

# **THE IMPLICATIONS OF THE CONSTITUTIONAL REFORM FROM AN ECONOMIC POINT OF VIEW**

Dr. Dieter Schindowski

July 2004

A decision for the federal constitution from an economic point of view should not only be based on cost aspects, rather it should consider its **costs** and **benefits**. To design and implement this form of statehood has been a mandate by Solomon Islands' people and one of the main justifications for it was that federalism would bring higher benefits for the people whereas the costs would remain manageable. This essay is therefore made up in three parts: The first part describes the provincial costs under the present centralized system while the second part discusses the costs under the new federal system splitted into deliberations on the future recurrent costs and on the additional capital, or investment, costs. Part three outlines the economic benefits of the forthcoming state-oriented system.

The transition of the present centralised system to the federal system will not come over night, therefore the costs of the transition will not occur immediately. **This is a long-term process which is anticipated to take about 10 years.** Taking over additional functions by the new states, the former provinces will require a lot of training and institution building. The states will have to shoulder new responsibilities like caring for their own infrastructure and taking over the administration - and payment - for teachers, health care personnel etc., **but only step by step.**

From an economic point of view the new federal system can only work effectively if two conditions are agreed upon. Firstly, when additional recurrent costs occur in the new states, it must be earnestly endeavoured **to reduce an adequate amount of recurrent costs for central government and administration.** As most of the recurrent costs are payroll costs, public servants will have to be shifted from central administration to state administration and, accordingly, departments on the central level will have to be reduced in numbers and size.

Secondly, the entire financing system for the new states has to be altered. This means a decisive shift from the grant system (as for example Australia has it) to a **revenue sharing system**. In addition the new states must be given the chance to **enhance their own revenues**.

## 1. The Cost of the Present System

The actual allocation of costs between the two tiers of government - central government and provincial government; while local government was abolished under the SIAC government - cannot be exactly established because up to now an artificial system of transfers, in monetary terms and in kind, prevails in Solomon Islands to finance the provinces (including Honiara Township). Nevertheless, it is estimated that in the “good years” up to the year 1999 (inclusive) the recurrent costs for the provinces amounted to about **SBD 100 million a year**. These costs were financed as follows:

- (1) A bit less than 1/3 (about SBD 30 million a year) was financed through three major **grants** plus several special grants from central government’s budget. As a rule of thumb this amount was distributed in a relation of three – two – one among administrative grants (SBD 15 million), health grants (SBD 10 million) and education grants (SBD 5 million). In 2004 grants for education will be higher.
- (2) In addition come the **political costs** of the provinces which are so far fully paid by the Department of Provincial Government and Constituency Development (DPG&CD). They comprise the payments for the premiers and the members of the provincial assemblies and used to be rather high in the past (about SBD 8 million in 1999). The costs for provincial elections increase these costs. Taken as an example, total costs of elections in 9 provinces in 1998 amounted to SBD 3.3 million.
- (3) 2/3 of the provincial costs occur through **indirect transfers** (SBD 65 – 70 million a year). This means the costs of staff paid by central government ministries/departments, mainly administrative staff, teachers, health care staff and police and security staff, but also staff from natural resources and infrastructure development departments. (The cost of teachers’ salaries in provincial schools made already up for more than SBD 35 million in these years.)
- (4) A small rest of revenues has been generated by the provinces **on their own** (between SBD 2 million and SBD 6 million at best).

The figures of provincial recurrent costs are to be compared to the **overall** recurrent public revenues of the country in order to establish the ratio of provincial to overall revenues. In the “good years” up to 1999 government succeeded in collecting on average about SBD 350 million a year, with 1999 forming the peak with SBD 381 million. (A major contribution to this amount came from SIPL and from the Gold Ridge mine, which 1999 was in its first, and only, full year of operation). In the following years 2000, 2001 and 2002 the overall recurrent public revenues slumped to a significantly lower level of about SBD 260 million on average, which had a heavy influence on the ability of central government to pay the provincial grants.

Leaving out the allocation for Honiara Town Council this means that the provinces got in the “good years”, as a rule of thumb, **about 30 %** of all available recurrent public revenues meaning on the other hand that about 70 % were kept in Honiara for central government and for Honiara Town Council.

For the year 2003 originally a modest increase to slightly over SBD 300 million was anticipated. After RAMSI arrived in the middle of the year and took over part of the work in the Ministry of Finance, particularly in the Treasury and the Budget Unit, the figure rose to SBD 330 million. Due to a super performance in the forth quarter of this year the final figure for the year 2003 ended up at SBD 397 million. As this was not known when the budget for the year 2004 was drawn up the original budget estimate for 2004 anticipated overall revenues at a magnitude of SBD 362 million (a modest increase against the SBD 330 million for 2003). In addition a budget support was promised by Australia and New Zealand totaling up to SBD 118 million. In the light of the excellent performance of the revenue collecting divisions in the first two quarters of 2004 the overall revenue figure for 2004 is now revised upwards to SBD 442 million (or SBD 110 million per quarter). On the other hand the actual budget support will end up with less than the anticipated SBD 118 million, it is now estimated at about SBD 75 million for the entire year 2004. (The Australian budget support will be terminated by the end of this year.)

Nevertheless, **the share for the provinces has not significantly improved**, on the contrary, the provincial grants are only up to the level received before the ethnic tensions although the total recurrent revenues are now considerably higher, and it was reconfirmed by the Department of Treasury and Finance that the provinces can not expect to be paid any backlog in grant payments from previous years. This means as a consequence that the actual relation of provincial to overall revenues has fallen from about 30 % to **about 25%**.

## **2. The Costs of the New System**

### **2.1 Recurrent Costs**

It is hoped that the new federal constitution will come into effect in early 2005 and its implementation process can be started then. For planning purposes the implementation process is divided into three phases, an interim phase of two years, the initial phase of the state-oriented government of about 3 years, and the phase of full state development of about 5 years.

At first the recurrent costs of the new system are discussed because they have to be financed mainly from Solomon Islands recurrent budget although for the next years some **budget aid** from donor countries (mainly Australia, New Zealand and ROC) can be expected and the new states will surely benefit from it.

#### Interim Phase

During the interim phase (mainly the years 2005 and 2006) no considerable recurrent cost increases will occur. The provinces/states have to live with what they have, and the **planning and drafting process of the new state constitutions** will mainly be done by experts paid from donor countries or by volunteers. On the other hand the states can rightly expect the grants now to be fully disbursed and on time. Some budget aid may still add up to these grants and the process of re-staffing the substations may be started. However, additional costs for telecommunication, power supply, transport and maintenance have to be paid from the administrative grants or the budget support during this 2-year phase, whereas the coverage of capital costs (e.g. additional vehicles and other assets) has to be discussed with donors under the development budget.

#### Initial Phase

The 3-year initial phase lasting to the year 2009 will be the decisive time period for the new federal system to prove its practicability and viability. Overall recurrent public revenues during that period are assumed to amount on average to **about SBD 480 million a year** (not considering budget aid). The figure is

based on a **nominal** increase of public revenues due to inflation. If Solomon Islands economy significantly recovers during that time (e.g. through re-opening of the Gold Ridge mine) there might even be an increase **in real terms**, which would bring this nominal figure to the higher average amount of SBD 500 to 550 million.

At the beginning of the initial phase (year 2007) the **revenue sharing agreement** between the new states and central government ought to be in place, at least in principle and on a tentative basis. How would the sharing ratio look like?

The author did a calculation on the basis of the provisions of the new constitution for revenue sharing and the figures of the original 2004 recurrent budget of SBD 362 million. **It revealed a revenue sharing ratio of 53 % (states) and 47 % (central government) or SBD 190 million for the states and SBD 172 million for central government.** A recurrent budget of SBD 480 million would, therefore, see an allocation of SBD 254 million for the states and SBD 226 million for central government.

Whereas the new states will be very satisfied with this new figure as it would bring them SBD 154 million in addition to the SBD 100 million available at present under the centralized system, the central government, on the other hand, would have to live with only half of its present current revenues. This is, of course, totally unthinkable and impracticable considering the present debt service of nearly SBD 80 million and a present payroll of about SBD 180 million!

Assuming that central government, after a successful and far reaching redundancy exercise, could live with about **SBD 300 million** annually this results in **additional recurrent costs caused by the new constitution of SBD 74 million a year** (the difference between the share available for central government under the new constitution (SBD 226 million) and the recurrent revenues necessary for running the central government machinery (SBD 300 million)).

What could be done to keep the financial situation manageable?

The first question is if the new states can immediately swallow this immense increase in their revenues and if this increase would be necessary at all. It would for example mean administering SBD 35 million teachers salaries, SBD 13 million health staff salaries, SBD 10 million police and security staff salaries and so on and this after a very short introductory time of two years. Quite obviously the new states are not prepared for this immense administrative task. Therefore it seems reasonable not to overload the new states immediately with new administrative tasks, but to use a careful step-by-step approach.

A practical way seems to be to increase the share of revenues for the new states gradually and to start only with a minor increase of, let's say, 5 to 10 percent points. With the present sharing ratio for the provinces standing at about 25% it would already help the new states if this ratio were increased to 30 % and then every two years by another 5 percent points until the final revenue sharing ratio of 50/50 % or 60/40 % respectively (for revenues from natural resources) is being reached. Calculated on the basis of overall revenues of SBD 480 million a sharing ratio of 30/70 % would mean SBD 144 million for the states and SBD 336 million for central government whereas a ratio of 35/65 % would mean SBD 168 million for the states and SBD 312 million for central government. SBD 144 million for the states is a nearly 50 % increase of their present income under the grant system whereas SBD 336 million for central government is the same figure originally anticipated as total revenues for the year 2003 under the present centralized system.

The increase in revenues by SBD 44 million for the new states would allow them to take over, inter alia, the financing of their political costs for their premiers, deputy premiers and executive and ordinary state assembly members and to bring up the establishment for the state administration to full strength (including new staff for the restored state subcentres). The political costs were heavily curbed in the years 2003 and 2004, but the new states may wish to bring them up again to the long established magnitude of about SBD 8 million a year, in

addition the present modest ward allowance could be handled a bit more generously.

### Full State Development

At the present time it is not possible to give exact recurrent cost figures for a time span nearly 10 years ahead in future.

Such figures will, inter alia, depend on the development of the following factors:

- (1) Solomon Islands economic development and its ability to generate more public revenues;
- (2) A reform of the taxation system;
- (3) The export and import situation and the magnitude of customs duties to be collected;
- (4) The states' own economic activities.

To give a broad picture, let's assume the following alternatives:

Year	Assumed recurrent revenue (SBD mill.)	States		Central	
		60 %	50 %	40 %	50 %
2009	500	300	250	200	250
2015	700	420	350	280	350

Obviously, central government cannot expect to grow any longer. On the contrary, it has to face a situation with incisive reductions: in recurrent expenditures, in public service staff, in number and size of departments, and so on.

## **2.2 Additional Capital Costs**

To determine the costs of necessary public and private investments in the new states over the next 10 years requires detailed investigations, and extensive discussions will be held on all levels in and with the new states. The present National Economic Recovery and Development Plan is not very detailed in respect to the exact allocation of public investment among the provinces/states.

Some projects can clearly be identified as located in and for the benefit of a particular province, whereas other projects extend over more than one province or even cover all provinces. So further discussions have to be held with the implementing agencies on the splitting of capital costs among the provinces. The main part of the provincial submissions for new projects has been put under pipeline projects in the development budget 2004 for they have not been fully appraised so far and/or need donor approval.

An EU-sponsored project in the DPG&CD is about to establish the present status of assets in the provinces, then to further detail the projects already approved under the development budget, and to draw up scenarios on how the state governments and administrations will develop in future and their investment needs. Two issues have, nevertheless, to be mentioned here already, which are of economic relevance for the new state-oriented system.

Firstly, any planning of the development budgets for the years to come must go hand in hand with **a fundamental change in the planning system of Solomon Islands**. A sort of “counter stream principle” needs to be established. Parallel, but in reverse direction, to the present top down approach, **bottom up planning** must be given rightful attention, and only the harmonization of these two streams can lead to an acceptable planning result for both states and central level. It is not so that provincial plans had not been produced and made available in the past, but they were not given sufficient attention (or sometimes they did not have the necessary quality to be further processed). In future, states will have a constitutional obligation to produce state development plans, on the other hand central government will have the obligation to fully recognize them and include them in the overall planning framework. Furthermore direct involvement of state representatives in negotiations with donors should be considered.

Secondly, the implementation of the new state-oriented system will entail **additional** capital costs which have not sufficiently been incorporated so far in

central government's development plans. Four main categories are of relevance here:

- (1) Additional infrastructure, including far better transport (road and sea) and telecommunication facilities;
- (2) Restoring the system of state subcentres;
- (3) A considerable number of new staff houses;
- (4) The training costs for the new state public servants (human capital formation), including re-establishing a specific public service training institute (IPAM).

“Additional” means here only such costs which can be directly attributed to the change from the centralized to the federal system, whereas investment in infrastructure, schools, clinics etc. which would anyhow occur in the provinces/states, regardless of the system, has been left out.

Considering that Solomon Islands has not paid much contribution to its development budgets in the last years, **infrastructure development** in the new states will be a matter of discussions with the donor community. The EU has already announced its willingness to further invest in the transport system of Solomon Islands including inter-island shipping, rural roads and wharves, under the development budgets for 2004 and 2005. Investment in additional telecommunication, even in some additional or improved marine transport facilities (ships, barges), may be borne by the private sector, but this will only happen if a steady return on investment can be guaranteed, particularly meaning that customers will be able to pay their bills in these sectors.

It remains to be seen if it is possible to find foreign donors to pay for a big **staff housing** programme, this will probably be left as governments' financial responsibility.

Part of the **training costs** for the new state public service, particularly the cost of establishing a new IPAM with concentration on state public administration, may perhaps be taken over by donors, but only if they can be convinced that through

these training measures better service delivery is brought to the ordinary people in the new states.

At present prices, and to be spread over 10 years (2005 – 2015), a tentative cost estimate for the above three categories would be:

(1) <b>Additional</b> infrastructure (including costs of new state ministries of work and their machinery)	SBD 130 m
(2) Restoring the subcentres	SBD 20 m
(3) Staff houses and upgrading of state HQs and assembly halls	SBD 50 m
(4) Staff development, IPAM	<u>SBD 50 m</u>
	<b>SBD 250 m</b>

This is equivalent to EURO 28 million or AU\$ 47 million.

The costs of additional infrastructure comprise roads, jetties etc. for better accessibility of state HQs and subcentres as well as their telecom facilities and new vehicles and canoes with OBM. The new state ministries of public works will need a considerable amount for acquisition of new machinery. The state HQs have to be enlarged in order to keep pace with the devolution of new functions to the state administrations.

The provinces have already drawn up submissions for financing additional staff houses and upgrading or repair of their provincial HQs and/or their assembly halls. Excluding the costs for construction of the provincial HQs for Central Province and for Guadalcanal, which are being financed by ROC, these submissions total up at present to SBD 15 million.

### **3. The Economic Benefits of the New Federal System**

The economic benefits of the federal system can be categorized as follows.

#### **Better Development Planning**

A lot of complaints occurred in the past about development planning in Solomon Islands being more or less centralized, and provinces had next to no say in development projects relevant for them. This will be altered under the new constitution. **State governments and planners will have the chance to care for the state's own development**, which is what they have longed for since years. Hopefully donors will be willing to send experts, particularly volunteers as lawyers and as economists and planners to the new states to support this process. A main argument for federalism in this context is that if states are better developed this will stop unwanted migration processes, and it is generally admitted that such migration processes were one of the root causes for the ethnic tensions.

#### **More State Revenues**

Through the new constitution the states will enjoy a far better financial basis than in the past. The constitution will do away with the grant system which has never worked well and which has made the provinces too dependent on the fiscal policy of the central government. The new revenue sharing system will not only enhance the financial basis of the states, it will above all do away with the grievances about insufficient provincial earnings from the harvesting of their natural resources. On the other hand the new states should not forget that receiving more revenues means on the other hand taking over more functions, e.g. in the education and the health sector, which have so far been rendered by the central government.

For the first time the new constitution will enable the new states to levy own state taxes which has been forbidden so far under the present constitution. In particular the states may replace the business license system, which has brought only insufficient revenues for the provinces so far, by a new trade (or state

business) tax. Raising trade or business tax is normal in developed countries. **As a consequence the new state revenue system will be a combination of revenue sharing and enhanced own revenues by own taxation.**

### **Improving the Land Tenure System**

The new states will be encouraged by the new constitution to establish provisions and institutions for handling their land matters, particularly by registration of land and by returning to traditional forms of decision making and harmonization in case of land disputes. This will do away with a major obstacle for investment decisions and encourage foreign investors to start projects in the states because it will give them a firm basis for their investment calculations.

### **New State Investment Policies**

In developed countries, which have a federal system, it is absolutely normal that states compete among each other for investment projects and for relations with companies and entrepreneurs outside the state, even overseas. State governments and administration will now be allowed to travel to overseas countries and to seek new business relations and to identify investment opportunities. The opportunity to generate more own state revenues will help financing such overseas traveling.

The Constitutional Review Commission pondered giving the new states the authority for negotiating loans with outside financiers but for reasons of financial control the commission concluded in the end that loans should only be negotiated, contracted, and guaranteed by central government. This does not exclude the possibility for on-lending to the new states of loans to central government.

### **Boost of the Rural Economy**

The new statehood will enable the provinces to initiate their own economic policy based on grassroots level- and community based activities. Prerequisite for this

is, however, that the new states render better services to this level, which can, inter alia, be achieved by **restoring the system of substations** in the states.

The SIAC Government did away with this third tier of public administration (local administration) in order to save costs. As a consequence the area councils were abolished and the provincial substations closed. Their buildings are now deteriorated and no extension staff is stationed there any longer. **As one of the most urgent measures under the new constitution the network of provincial substations will be restored.** The new substations will not only offer administrative services but, what is more important, revive decentralized extension services in the agriculture, fishery and forestry sectors. As a new function commercial and financial advice will be delivered to the community level in order to support and promote smallholder activities. In addition the rural banking and credit system will be restored.

### **State Economic Development**

Parallel to the economic development on the local level the **provincial capitals** will benefit from the new statehood. A lot of new staff will be shifted to the states thereby creating additional demand for retail, repair, advisory, financial, entertainment, and other services.

In addition to the state capital more **growth centres** will be created in the new states. The first step has been done through the repair or new construction of wharfs in the provinces. In addition improved road infrastructure will offer better market access for rural farmers to market places, and agro-based and forest based small enterprises will be developed in these new growth centres.

Some states have already deliberated on establishing **state free trade zones**. Particularly Malaita province brought up such an idea in connection with the Bina Harbour Project. Experiences from other small island states (e.g. Mauritius) show that such centres can attract international manufacturing enterprises to make use of customs-, tax-, and other privileges offered by the centres. In addition, as the Mauritius example shows, international financial services might be interested in

using these centres. It must, of course, be secured that such centres will not be used for money laundering or other fraudulent activities.

### **Decentralisation of Enterprises and Services**

So far SI has only one large enterprise outside Honiara, this is the SOLTAY fish factory in Western Province. If more autonomy in investment planning and more financial means are available to them, the states will have the opportunity to create more enterprises of this sort. SI could have three fish factories (the restoring of the fish factory in Tulagi would be a beginning), an international port for Malaita has long been under discussion, which could be combined with a light industrial zone and free trade zone activities. There are abundant opportunities for the new states to create new tourism centres and holiday resorts, which would also encourage related services, like diving operators, production of textiles, baskets, woodcarvings, etc.

After a sufficiently long introductory time the administration, and the payment, for public employees like teachers, health care personnel, policemen etc. will be shifted to the states. Among other services this will require banking services to be made available in the states for these employees. It has always been a great concern for provincial staff that there was no easy access to their salary accounts because of the closure of most of the bank branches, above all those of the DBSI, in the provinces. The shift of staff will encourage banks to start again their operations in the new states.

There is no economic reason why a state-owned enterprise like SIEA should serve the whole country, all the more as different techniques of power generation prevail in the provinces, like e.g. hydro electricity in Isabel province or the tentative use of coconut oil for power generation in Temotu province. The states should not be obliged to share the burden of a company whose major problems lie in the national capital Honiara. However, if the states shall have decentralised power supply they must, of course, have access to affordable financing means for investing in this sector.

### **Broader Economic Base of Solomon Islands**

Solomon Islands' economy is to a large extent still a subsistence economy with the majority of the population living in rural areas. This form has helped a lot to secure so far the livelihood of the population, but any long-term plans for the development of the economy must not overlook the fact that in about 25 years from now Solomon Islands' population will have grown to 1 million people for whom food security has to be guaranteed. Quite obviously this will not be possible at that time if the larger part of agriculture remains based on subsistence. The new state-oriented system will help extended families and communities to switch from subsistence economy to semi-commercial activities particularly in agriculture but also in reforestation activities and in coastal fisheries and aquaculture (pearl- and shrimp farming).

In addition we must solve the problem that an immense portion of our balance of payments is being used for the import of rice. Community- and family-based, semi-commercial rice farming in the new states can help produce a significantly greater quantity of locally grown rice at good quality. Recently it has been doubted if this could be done cost-efficiently. Rice growing is a labour-intensive activity. If done by contracted labour like at the big plantations, it would in deed be rather expensive, but if rice farming is kept family-based, the labour costs can be kept low.

The state-oriented system is the best guarantor for these family-based semi-commercial activities to become successful. State administration in connection with the revived extension services in the subcentres will care for the necessary infrastructure being available and accessible (e.g. rice mills). Storage and transport facilities as well as advisory and financial services will be made available and achievable for the rural people.