

REVENUE EQUALIZATION RESERVE FUND: OVERVIEW¹

1. Background

1. **Origin of the fund.** The Revenue Equalization Reserve Fund (RERF) was established in 1956 during the United Kingdom's colonial administration of the Gilbert (now Kiribati) and Ellice (now Tuvalu) Islands in anticipation of the expected exhaustion of phosphate minerals (which occurred in 1979). Until then, the RERF was capitalized using tax revenue and royalties from phosphate mining. Since, fishing license revenues have been used, at times, to increase the RERF balance. Given Kiribati's natural limitations to growth (geographic isolation and dispersion, small market, and narrow economic base) and high exposure to external shocks, the fund was envisaged to help the government in countering significant revenue volatility and balance future (recurrent) budgets.

2. **RERF set-up.** The Government of Kiribati, as both the trustee and beneficiary, has sole authority over investment, distribution, and utilization of RERF resources. The RERF is considered a special fund, established through the Public Finance (Control and Audit) Act, and its governing policies are proposed by the Minister of Finance and approved by parliament. The Reserve Fund Committee, chaired by the Minister of Finance and staffed by public servants, has management responsibility for the fund. The Kiribati budget and the RERF are integrated, with fiscal surpluses deposited into the fund and any fiscal deficits financed via drawdowns. While there are no rules on withdrawal limits, the parliament in 1996 agreed in principle to hold the RERF real per capita value constant at A\$4,700 (in 1996 A\$).

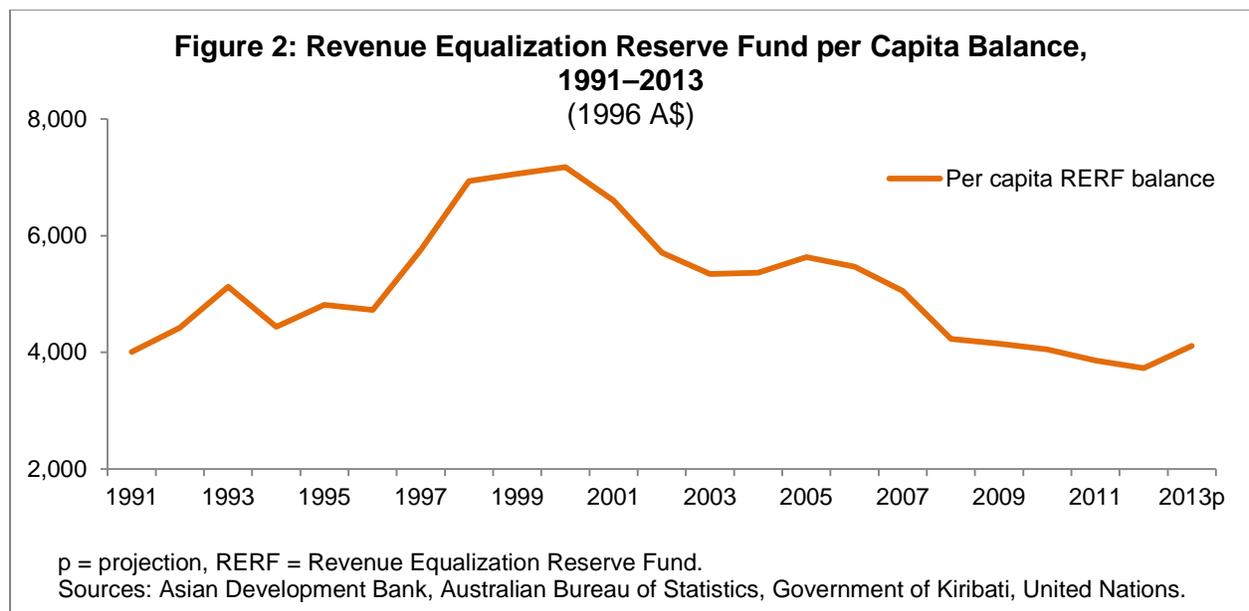
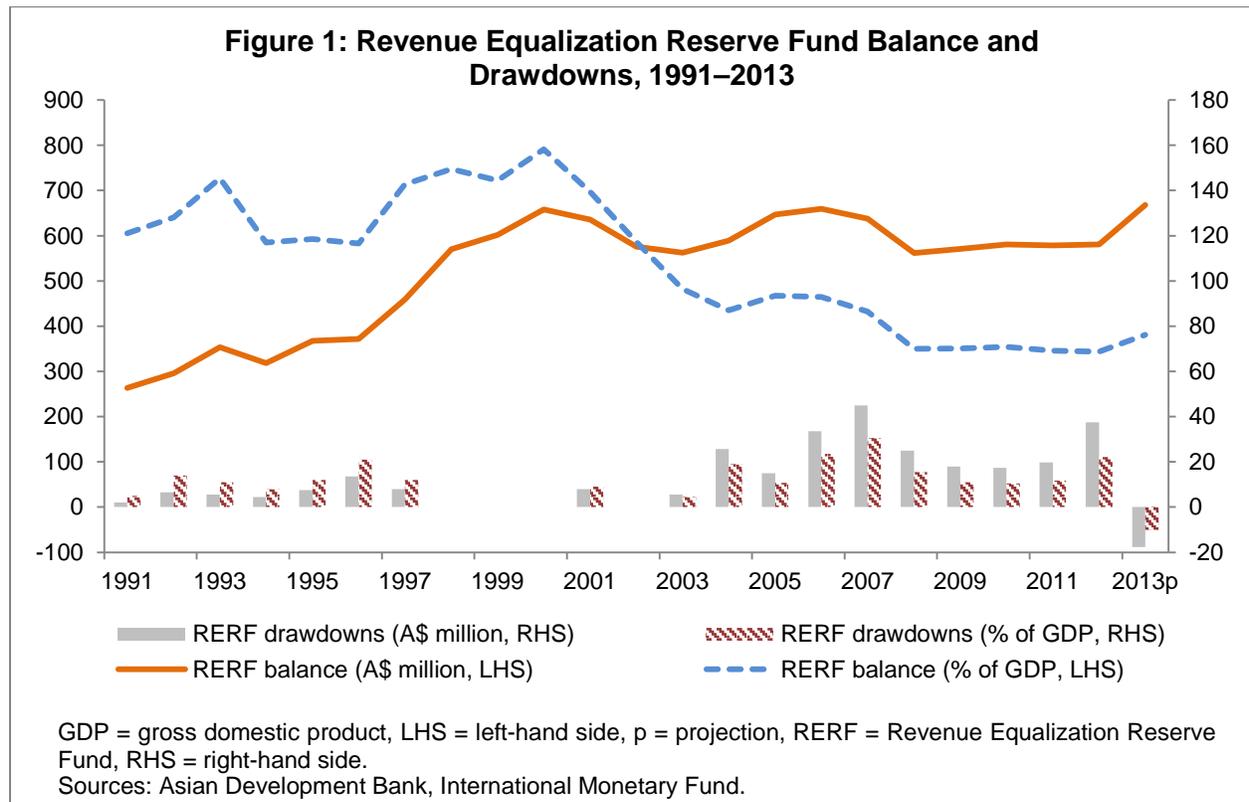
2. Revenue Equalization Reserve Fund Performance

3. **Building up the RERF balance.** During the RERF's formative years, significant phosphate mining revenues deposited into the fund, combined with a conservative capital accumulation and reinvestment policy, led to a growth in balance from its original A\$556,000 in 1956 to \$69 million by 1979. Until 2000, the nominal size of the fund steadily grew to over A\$600 million in assets, equivalent to almost 800% of GDP, driven by high returns on investment and a period of limited drawdowns between 1997–2000 (Figure 1). The RERF real per capita balance in 1996 Australian dollar concurrently increased steeply from about A\$4,000 to over A\$7,100 between 1991 and 2000 (Figure 2).

4. **Halving of real per capita resources in the past decade.** However, since, mounting fiscal pressures from weak revenue performance and increasing current expenditure, and subsequent substantial drawdowns, prevented continuous nominal growth of the fund. This has been aggravated by lower returns on investment since the early 2000s and led to halving of the RERF balance from almost 791% of GDP in 2000 to about 350% by 2008. Similarly, the real per capita balance halved to about A\$3,700 by 2012. In 2013, the budget surplus deposit of A\$17.7 million into the RERF, and recovering returns on investment, led to a slight increase in the fund's assets to A\$668 million in 2013, equivalent to 381% of GDP. The real per capita balance recovered to A\$4,110 (in 1996 A\$). However, given the substantial losses generated during the

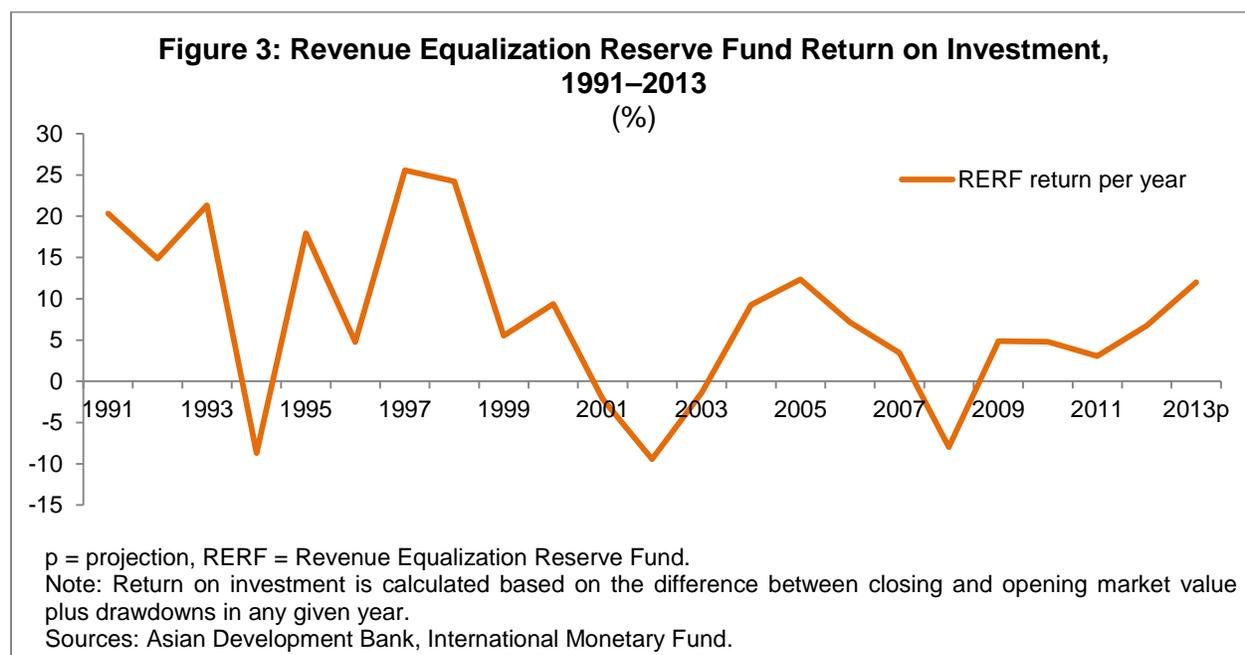
¹ This summary is based on ADB. 2005. *Trust Funds in the Pacific*. Manila; ADB. 2009. *Kiribati Social and Economic Report 2008*. Manila; Edwin Truman. 2010. *Sovereign Wealth Funds. Threat of Salvation?* Peterson Institute for International Economics. Washington DC; Government of Kiribati. 2014. *Kiribati Government 2014 Budget*. Tarawa; International Monetary Fund (IMF). 2013. *Kiribati Article IV Consultation 2013*. Washington DC; IMF. 2014. *Kiribati Article IV Consultation 2014*. Washington, DC.

global financial and economic crisis in 2008 and high drawdowns during the past decade, the real per capita balance remains far below the targeted minimum value of A\$4,700 (in 1996 A\$).



5. **Return on investment.** The RERF is held offshore and was, as of 2009, split 70:30 between bonds and equities. Exchange rate risk is reduced by investments in more than 20

currencies, including the Australian dollar, United States dollar, the Japanese yen and the euro.² The Government has gradually shifted from a conservative, fixed income capital-heavy growth strategy to a balanced portfolio strategy that aims to optimize interest income and capital growth with respect to risk tolerance.³ The fund currently has internationally diversified debt, equity, and foreign exchange holdings. The RERF operates on a minimal draw-down principle—with limited enforcement in recent years—preferring instead to reinvest most annual earnings. The return on investment, as the difference between opening and closing market value plus drawdowns per year, averaged 7.7% from 1991–2013; however, this results from significant fluctuations ranging from positive returns of 25.6% in 1997 to substantial and regular losses on investment between 8–10% in 1994, 2002, and 2008 (Figure 3). Failed investments in Icelandic banks contributed significantly to the most recent losses during the global financial and economic crisis, estimated at over A\$30 million in assets (the equivalent of roughly 25% of GDP in 2009).



6. International comparison. The RERF slightly improved its performance on the Sovereign Wealth Fund (SWF) Scoreboard—a voluntary set of international best practices to assess structure, governance, accountability and transparency, and behavior of SWFs that was developed and first applied in 2007 by Edwin Truman of the Peterson Institute for International Economics—from 30 in 2007 to 35 points in 2009 and 2012 on a scale from 0 to 100. With this, the RERF scores below the average of 54 points for all SWFs.⁴ In the 2009 ranking, the RERF scores high in regard to the structure, with full scores on fiscal treatment of the fund indicating clear source of funding and use of fund earnings, and a full integration with policies. While governance scores show mixed results (4 out of 7 points), information on accountability and

² IMF. 2009. *Kiribati: Selected Issues and Statistical Appendix*. Washington, DC.

³ Teuea, Toatu. 1993. *The Revenue Equalization Reserve Fund. Atoll Politics, the Republic of Kiribati*. Christchurch: University of Canterbury.

⁴ The best performing SWF on the scoreboard is the Norwegian Government Pension Fund–Global with 98 points, while, for example, the large Qatar Investment Authority fund scores only 17 points.

transparency (1 out of 14 points), and behavior (0 out of 4 points) of the RERF is either non-existent or not disclosed.⁵

7. Based on the scoreboard, the International Working Group on Sovereign Wealth Funds (SWF) developed in 2008 the Generally Accepted Principles and Practices of SWFs, the so-called Santiago Principles, to assess performance of SWFs. Its successor body, the International Forum of SWFs, monitors implementation of the 24 principles and provides performance assessments. While, given the relatively small size of the RERF, Kiribati has not been a member of the working group or its successor body and the RERF is therefore not part of their performance rankings, Truman applied the Santiago Principles to the RERF for 2009, resulting in a score of 44 out of 100 (footnote 5). In 2014, the RERF scored only 1 out of 10, equal to the minimum score, on the Linaburg-Maduell Transparency Index. Overall, international comparative rankings point toward major shortcomings in transparency and accountability, and a lack of policies guiding investment behavior of the RERF.

3. Future of the Revenue Equalization Reserve Fund

8. **Revised RERF management policies.** The Government of Kiribati recognizes shortcomings in RERF management that lead to volatile returns on investment and contribute to resource depletion. The adoption of revised RERF management policies is therefore included in the Kiribati Economic Reform Plan for 2014 that is supported by the Strengthening Fiscal Stability Program (policy action 3.2). With the adoption of new policies, the government commits to (i) the reallocation of RERF assets to achieve consistency with clearly-stated investment objectives; (ii) the application of new concentration and deviation limits; and (iii) the application of more appropriate benchmarks to improve monitoring of asset manager performance. The revision of these policies and their implementation is supported by the International Monetary Fund and the World Bank. It is expected that this leads to a stabilization of the return on investment and a better set-up that allows the government to pursue its policy objectives.

9. **Drawdowns to balance current fiscal deficits—four scenarios.** Apart from improving the RERF management, the performance of the RERF depends, to a large extent, on the level of drawdowns to fund current fiscal deficits. The extent of these, in turn, is linked to economic and fiscal reforms that promote economic growth and limit fiscal pressures (in addition to partly external factors, such as fishing license revenues that depend on fishing conditions). The International Monetary Fund, as part of its annual Article IV Consultations, has developed long-term projections under four different scenarios for the current fiscal deficit, which is almost fully funded by RERF drawdowns, and the corresponding RERF real per capita balance.⁶ Growth in the different scenarios is driven by government and development spending as well as private sector growth. The contribution of each of these factors varies between the scenarios. It is projected that higher growth in the short- to medium-term is driven largely by the implementation of development projects. Fiscal adjustment is expected to take place gradually, with slight reductions in government spending in the first years under the reform scenarios expected to be

⁵ Edwin Truman. 2010. *Sovereign Wealth Funds. Threat of Salvation?* Peterson Institute for International Economics: Washington DC.

⁶ The 2014 Kiribati Article IV consultation report (IMF. 2014. *Kiribati Article IV Consultation 2014*. Washington, DC) includes the reform, strong reform, and strong reform and high fishing license revenue scenario. The 2013 consultation report (IMF. 2013. *Kiribati Article IV Consultation 2013*. Washington DC) includes a policy stagnation scenario that is updated here to reflect newly available data on current fiscal deficit and drawdowns for 2013. It should be noted that investment returns are a significant source of uncertainty affecting the projections, leading to substantial confidence intervals around the projected balances for 2018 and, especially, 2030. The analysis rather aims to show, in relative terms, the likely effects of reforms.

offset by stronger private sector growth, thus resulting in similar growth rates across all scenarios. Development partner spending is expected to remain relatively stable over the long-run, except in the strong reform and high fishing license revenue scenario where slight reductions are expected in the long run, offset by less stark fiscal adjustment. In the policy stagnation scenario, high public spending drives growth while private sector's contribution to growth stagnates. In the reform scenario, public spending and private sector development contribute both to overall growth. In the strong reform scenario, significant fiscal adjustment (narrowing down the current fiscal deficit by more than 8% of GDP to 3.8% of GDP in the long run) and the effect of that on public sector driven growth is not fully compensated by private sector growth, resulting in a marginally lower growth assumption in the long run. Growth in the strong reform and high fishing license revenue scenario is driven by slightly higher government spending compared to the strong reform scenario (due to increased fiscal space from fishing license revenues).

Revenue Equalization Reserve Fund Scenario Overview

Scenario	Average annual GDP growth (%)	Average current fiscal balance (% of GDP)	RERF balance (% of GDP)		Real RERF balance per capita (2006 A\$)	
	2014–2030	2014–2030	2018	2030	2018	2030
Policy stagnation scenario	2.1	-22.5	275	26	3,760	286
Reform scenario	2.1	-12.8	306	204	4,192	2,810
Strong reform scenario	2.0	-8.6	306	281	4,192	3,843
Strong reform and high fishing license revenue scenario	2.1	-6.3	338	324	4,620	4,475

GDP = gross domestic product, RERF = Revenue Equalization Reserve Fund.

Note: Current fiscal balance excludes grants and development expenditure.

Sources: Asian Development Bank, International Monetary Fund.

- (i) **Policy stagnation scenario.** Absent reform progress—and a return to average fishing license revenue receipts after two years of exceptionally high yields in 2012 and 2013—, current fiscal deficits will remain at an average of 22.5% of GDP over the period 2014–2030. While growth can be maintained at an average of 2.1% of GDP during that period driven by public spending, the fiscal deficit widens over time given the unsustainable fiscal position that destabilizes the business climate in the long run. In this scenario, the per capita RERF balance fails to stabilize and RERF assets will eventually be depleted.
- (ii) **Reform scenario.** The baseline scenario builds upon the government's current reform commitments (including the implementation of value-added tax), limiting of current expenditure growth to below nominal GDP growth in the medium and longer term, conservative fishing license revenues, and the receipt of A\$25 million budget support in 2014–2016. This leads to a gradual reduction of the current fiscal deficit from over 22% of GDP in 2014 to 11.8% in 2019 and stabilization at this level in the longer run. This would result in corresponding RERF drawdown reductions; however, despite the significant reduction in fiscal deficit, the RERF per capita value does not stabilize and declines by almost half from A\$5,058 in 2014 to A\$2,810 in 2030 (in 2006 A\$).
- (iii) **Strong reform scenario.** The strong reform scenario incorporates rigid fiscal consolidation that reduces the current fiscal deficit to about 3.8% of GDP on average in 2023–30 to stabilize the RERF per capita value by 2023–24 at about A\$3,900 (in 2006 A\$). The present strong reform commitment by the government forms a basis on which ambitious reforms can be designed and implemented; however, the substantial

fiscal adjustment required for stabilization will require government commitment to extend into the medium- and long-term to ensure steady progress with fiscal consolidation and structural reform implementation.

- (iv) **Strong reform and high fishing license revenue scenario.** In case of continuing high fishing license receipts, combined with ambitious fiscal measures, the RERF could be stabilized at about A\$4,500 (in 2006 A\$) in the longer term. Given the higher revenue projections, the extent of fiscal consolidation required would be less compared to the strong reform scenario (current fiscal deficit narrowing to 4.2% of GDP in the long run).

