0.302	2.894	55.647
2. Communications	0.006	...	0.485	0.047	6.618	2.236
3. Energy	6.615	...	4.092	0.092	0.032	0.027
4. Banking & Financial Services	...	...	...	0.313	...	0.344
5. Business & Other Services	0.451	0.022	0.055	0.078	2.062	1.917
1.a. Agriculture	0.507	2.454	1.141	0.964	12.750	4.936
1.b. Forestry	4.719	0.141	0.532	0.284	0.487	0.358
1.c. Fishing	3.348	1.547	2.862	2.913	6.092	1.466
2.a. Industry	0.257	0.026	...	0.018	11.282	0.154
2.b. Mineral Resources & Mining	0.167	0.042	...	0.010	0.016	0.020
3.a. Trade Policies & Regulations	0.085	0.101	0.600	1.391	0.716	1.771
3.b. Tourism	0.038	...	0.023	0.015	0.071	0.002
Total Sector Allocable (Ii+Iii)	230.135	258.669	276.841	261.733	344.387	313.184

Source: Solomon Islands Government 2015

Integrated Framework (EIF) for Trade-Related Technical Assistance to LDCs that resulted in the Diagnostic Trade Integration Study finalised in January 2009. The country also participated in technical assistance activities of the WTO. The Solomon Islands has received bilateral aid for trade assistance from a number of countries, including Australia, the European Union and New Zealand (Solomon Islands Government 2015).

Despite these major aid inflows, it is not obvious that expenditure has gone into the most appropriate areas. In the table above, for example, tourism, one of the most promising areas for economic development, received only a negligible share of Aid for Trade, and less than mining, which tends to receive large sums of incoming foreign investment. Energy appears to have received limited investment despite the continued problem of black-outs and high electricity prices. ODA to individual sectors has mostly been in the form of technical assistance and regulatory reform rather than direct support for infrastructure or the productive sectors. Of the A$2.6 billion in expenditure under the Regional Assistance to the Solomon Islands (RAMSI) in the decade following the Tensions, A$2.2 billion was spent on law and order, ten times the sum spent on the economy. Of spending on the economy, most was on economic governance rather than infrastructure or the development of commercial activities.[15]

One of the risks for Aid for Trade is that it falls short of its objectives on building supply-side capacity. Simply producing more of the same products is not always developmental.[16] Economic development,

15 The annual sum of 5900 Solomon dollars per capita officially spent during the 10 years of RAMSI was enough to meet the entire basic needs of an individual throughout the period. http://phtpacific.org/sites/default/files/surveys_dev_reports/90/files/SLB_HIES-2005-06_AnalyticalReport_2008-07.pdf

16 http://www.odi.org.uk/sites/odi.org.uk/files/odi-assets/publications-opinion-files/8740.pdf

even in microstates, is associated with increasing economic complexity (Hausmann, Hidalgo et al. 2011). As countries develop, they diversify rather than specialise their export baskets (Hausmann and Rodrik 2003; Hausmann, Hwang and Rodrik 2006). Without attending to the issues of diversification and value-addition, the Solomon Islands will not build enough governance capacity to attract investment or to encourage the acquisition and learning of new technologies. Aid for Trade must complement industrial policy and trade diversification.

The draft Consolidated Aid for Trade Matrix prepared for the Pacific Islands Forum Secretariat identifies trade-related needs, and is shown in table 1. A considerable proportion is related to the cost of implementing trade agreements rather than the development of the supply-side. More needs to be done to identify areas of realistic dynamic comparative advantage, and for industrial projects to be identified based on this analysis. Aid for trade also needs to be used more for the development of infrastructure, building on existing initiatives such as the installation of the internet cable; the upgrading of the road in the capital; and the airport and road in Georgia and Gizo in Central Province.

Aid for Trade and institutional capacity are connected. Whilst Aid for Trade can be beneficial if spent on the essential building blocks of economic development, it can also hinder the development of institutional capacity if technical assistance prevents Government from learning by doing and if policymakers are not permitted to make mistakes. There is evidence that the Economic Reform Unit (ERU) established in the Ministry of Finance under RAMSI has taken certain decisions away from some government ministries and centralised authority within a small, foreign-staffed institution. Some government officials have said that they feel marginalised from economic decision-making. For instance in 2007 an overseas short-term government adviser in the ERU lowered and simplified the import tariff structure without consulting the Ministry of Commerce, which at the time had responsibility for trade policy.[17] This both undermined trade negotiations strategy and soured relations between the two institutions, leading to a feeling of frustration amongst trade officials. More broadly, the process of state legitimation in Solomon Islands risks being undermined by the perception that donors are running Government.

17 Diagnostic Trade Integration Study 2009

Table 3

Aid for Trade priorities identified in Pacific Islands Forum Secretariat Consolidated Aid for Trade Matrix

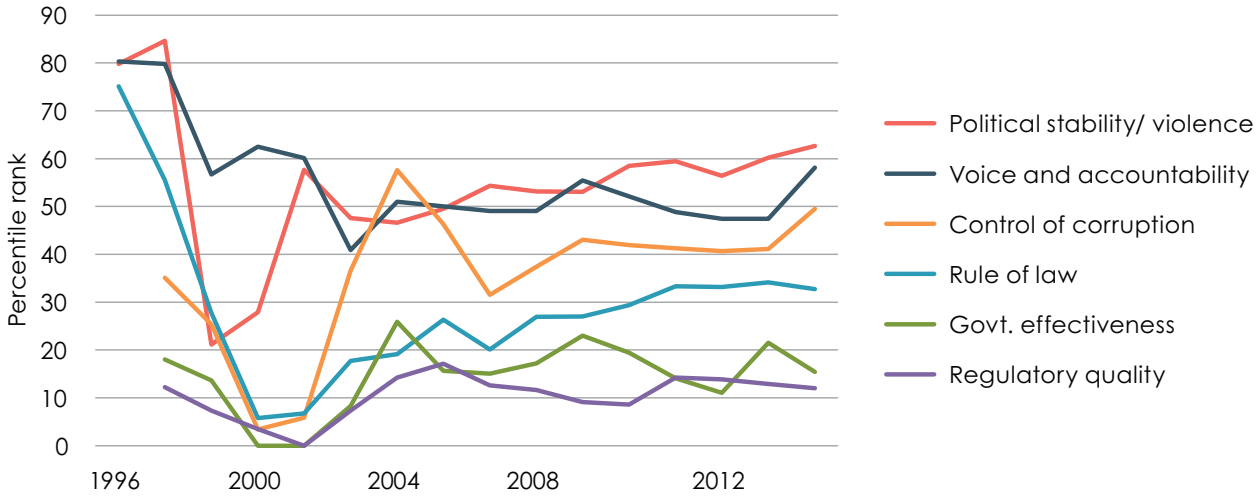
Project	Cost (Euro)
Implementation of Pacific Island Countries Trade Agreement (PICTA)	400,000
Implementation of Melanesian Spearhead Group Trade Agreement (MSGTA2)	560,000
Implementation of Economic Partnership Agreement (EPA) (customs procedures, rules of origin, export tax, fiscal implications, trade remedies, TBT and SPS, competent authority for export of marine products, dispute settlement)	6,017,722
Technical assistance for service negotiations	250,000
Establishment of competition authority	2,000,000
Construction of Honiara Port coastal bypass[1]	15,500,000
Vapour heat treatment system for fresh produce	1,159,848
Study of potential value added industries	249,546
Cold storage and handling facilities for export of marine products	5,449,000
Technical assistance for Attorney General	355,080

Source: Solomon Islands Government 2015

It is also a mistake for external institutions such as aid donors or multilateral institutions to identify technical policy proposals, however well-founded, and to imagine that they can simply be handed to government officials for implementation. One of the main trade policy shortcomings in the Solomon Islands is indeed the institutional capacity to enact trade policy. Institutional capacity needs explicit attention and funding (and indeed some support has

Figure 10

Worldwide governance indicators, 1996-2014



Source: World Bank

been received under the EIF). At the time of writing the Ministry of Foreign Affairs and External Trade had three senior trade officials who were obliged to deal with negotiations toward the four trade agreements mentioned above, as well as trying to enact policy and day-to-day operational issues. Policy proposals must be aligned with government abilities and priorities.

Trade policy is itself buttressed by the act of formulating and enacting it. Without national ownership, technically "correct" solutions risk failure. Proposals such as that of Francis Fukuyama, who after visiting the country recommended a system of shared sovereignty with Australia, are thus counterproductive (Fukuyama 2008) because they prevent policymakers from learning and are in any case not in the national interest. National policymakers are best-placed to create and implement policies that are adapted to local circumstances.

Although the importance of benchmarking can overstated because the importance of institutional characteristics varies between contexts, the following data from the World Governance Indicators shows that in the Solomon Islands perceptions of governance rank among the bottom half of countries worldwide.[18] Confidence in institutions has deteriorated overall since the mid-1990s, a finding that fits with anecdotal observation. In 1996 the country scored fairly highly on voice and accountability, rule of law and perceptions of political stability and violence.[19] After views about government effectiveness fell to zero during the Tensions, the measure climbed back only to the 15th percentile of countries on the index by 2014.[20] Regulatory quality is considered

18 It should also be noted that the number of data sources is lower than for many other countries and that the lower and upper bounds of the 90 percent confidence intervals are wider than the average.

19 Definitions are as follows. Voice and accountability: perceptions of the extent to which a country's citizens are able to participate in selecting their Government, as well as freedom of expression, freedom of association, and a free media. Rule of law: perceptions of the extent to which agents have confidence in and abide by the rules of society, and in particular the quality of contract enforcement, property rights, the police, and the courts, as well as the likelihood of crime and violence. Political stability and violence: Political Stability and Absence of Violence/Terrorism measures perceptions of the likelihood of political instability and/or politically-motivated violence, including terrorism.

20 Government effectiveness is defined as perceptions of the quality of public services, the quality of the civil service and the degree of its independence from political pressures, the quality of policy formulation and implementation, and the credibility of the Government's commitment to such policies.

particularly bad, with perceptions remaining among the worst in the world.[21] Interestingly perceptions of political stability and violence, despite dipping significantly during the Tensions, are relatively benign, while voice and accountability remained at a relatively high level despite the crisis, though below the high levels seen in 1996.

It is possible that the low perceived level of government effectiveness is associated with the problems of state legitimation, which are partly a result of the country's fragmentation and the separation of linguistic/cultural groups (known as wantoks). But inequality, limited access to education and the slow rate of wealth generation also play a part. Alonso and Garcimartín (2013) find that, "the quality of institutions depends essentially on development level, income distribution, tax revenue and education. Development fosters good institutions, thus creating a virtuous circle between growth and institutional quality". The improvement of institutional capacity, therefore, is a prerequisite and a consequence of equal and broad-based economic development.

4 Conclusions and policy recommendations

One of the most notable features of economic performance in the Solomon Islands is that the rate of investment has been in decline more or less since independence, and despite a small upturn in recent years remains low by Pacific island and global standards. Yet investment is critical in order to develop productive capacity and to transform the economy. Countries must actively develop the productive capacity to be able to benefit from market access opportunities; this is not a process that is likely to take place spontaneously. Now may be a propitious time to take action: the country is undergoing a period of relative economic and political stability and has significant fiscal space given that government spending and debt are very low.

In effect the proactive stimulation of investment in appropriate areas constitutes industrial policy. Given that tariffs cannot be raised because of external commitments and that export subsidies or tax breaks for foreign corporations may bring associated governance issues and rent-seeking, the kind of softindustrial policies described in Harrison and Rodriguez-Clare (2010) might be appropriate, meaning: "programmes and grants to help particular clusters by increasing the supply of skilled workers, encouraging technology adoption, and improving regulation and infrastructure".

Sectoral prioritisation is important because such a small Government has limited institutional capabilities. A number of areas show promise for diversification: tourism, labour mobility, fisheries and agricultural processing, and information communication technology. Initiatives to promote linkages are particularly necessary; in mining, where possible, as well as between tourism and agriculture. Measures to increase the rate of uptake of technology may be considered, such as the kind of national innovation funds used in Latin American countries such as Nicaragua (Gore 2007). The proposed United Nations technology bank may also hold promise. The bank, hosted in Turkey, will be set up in 2017 and will consist of a Science, Technology and Innovation Support Mechanism and an Intellectual Property Bank accessible by LDCs.

Human resource development should be seen not just as a social objective but as having trade and economic benefits. There is a particular shortage of vocational training in the industries in which the Solomon Islands has, and might have, a comparative advantage, such as tourism and low-level ICT facilitated activities like business process outsourcing, or where there is some opportunity for import replacement, such as light manufacturing.

Infrastructure should be a particular target for investment, particularly in support of non-resource-based economic activities such as light manufacturing,

21 Regulatory quality is defined as perceptions of the ability of the Government to formulate and implement sound policies and regulations that permit and promote private sector development.

tourism and ICT. Given adequate planning, oversight and transparency, rates of return are likely to be far higher than the cost of capital. Promising recent joint donor-government projects in roads, hydropower, and internet connectivity need to be accompanied by other large private and public investments away from the main island, particularly in support of employment-generating activities such as fisheries and tourism. The associated increase in demand will itself have a macroeconomic impact, and it is likely to bring with it other business opportunities, in turn creating possibilities for export.

Lending also needs to increase, via competition in the banking sector and an improvement in the availability of collateral. The improvement of financial intermediation is critical, including the full range of financial institutions: conventional banking, microfinance, travelling banks and banking by mobile telephone.

Trade liberalisation has been a marked feature of economic policy, with a number of trade agreements negotiated over the last decade or more (although not with East Asia, with which an increasing share of trade is conducted). Import tariffs have been reduced and market access under Generalised System of Preferences schemes has increased. Yet exposure to international prices and competition has not resulted in a corresponding domestic adjustment. Exports have become even more concentrated by both product and destination, while the contribution of trade to economic growth has not increased other than in the logging industry, which has been the source of the resource curse, is in terminal decline and faces environmental, sustainability, social and governance challenges. Similar concerns surround its replacement by mining. Given that so much of trade policy has concerned trade agreements, with limited obvious benefit, this is further reason for the Government to devote fewer of its resources to trade negotiations and comparatively more to building active policies aimed at building the capacity to export.

There is a need for much more connected, cross-governmental thinking about industrial policy, with donors, the public sector and existing and potential private-sector stakeholders and entrepreneurs collaborating on a shared vision which identifies and prioritises the likely future sources of economic growth, and invests in the requisite infrastructure. A strong relationship between donors and their own domestic private sector would hopefully encourage appropriate, good-quality investment. Until now different donors and public-sector entities have sometimes acted relatively autonomously, without appearing to consider the impact of decisions on other areas. If, for example, adventure tourism continues to hold promise, donors may agree to finance roads and inter-island transport to and within several key potential adventure tourism zones, with Government and the domestic private sector collaborating in construction and service-provision. Donors may, for example, promote hotel and resort investment in the Solomon Islands among domestic investors. The Government would promise to provide or facilitate the provision of basic services. Explicit linkage policies would aim to connect agricultural providers with hotels and resorts.

Policy proposals are all very well, but they need to be put into practice, and it is this where the Solomon Islands is likely to face the biggest challenge. Investment in useful areas will be impossible without the necessary political and bureaucratic machinery. A strategy focused on building production for export cannot be carried out without the requisite institutional capability. It will require cross-governmental buy-in, which will take time, funding and continual work and advocacy on the part of trade-related agencies and donors, who must allow policymakers to learn by doing and to make mistakes. State legitimation is in part a process of equitable wealth-generation, and the achievement of these objectives is vital in enabling the Government to enact policy.

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Annex I

Balance of Payments, 2000-2013

BALANCE OF PAYMENTS *million US dollars*	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2012	2013
Current account	-36.8	-32.7	-7.1	5.3	41.9	-5.9	-42.7	-81.1	-108.5	-128.0	-210.1	-60.6	-1.2	-91.4
Balance on goods	-23.1	-34.6	10.2	4.2	25.1	-17.4	-81.7	-97.5	-68.4	-74.1	-136.6	-6.0	47.1	-23.0
Exports	69.3	47.1	57.8	74.2	97.3	103.4	114.0	164.6	210.1	164.9	223.7	415.2	493.1	439.8
Imports	-92.3	-81.7	-47.6	-70.0	-72.2	-120.9	-195.7	-262.1	-278.4	-239.0	-360.3	-421.2	-446.0	-462.8
Services and income	-23.4	-9.2	-26.0	-26.4	-8.3	6.4	-33.6	-76.4	-150.1	-170.2	-206.0	-183.5	-146.6	-171.1
Credit	49.3	51.6	16.0	25.3	41.3	49.9	65.6	73.3	79.6	83.2	124.0	163.5	175.8	160.7
Debit	-72.7	-60.8	-42.0	-51.7	-49.7	-43.5	-99.2	-149.6	-229.7	-253.4	-330.0	-347.0	-322.4	-331.9
Current transfers	9.6	11.0	8.7	27.5	25.2	5.1	72.6	92.7	109.9	116.3	132.5	128.9	98.2	102.7
Credit	35.3	...	28.9	46.3	50.0	41.1	82.9	101.6	122.9	151.3	191.4	190.7	145.1	142.4
Debit	-25.6	...	-20.2	-18.9	-24.9	-36.0	-10.3	-8.9	-13.0	-35.1	-58.9	-61.8	-46.8	-39.7
Capital account	13.3	4.4	7.0	12.5	1.5	27.6	19.5	25.6	14.9	26.8	50.3	70.5	92.1	82.7
Financial account	12.6	16.1	6.9	-17.3	-21.7	-15.3	-23.4	-44.6	89.7	137.8	291.6	175.3	3.4	61.8
Direct investment	1.4	-11.6	-1.4	-1.8	1.6	10.2	20.8	32.3	91.2	116.8	235.6	142.6	66.8	103.6
Portfolio investment	...	...	...	...	...	...	...	...	3.4	1.2	-2.6	0.1	-3.7	1.5
Other investment	11.3	27.8	8.3	-15.5	-23.2	-25.4	-44.3	-76.9	-4.8	19.8	58.6	32.6	-59.7	-43.3
Net errors and omissions	-1.0	1.3	-6.3	-4.1	-4.0	-5.6	-0.3	11.0	-22.9	20.6	-12.0	-68.8	-8.0	6.0
Overall balance	-11.9	-11.0	0.5	-3.7	17.8	0.8	-46.9	-89.2	-26.8	57.2	119.8	116.4	86.2	59.0
Reserves and related items	11.9	11.0	-0.5	3.7	-17.8	-0.8	46.9	89.2	26.8	-57.2	-119.8	-116.4	-86.2	-59.0

Source: Central Bank of Solomon Islands