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Solomon Islands

Despite rising exports of timber, fish, and minerals, growth decelerated in 2018 as government spending slowed and cash crop yields declined. Inflation rose on higher taxes but will ease this year and next. Growth will likely slow in 2019 and 2020 as new construction only partly offsets lower logging output. The current account deficit is expected to return to deficit, reversing last year's surplus. A tax review shows progress, but broadening the revenue base remains a challenge.

Economic performance

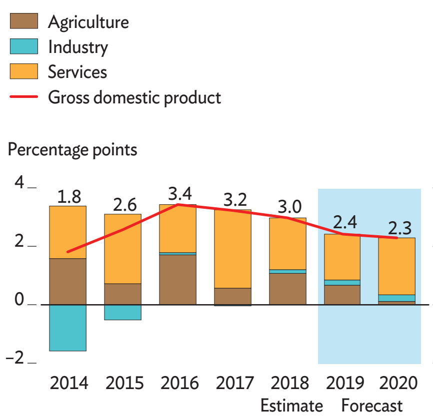
Economic growth is estimated to have slowed slightly to 3.0% in 2018 (Figure 3.34.1). Log output continued to outperform expectations and increased by 2.6% in 2018 to a record 2.7 million cubic meters (Figure 3.34.2). Higher volume and global prices sent the value of log exports up by more than 25.0%. Exports of minerals, notably bauxite and nickel, rose by 29.9%. Fish exports grew 15.1%, in line with growth in the previous year. However, the export value of most crops declined in 2018, with copra and coconut oil falling the most. The exception was cocoa, which reversed a plunge by 47.5% in 2017 with a rebound by 42.7% in 2018.

Growth in services slowed to 3.5% in 2018. Wholesale and retail trade decelerated with lower cash crop output and higher taxes, and as growth in government spending slowed. Industry expanded 1.2% in 2018, mainly on higher mining.

The government made a concerted effort to restore fiscal stability after several years of widening deficits, which had significantly reduced its cash reserves, undermining their usefulness as a buffer against shocks. The fiscal deficit narrowed from the equivalent of 3.8% of GDP in 2017 to 0.6% in 2018 (Figure 3.34.3). Growth in government spending slowed with substantial reductions in development expenditure. Revenue rose on higher log export duties, estimated to be up from 2017 by more than a fifth, and budget support from development partners. A domestic development bond helped to capitalize a new state-owned enterprise to lay an undersea telecommunications cable.

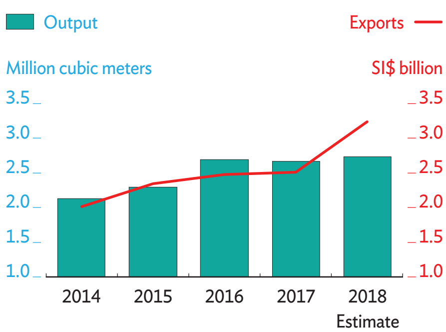
A new price index introduced in 2018 showed inflation accelerating to 3.3% in 2018, mainly on higher prices for domestic goods; partly reflecting hikes in the goods tax, excises on alcohol and tobacco, and import duties on fuel.

3.34.1 Supply-side contributions to growth



Sources: Solomon Islands National Statistics Office; ADB estimates.

3.34.2 Logging output and exports



Sources: Solomon Islands National Statistics Office; ADB estimates.

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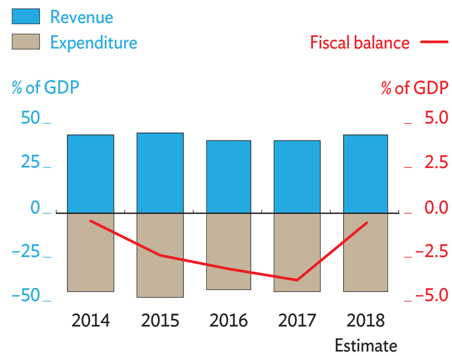
The new price index lowered the share for food mostly in favor of alcohol and tobacco, based on the results of the 2012–2013 Household Income and Expenditure Survey (Figure 3.34.4).

The current account turned into a surplus equal to 3.9% of GDP in 2018, mainly on a 21.2% rise in exports of goods that exceeded import growth at only 8.8%. Tourism receipts jumped by a fifth. Arrivals by air grew by about 10% in 2018, and the average length of stay rose from 13 days in 2017 to 15 days in 2018. Fewer cruise ships visited, though, dragging down arrivals by sea to a fifth of 2017 arrivals (Figure 3.34.5).

Gross international reserves rose by 8.3%, providing import cover for 15 months. Monetary policy remained relatively accommodative in 2018 as the money supply rose by 6.0% and bank loans by 7.8%

3.34.3 Fiscal balance



Sources: Solomon Islands Ministry of Finance and Treasury budget documents; ADB estimates.

Economic prospects

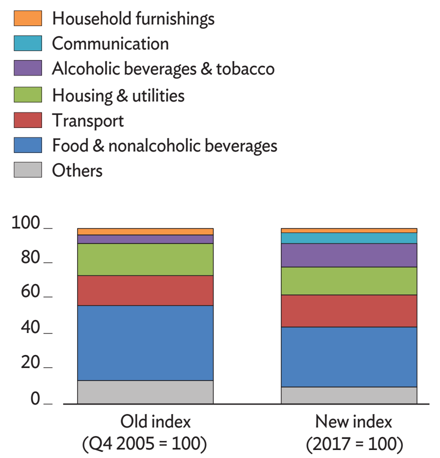
Growth is projected to slow to 2.4% in 2019 as logging tapers but is partly offset by construction on large infrastructure projects, with growth slowing a bit more to 2.3% in 2020. The Forestry Sustainability Policy, approved in 2018, aims to reduce log production to a more sustainable rate by introducing export caps. The economic impact is potentially large, given that logging supplied some 72% of exports in 2018 and is the country's largest employer after the government. With El Niño weather disturbances expected in 2019, the fish catch will likely suffer, and recovery in cash crops may sputter.

Growth will depend on infrastructure investments in roads, airports, and the undersea telecommunications cable financed by development partners. Construction of the Tina River Hydropower Project is expected to commence in 2020, after delays in signing the electric power purchase agreement.

The government aims to balance the budget in 2019 by further cutting government development expenditure by about a third compared with 2018. Partly offsetting this, the payroll budget is projected to increase by 15% from 2018 to accommodate new staff positions and increased allowances, including a 3.5% boost to cost-of-living allowances for all public servants. A national election scheduled for April 2019 may put additional pressure on government spending and the budget, including an increase for police security.

The Forestry Sustainability Policy is expected to weigh on government revenues in the medium term. The government projects logging export duties to fall in 2019 by 16% from 2018. It hopes to claw back some revenue by raising logging license fees and improving compliance, while recent amendments to the withholding tax and the goods tax should also increase collections. The fiscal deficit is expected to widen in 2020 as government investment in the Tina River Hydropower Project begins.

3.34.4 Components of the consumer price index basket



Q = quarter.
Source: Central Bank of Solomon Islands.

3.34.1 Selected economic indicators (%)

	2019	2020
GDP growth	2.4	2.3
Inflation	2.5	2.5
Current account balance (share of GDP)	–1.4	–2.6

Source: ADB estimates.

Lower inflation is expected as a base effect from higher taxes in 2018 dissipates and as global commodity prices fall, in particular for oil. However, the increased cost-of-living allowances for public servants threaten to stoke inflation in 2019.

As logging exports taper and imports for construction projects rise, the current account balance is expected to fall back into deficits equal to 1.4% of GDP in 2019 and 2.6% in 2020. On the other hand, visitor arrivals by air are expected to continue to grow, boosting exports of services.

The reopening of the country's sole gold mine, Gold Ridge, poses an upside risk to the forecast. Rehabilitating the mine, which closed in 2014 following flashfloods, could spur growth. This prospect is a reminder that the government needs to continue strengthening its regulation and taxation of mining to maximize its benefits and encourage inclusive growth.

Any delays in infrastructure projects, particularly Tina River, would weigh on growth. The only domestic bank in Solomon Islands provides key services to the logging industry but lost its correspondent bank relationship for US dollars in 2018. The problem was resolved by year-end, but it highlights the challenge to the economy and government financing posed by heavy reliance on revenue from the logging industry.

3.34.5 Visitor arrivals by mode of transport

Sources: Solomon Islands National Statistics Office; ADB estimates.

Policy challenge—sustaining tax reform

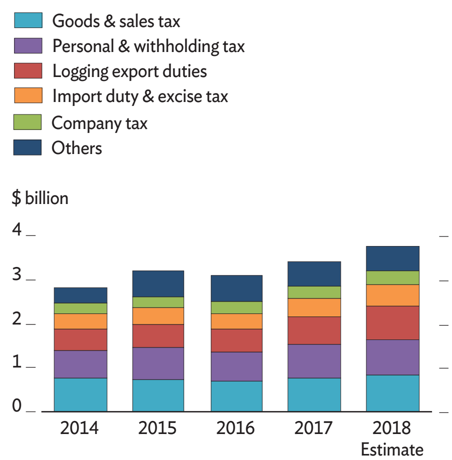
The current tax structure of Solomon Islands is complex, outdated, and expensive to administer. It is heavily biased toward consumption taxes, partly reflecting dependence on imports and the relatively small proportion of people in formal employment and business (Figure 3.34.6). By relying on high rates applied to a narrow base, the tax system discourages compliance.

Getting the tax system right is important in light of expected declines in logging revenue in the medium term. In November 2017, the Ministry of Finance and Treasury began a system review with the aim of making revenue collection more efficient, fair, and equitable.

The first phase of the tax review has focused on tax administration and consumption taxes. The next phase will address income tax with the aim of lowering marginal tax rates and expanding the tax base. Currently, the highest marginal tax rate is 40% for taxable annual incomes higher than SI$60,000, which is five times GDP per capita in 2017. In 2016, only 4.6% of registered income tax payers filed an income tax return.

In 2018, Parliament enacted amendments to the Goods Tax Act that increased excise taxes on alcohol and tobacco and changed procedures for collecting withholding taxes to improve compliance and bring them in line with international practice. These measures will generate more revenue and fiscal space with which to respond to shocks.

3.34.6 Domestic revenue



Sources: Solomon Islands Ministry of Finance and Treasury budget documents; ADB estimates.