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Focusing Strategic Concerns

Evolution of the Monetary Economy

Kiribati society and economy are evolving under strong domestic and external pressures. Population growth and the opening up of society to outside influences through travel, trade, and communications are driving an irreversible process that pervades all aspects of life. No social or economic institution in the country can escape change—everything evolves or decays. Sustainability of the nation's social and economic systems is not about resisting change, but managing it.

The economy long ago ceased to provide all its people's needs by domestic production. Trade with the outside world and the need for money for this trade are now embedded in the Kiribati way of life. The economy is moving from a basis of limited individual ability to produce and accumulate material wealth, private ownership of productive knowledge, and strong informal obligations to redistribute income to those in need; to a basis of unrestricted ability to accumulate monetary wealth, public access to economic information and skills, and the assumption of welfare and redistribution functions by formal machinery of government.

Although Kiribati is a relatively homogenous nation, the process of change is not smooth, and the costs and benefits do not fall evenly on people and communities. Strains arise at all levels of the political economy. At the heart of the process is the conversion of the material and ethical dimensions of personal and community relationships into monetary values. Traditionally, people, foodstuffs, and artifacts were valued for their productive, nutritional or artistic merit, and this value was recognized in marriages and material exchanges.

However, such values decay over time. In Kiribati as elsewhere, the use of money as the principal medium of exchange and store of value has enabled the emergence of savings and trade, with specialization of economic roles and more efficient production, and the accumulation of financial and physical capital.

Monetization has made possible Kiribati's economic growth, but at a social cost. Monetization has depersonalized transactions and—to a significant extent—dehumanized relationships. Formerly, there was little scope for deceptive or selfish behavior by families or individuals, and if it was detected it was punished by direct or indirect sanctions. Politically more powerful and wealthier families lived much like others, receiving and redistributing surpluses in their communities. As the economy becomes more monetized and the sense of community weaker, more scope emerges for rewarding enterprise and work, but also for selfish behavior, “free riding” on the efforts of others, concealing wealth, and cheating on transactions. The community looks to public institutions for protection from the negative effects of monetization.

Governments accordingly collect money as taxes, fees, and charges for the provision of public goods and services, and receive grants and loans from overseas. These resources in turn can be stolen, wasted, or lost by public persons and institutions. As society becomes less personal and people employ and work for strangers, older ethical standards of fair play and reward for effort are decaying, and new standards measurable in money terms are slow to emerge. Responsibilities for redistribution and caring for the less well-off are increasingly assigned to government, while political governments—like their traditional counterparts—tend to use their redistributive powers to strengthen their hold on office.

Risk-minimizing attitudes and methods of production are only slowly being invaded by more entrepreneurial ideas and practices. Aversion to excessive accumulation of wealth, based on an instinctively static “zero-sum” concept of the economy (*if you are doing better, I must be doing worse*) leads to restriction of private enterprise, deterrence of foreign investment, and reliance on “big government” for both production and distribution. The public sector, undisciplined by competition and effectively supervising itself, can easily become a vehicle for looking after its own interests rather

than those of the public at large. That would be a perverse outcome, failing to maximize the welfare of the people of Kiribati.

Kiribati, like other Pacific nations, has adopted a "mixed economy" development model, for the good reason that, with few exceptions, neither totalitarian socialist economies nor minimalist-government, business-driven systems have delivered sustainable growth in developing countries. The mixed economy—effectively the only show in town—is adaptable to individual country circumstances and stages of development, and caters to all kinds of human and institutional capacities. But Kiribati is not operating the mixed economy model to best effect for its people. To function well, the mixed economy requires its two sectors, private (business) and public (government)(Box 1.1), each to focus on what it does best, and to collaborate in activities where neither commands all the resources needed for efficient operation. The Kiribati economy is falling short of its potential performance because of inefficiencies in the public sector and restricted opportunities in the private sector.

The private sector's economic role comprises innovation, risk-taking investment, competitive trade, profit, and reinvestment, through the use of organized processes and technology. It ranges from the smallest village store or fishing enterprise to the biggest privately-owned import-export or shipping businesses. In Kiribati as elsewhere, the private sector—much of it owned and directed by women—aims at accumulation of wealth, sharing the return to capital and labor sufficiently to motivate each to remain committed to the enterprise. The private sector is by nature energetic and turbulent, made up of many interacting business activities, each striving to succeed and generally happy to "externalize" the social costs of its success while retaining the benefits. Private enterprise will only go where there is a profit to be made, even though the profit may not be quickly made, and may not always be apparent to the outside observer. Businesses employ people and contribute to their provident fund savings. Taxes paid on business profits are a major source of mixed-economy government revenue to fund public sector activity. Profits retained by enterprises are worldwide the most important source of funds for new private investment, growth of output, jobs, and earnings. For this to be the case in Kiribati requires sustained policy attention to improving the business environment.

Box 1.1: Public and Private Sectors and Enterprises

There is some potential for confusion in the way the words *public* and *private* are used in Kiribati when referring to economic sectors and enterprises. The following definitions are used in this report.

The public sector means all those organizations and institutions engaged in economic activity, administration, and provision of services that are wholly or partly owned and controlled by the Government, whether they are ministries, departments, agencies or corporations set up by specific laws or incorporated under the Companies Act.

Public enterprises form part of the public sector. These are organizations set up as corporate bodies by the Government to produce or purchase and sell goods and services for payment in Kiribati or overseas, whether under a specific statute or under the Companies Act. Elsewhere, such organizations are sometimes referred to as state-owned enterprises, government enterprises or government corporations. Those terms are not used in this report.

The private sector means all those organizations and institutions engaged in production, purchase, and sale of goods and services that are owned and controlled by private persons or nongovernment organizations, including households and individual entrepreneurs, whether operated for profit or not, and whether their owners are domestic or foreign residents. It includes businesses or educational institutions owned and operated by churches that are financially and organizationally distinct from the religious activities of the church. The private sector can be divided into formal and informal activities according to the degree of formality surrounding the entity concerned (incorporation, registration, contributions to the Kiribati Provident Fund, engagement in formal employment and other contractual obligations, etc.) but the borderline between them is not hard and fast.

The economic role of the Kiribati public sector, owned and directed by the Government and ultimately accountable to Parliament, derives from the Government's ability to take a broad and long-term view of the nation's situation and needs, and to apply developmental and distributive policies across the whole economy. The conservation of key economic assets—reserve funds, marine resources, access to work overseas, the fragile atoll environment, and good relations with aid donors and financial institutions—and

the provision of an economic environment conducive to enterprise, saving, and investment are crucially important roles of government.

Through its fiscal policies and direction of the public sector, the Government should be able to moderate the instability caused by changes in overseas markets; minimize the social costs of private enterprise by regulation; produce public goods such as security, education, and health services; mobilize investment in infrastructure and utilities; and redistribute wealth created by the private sector, through taxation, subsidies, and direct expenditures. The public sector in Kiribati reaches into people's lives deeper than in most Pacific countries, because of the number, size, and scope of its public enterprises (PEs). It is as important for people's well-being that the public sector should perform efficiently as it is for the owners and employees of a private enterprise that their firm should be competitive.

The current statement of National Development Strategies (NDS) *Uataboan Te Rikirake ao Te Rau* was designed to cover 2000–2003 (see Box 1.2). This report is intended as a contribution to the preparation of a successor statement expected in 2003. Such statements are normally preceded by an expression of the national vision or overall goal of development. This is primarily a political statement, behind which public opinion and resources can be mobilized in support of a broad-based development effort. The problem in drafting a single statement of a national goal is how to make it broad enough to mobilize wide support and specific enough to indicate policy directions, without being too long to make an impact.

Whatever form of words the expression of the national goal or vision of Kiribati takes, this report suggests that the development philosophy behind the statement will need to embrace 6 key result areas:

- economic growth
- fair distribution
- public sector performance
- equipping people to manage change
- conservation of physical assets
- sustainable use of financial reserves.

Box 1.2: National Development Strategies 2000–2003

Uataboan Te Rikirake ao Te Rau—Working Together for Prosperity and Peace

National Development Strategies (NDS) 2000–2003 was published in October 2000, the successor to NDS 1996–1999. It is a comprehensive statement of development goals and strategies, many of which necessarily apply well beyond 2003. The statement is the outcome of an extensive consultative process involving civil society institutions and private sector representatives. The 70-page English version has served as the official development policy statement of the Government in domestic and international forums in 2001 and 2002. The Kiribati language version was published in mid-2002 and widely distributed.

NDS is a well-organized vehicle for key economic and social information, as well as a development policy statement. It provides a review of developments in the previous NDS period, describing failures as well as successes. It identifies six strategic outcomes to be pursued in 2000–2003, and three key policy issues where difficult questions have to be resolved if the strategic outcomes are to be achieved. Finally, NDS describes future strategies and priorities for macroeconomic policy, public sector reform, structural reform of the economy, and eight sectors corresponding broadly to ministry responsibilities.

The NDS "strategic plan" format is intended to be used together with a multiyear budget formulation, which is still evolving, and periodic, more detailed sector-focused statements (e.g., for education, environment, and land reform). With that documentary support, the NDS format is capable of performing the essential medium-term planning functions of government in a mixed economy—guiding the public sector and informing the private sector.

In 2003, the Government is expected to review and revise NDS, taking the planning framework forward into the second half of the decade. Some shifts in emphasis are to be expected. Some observers feel that the public sector and structural reform expectations of NDS were unrealistic; others feel that targets are best set high to serve as guiding stars—the direction is more important than the distance traveled.

On balance, it seems advisable to make the medium-term targets achievable through good organization and reasonable effort, so that some return can be identified and enjoyed for the effort made in development planning. It is important that the central organization charged with planning, monitoring, and review should be well resourced and staffed, and have excellent access to political and operational government departments. Above all, if development strategies are to be credible, and if they are to overcome the many and varied constraints in their path, there must be sustained top-level political and official commitment to their implementation.

Those are examined in more detail in the next chapter. For each key result area, the report identifies issues and suggests responses that will need to be considered in the Government's planning process. The key result areas are linked by the central theme of this report, the impact of monetization. Kiribati is undergoing profound economic and social change driven by the dismantling of its historic isolation and the steady growth of its population. The most striking manifestation of this change is the monetization of income, wealth, personal and institutional relationships, and obligations.

The development issues add up to the problem of managing this process of change in such a way that

- all legitimate opportunities for achieving economic growth on a sustainable basis are taken; and
- the people feel satisfied that the distribution of the costs and benefits of the process is clear, fair, and efficient.

Part II of the report examines the current position and prospects of Kiribati under 5 broad headings, describing the developmental task facing the Government and people in terms of managing the process of change.

Key Result Areas, Issues, and Proposed Responses

Economic Growth¹

Kiribati has experienced a decade of real (inflation-adjusted) economic growth averaging 4–5% annually, driven by annual increases in government expenditure, funded by fishing license and passport fees, Revenue Equalisation Reserve Fund (RERF) drawings, and foreign aid. With annual population growth less than 2%, this is a significant increase in national income per head. But it has been achieved by rapid expansion of government expenditure underpinned by an unsustainable² rate of growth in RERF value—both of which more than doubled during the period.

Kiribati needs a growing economy. The nation cannot escape the economic consequences of population growth, education, and the absorption of concepts from abroad. The existing demand for goods, services, and ideas—almost all of them imported—requires a sustained rate of economic growth even to maintain the existing levels of consumption.

To *raise* standards of material and intellectual well-being requires real economic growth per head—that is, growth of total output and income faster than price increases and population growth. To be sustainable, the growth must be achieved without running down the stock of physical and financial capital. This requires successful (job-creating, value-adding, surplus-earning) investment, continuous

replenishment of capital stock, and accountable, effective distribution of social services and economic opportunity among a growing population.

To make possible a *sustained improvement* in income and welfare per head, the rate of population growth will need to taper off toward stability of total population. There is currently little official or public discussion of the need to reduce population growth, even though in the economic circumstances of Kiribati, this is the most important factor under domestic control that will influence future levels of income and welfare per head (Box 2.1).

Kiribati is well endowed in some respects, handicapped in others, to achieve sustained growth of income per head. Backed by healthy financial reserves and rent from its marine resources, the country has adopted systems of government and economic management that inherently favor distribution rather than growth, but are in practice failing to distribute goods and services efficiently. Land-based resources are few, skills scarce, and the domestic economy shallow, with most activity dependent on government expenditures, which are almost immediately respent on imported goods.

Recent economic growth has come largely from the construction of public assets that will tend to consume wealth in maintenance and operating costs, rather than create it. These projects have been financed by resource rents and foreign aid, not by taxation on the profits of domestic economic activity. Deepening the economy to increase domestic value-added production³ and generate more and better-distributed taxable incomes will require private investment and enterprise.

Many people are ambivalent about profit-oriented business activity, actively engaging in it themselves at relatively small scale, but suspicious of it at larger scale or in the hands of foreigners, apparently because of a dislike of obvious income disparities. Most of the larger privately-owned businesses are controlled by families with some Chinese or European trading ancestry. However, they are being joined by a growing number of successful I-Kiribati entrepreneurs including politicians and civil servants, directly or through their spouses who are able to manage their kinship and business relationships side-by-side. The private sector competes with PEs that receive operating and capital subsidies, enabling them to

focus on creating, distributing, and preserving wage employment, rather than delivering efficient services and accumulating investible reserves.

Proposals to give the larger private firms a bigger role in economic activity have so far been hampered by nationalist-distributionist preference for public sector forms of activity. Private enterprise is nevertheless slowly gaining ground at the medium and smaller end of the scale, reflecting the emergence of more entrepreneurial attitudes, and pressure is mounting on the PEs to perform competitively.

Key issue: Kiribati's prospects for sustained growth of income per head are at risk from over-dependence on government, lack of private investment in value-adding and export-oriented enterprise, inefficiencies in public sector operations, and continued population growth.

Proposed responses: Narrow the scope and sharpen the focus of government interventions, promote a greater role and make more room for domestic and foreign private enterprise and financial capital in economic activity, improve the efficiency of public sector operations, and revive public awareness of the value of family planning.

In several Pacific nations with limited natural resources, emigration plays a vital role in reducing domestic population growth, raising GDP per head and adding to disposable national income through remittances. Already around 1,500 men are temporarily away as contract seafarers and fishers, and there are hopes of increasing this number to around 2,000. But fewer than 100 families are believed to have emigrated permanently (apart from those who were resettled in the 1950s and 1960s in Solomon Islands by the former colonial administration). As education levels rise and competition for jobs and living space intensifies, it seems certain that permanent emigration will also increase. Families with some members established overseas will have higher incomes, more economic options, and fewer members dependent on getting a share of Kiribati's gross domestic product.

Box 2.1: Impact of Population Size on Income per Head

National income per head is widely accepted as the standard indicator of a country's level of development. Income (or output) per head and its annual rate of change are the two most frequently quoted statistics in comparative economic analysis. This is so despite the many difficulties of collecting reliable and comparable data for the calculation, and that as a national average it gives no idea of how income is distributed among the population.

The calculation simply divides total income by total population. Its usefulness is not in showing actual levels of income and welfare, which it cannot do, but in broadly indicating a country's *potential* to provide for its people, depending on how the costs and benefits of economic activity are distributed. Within this conceptual framework, population size, as the denominator of the equation, emerges as the most powerful single factor determining the potential of any given level of economic activity to improve—or even to sustain—people's well-being.

The rate of population growth is the difference between birth and death rates, plus net emigration. It is the outcome of private decisions on family size and location, and public decisions on social and economic services. According to the 2000 census data, Kiribati is now on track for a population of 100,000 by 2010 and 120,000 by 2020—that is to say, 35,000 more people over the next 15–20 years (the equivalent of another South Tarawa) to share whatever additional total output and income can be generated by then, by the time today's infants leave school.

The potential benefits of slower population growth are great. If the Government and people can together implement public and private policies that have the effect of stabilizing the population at, say, 125,000 by 2025, then by 2040, when today's infants are entering middle age, total national income at that time will be shared among 40,000 fewer persons than current growth rates would produce.

That makes for a 33% higher real income per head, and a correspondingly greater chance that Kiribati will be able to give its resident population a healthier and more rewarding life. This analysis is particularly compelling in the case of Kiribati, where so much disposable national (and household) income originates not in

Box 2.1 (continued)

There is substantial momentum in population dynamics—a population of 120,000 is surely coming over the horizon, and growth cannot be simply switched off. Even when a majority of couples chooses to have smaller families, the rate of population growth only comes down slowly. But the rate of growth does make an important difference to future levels of potential well-being, and it is a proper role of governments to help people understand that.

The factors that determine decisions on family size are much affected by cultural and religious beliefs, level of education, status of women, and the level and form of present and expected family income. Monetization is itself a powerful influence toward smaller families, as parents increasingly count the financial cost of giving their children and themselves a decent life. Ready access to competent advice on family planning is a key strategy not only for the health of mothers and children, but also for sustainable economic growth.

Kiribati has experienced a successful family planning program within living memory. In the early 1970s, community development and public health workers combined in a country-wide campaign that caught the public imagination and made a significant difference to population growth (see Population section in Chapter 3). Many people remember the campaign with positive feelings. That example could usefully be recalled and adapted to the circumstances of today.

domestic production, but in resource rents and remittances. There is no other single policy measure with the same potential to raise future income per head as the building of a broad-based consensus on the need to stabilize total population, and on the public and private policy measures to be used in doing so.

In building such a consensus, the attitudes of the organized churches will be critically important. The desire to increase church membership can sometimes override concern for the well-being of mothers and children. Official church policies have much to do with the present lack of government attention to population issues. For the future welfare of all the people of Kiribati, a shift in these attitudes is needed.

Fair Distribution⁴

Distribution of income, wealth, opportunity, and well-being in a political economy has never been equal. What matters is the way that these things are distributed. The outcomes of their distribution should be regarded as fair and reasonable by the participants of the economy. As and when unacceptable levels of inequality emerge, action to restore fair distribution is the responsibility of governments and the community at large.

Before monetization, Kiribati society did not have room for great disparities of material wealth. In the mid-19th century, before imported diseases drastically reduced the population, around 50,000 people⁵ lived in the atoll communities of the Gilbert group, in close harmony with a finely balanced environment. On each atoll, the effects of periodic famine and abundance and the costs, risks, and benefits of production, exchange, and social activity were shared in transparent ways by all levels of society. Although moderate differences in income and welfare were accepted as natural, those in serious need were helped by chiefs, better-off relatives or neighbors, as a matter of reciprocal obligation.⁶

The process of monetization began slowly, about 150 years ago, through sporadic trading of copra and marine products. It intensified with the start of phosphate mining on Banaba in the early 1900s, and spread rapidly after the Pacific War and the advent of new sources of money income and new ways of spending it.

The progressive shift from a subsistence to cash economy and the need to accumulate financial capital for family or business investment have put an increasing strain on traditional concepts of transparency and equity. Extremes of wealth and poverty⁷ are still not seen in Kiribati, but monetization and mobility have damaged traditional supportive networks. The outcomes of economic and social change include widening inequality.

Concentration of people in South Tarawa is overloading family ties and scarcity of paid employment is putting undue burdens on those who have jobs. Furthermore, monetization of consumption and investment is undermining older codes of moderation and reciprocity—money can be stolen and wealth concealed. The need

for money to buy necessities and satisfy desires leads to selfishness, distress, and crime.⁸ The transition from traditional to modern systems of support for the needy has hardly begun.

At the same time, political unification of the atolls as a colony and later an independent nation raised issues of inter-island equity in the allocation of public resources and services. Equal-price policies and cross-subsidy of freight costs date back to colonial times as attempts to lessen the financial handicaps of life on the “outer islands.” Mobility within Kiribati enables people to move to where they perceive better opportunities—usually South Tarawa or Kiritimati (Christmas Island). In the last 30 years, the population of the outer Gilbert Islands has risen by only 14% (in recent years it has been falling), while that of South Tarawa has increased by two-and-a-half times, and Kiritimati is growing fast, currently reporting annual population increases of 20%.

Customary land tenure preserved inherited rights to land. Population growth has led to increasing fragmentation and diffusion of use rights, to the point where in some islands useable land—Kiribati’s scarcest resource—is left unworked. Despite improvements to lands and surveys administration that have transformed the quality of records and transaction services available in South Tarawa, proposals for more far-reaching land reform have so far foundered on the fear that monetization of interests in land would lead to concentration of ownership and creation of landlord and landless classes. The first signs of this can be seen in South Tarawa with the recent sales of legally-charged land by financial institutions, made possible by specific legislative provisions relating to those institutions. Development requires a generally available form of registered tenure that adequately protects public and private investment while recognizing the underlying ownership structure. That structure is itself crumbling under population pressure, compounding the problem of providing security of tenure.

Key issue: Monetization and population growth are causing disparities in the distribution of incomes and well-being to worsen, and unacceptable levels of rural and urban deprivation are emerging.

Box 2.2: Economic and Social Statistics

Statistics in Kiribati could easily be improved. Much information is collected, entered into databases, and stored, but little is sorted, checked for reality, processed, and published. Part of the reason—the supply side—appears to be the prolonged absence on overseas courses of senior and professionally trained statistics staff. Another part—the demand side—may be that the potential users in the general public and government do not realize how useful an improved output of social and economic statistics would be, so they do not press for it. Some observers have suggested that absence of published data may reflect a government preference for restricting information about economic and social affairs, but the country's record in most respects compares well with other developing countries; thus, this seems unlikely.

In the preparation of the present report, large quantities of data were found in government departments and public enterprises and reviewed. Financial data are subject to audit, so in due course any inaccuracies should be corrected. But various improbable statistics in health and education were observed that suggest an audit process for nonfinancial data would be worthwhile at departmental level as well as at the Statistics Office.

A report in February 2000 by the Secretariat of the Pacific Community (SPC) Statistician made a number of recommendations for regular statistical publications, including a quarterly “Economic Indicators Bulletin,” that appeared to be within the capability of existing staff to produce. That has not happened and it would be useful to follow up those proposals in the light of subsequent staffing and other resource developments.

Proposed responses: Improve statistical reporting of living standards, distribution of income, and access to services (Box 2.2); undertake collaborative programs with civil society to assist needy sections of the community; improve infrastructure and services in the outer islands; broaden skills training and access to economic opportunity; and define and build support for forms of modernization of land tenure that minimize social costs.

Box 2.2 (continued)

An example of what can be done when things come together is the November 2001 publication “Government Finance Statistics.” This is a model of such publications—clear, focused, and easy to use. It was produced when the Republic Statistician was on hand for three months between multiyear overseas courses, and it remains unique.

Many of the issues and strategies discussed in this report will benefit greatly from quite simple improvements to the Government’s statistics operations, along the lines indicated in the SPC Statistician’s February 2000 report. Estimates of output and income (GDP) have to be treated with reservation because of weaknesses that could be rectified fairly easily. In some areas, particularly the distribution dimension of economic growth—which is attracting increasing attention—significant additional work is required, such as more regular and better-designed household income-and-expenditure and labor force surveys.

At present the lack of regular, reliable economic and social statistics handicaps the Government in its policymaking and operations, and similarly handicaps PEs, the private sector, and civil society. Kiribati’s commitment to a democratic system of government is not in doubt, but public access to reliable and up-to-date information on economic and social development is essential for the practice of democracy.

Public Sector Performance⁹

The public sector dominates economic activity and wage employment. Government expenditure exceeds estimated GDP, and the Government and its public enterprises together account for two thirds of all jobs. This activity can be made much more efficient and these workers much more productive by improving the way they are organized and directed.

At independence, Kiribati inherited a public sector that provided not only goods and services of a clearly public nature,¹⁰ but also many that private enterprise commonly provides in a

competitive market environment. There is no technical reason why government-owned entities cannot provide such goods and services, but Kiribati is no exception to the widely observed rule that they have difficulty doing so efficiently. The reasons are to do with the personal consequences of success and failure, that is, the motivation of the persons employed in the entity. The money, skilled persons, and other resources used by these activities are scarce. The economic aim should be to maximize the efficiency with which they are converted into the goods and services needed by the economy.

In the private sector, competition and the threat of closure drive enterprises to perform efficiently. Kiribati has chosen to retain a relatively large public sector at this stage of its development, for nationalist-distributionist reasons mentioned earlier. For this also to be a sound economic choice, government departments and PEs have to use the money and other resources entrusted to them to produce the required goods and services as efficiently as if their survival depended on it—they have to imitate the disciplines and motivations of commercial competition (e.g., Box 2.2).

Few will do this by themselves. Many public sector operations lack direction, accountability, and respect for the public as customer. The Kiribati public is remarkably tolerant of—or feels helpless against or afraid to complain about—government failure, at all levels from unanswered correspondence through nontransparent decisions to collapsed services. Much of the problem appears to stem from lack of definition of tasks, the absence of effective monitoring of performance, and the fact that in the public sector, good performance generally goes unrewarded and poor performance unadmonished.

The wide scope of public sector activity gives rise to potentially serious conflict of interest where the Government has regulatory responsibilities to the general public for the safety of services, and is also engaged in operations in the sector through its ownership of PEs. This arises currently in air and sea transport and telecommunications, and is likely to do so in the financial sector. Care is needed to define and keep separate the pursuit of these conflicting interests.

To help ministries, departments, and PEs to behave efficiently, the Government will have to create a stimulating environment, made up of more sharply defined performance requirements and efficiency

measures, increased personal motivation to do a good job, targeted subsidies, stronger supervision, and the real possibility of sale or closure of unsuccessful operations. An appropriate mix of public and private enterprises and government departments then has a chance to evolve, providing the required range of goods and services for national development at minimum economic cost.

Key issue: How to motivate government departments and PEs to behave as if they were operating in a competitive environment that rewards achievement, tackles problems, and punishes failure, while strengthening the regulatory independence and ethics of public service.

Proposed responses: *For ministries and departments*, tighter and clearer definition of key roles and tasks in policy statements and budget outputs, leadership training and stimulation of competitive “pursuit of excellence” within the public service, objective public reporting of departmental performance against output targets, and increased outsourcing of activities. *For PEs*, application of “hard budget” rules and tying of subsidies to specific noncommercial services, more detailed definition of corporate goals and enforcement of governance standards, opening up to competition in areas of interest to the private sector, and strengthened performance monitoring and public reporting.

Equipping People to Manage Change¹¹

Increasing population, a flood of outside influence, and the monetization of transactions and relationships strain people’s ability to adapt to change and retain some control of their lives. How effectively individuals at any income level can respond to this pressure is conditioned by their understanding and skills, their physical and mental well-being, their view of the future, and the nature of the social and political institutions in which they live—in development policy terms, by education, health, and governance.

Education

Kiribati has made great strides in increasing the availability of basic education, and is now within sight of providing free schooling for all children up to 14 years old. A massive program of junior secondary school construction is bringing Forms 1-3 to almost all outer islands and increasing secondary places in South Tarawa. Church schools at all grade levels are also expanding.

Official and parental concern is shifting now to the quality and content of education, the effect of formal education on the aspirations and capabilities of the 1,700 young people coming out of the system each year, and the huge gap between that output and the availability of wage employment. Most teachers are teaching well above their qualification level. The mainstream curriculum reflects the assumption that paid employment awaits the school leaver, while the number of out-of-school and not-in-work young people in South Tarawa is steadily rising.

These concerns will dominate education and social policy in the years ahead. Proposals are being brought forward to upgrade teacher qualifications, increase class sizes, revise curricula, and establish vocational schools. Even if all these efforts succeed, more than 1,000 young people each year will need to make the transition from school to adulthood without the comfort of further training or a regular wage. Their families and society at large will need help to adjust to this reality, through improved information, communications and services, and strengthened governance systems at island level.

Key issue: How to improve the quality of teaching and the relevance of the curriculum to the challenges that school leavers will face, ranging from engagement in the nonformal sector to tertiary education overseas.

Proposed responses: Progressively upgrade teacher qualifications and increase pupil-teacher ratios, enlarge classes, invest in male and female vocational training, improve asset maintenance systems, and strengthen community involvement in education.

Health

The physical health of the population, even in the outer islands, shows clearly the effects of monetization on eating and drinking habits, use of alcohol and tobacco, and other changes in lifestyle. Concern has been growing at the increased incidence and cost of treatment of illnesses related to unhealthy diet and lack of exercise. The nominal coverage of health services is satisfactory, with trained health staff on all populated islands, but maintenance of facilities is erratic, the transport and telecommunications required to link these facilities to central support services are frequently unreliable, and professional development and supervision are at best intermittent. Policy concerns are likely to focus on improving the delivery of primary health care—including family planning services—to the less well-off and general public. This can be done through the existing network, educating people to greater awareness of the causes of illness and the benefits of self-help through healthier diet and more exercise. Facilitating the establishment of private medical services in South Tarawa for those who are willing to pay for them, would ease the load on the public services.

Key issue: How to reverse the increasing incidence of lifestyle-related diseases, while improving the delivery of public health and basic curative services.

Proposed responses: Refocus and intensify health education activities, and strengthen management, supervisory, and maintenance arrangements for hospital and clinic-based health services nationwide.

Governance

Many development objectives likely to be adopted in 2003 will require strengthened governance at island level, where elected, grant-aided Island Councils coexist with the modern-day version of the traditional *maneaba*¹² system. A proposal to establish a trust

fund with ADB support for island-level development projects and programs is moving forward. It is already clear that a significant upgrade of administrative capacity at island level will have to precede the operation of the fund.¹³

Most of the institutions of civil society—churches, trade unions, *maneaba* assemblies, business associations, and domestic nongovernment organizations (NGOs) have been in existence for a long time, but they have little experience of working together to provide a regular check on the machinery of government and inputs to policy formation. A sense of dependence on the Government for most of life's needs and reluctance to be seen to complain may have acted as deterrents to any questioning of public sector performance. It is only natural for governments to accept that, but it does not help the cause of economic and social development. The temptation for governments to use their control of budgets and information media to stifle debate needs to be firmly avoided.

A number of recent studies in Kiribati including consultations for this report, have brought together civil society representatives with senior government officials in a “neutral” setting, providing valuable debate that has helped shape the concepts now put forward. These experiences may be built on to develop a better informed and more productive relationship between civil society and government, leading to a stronger foundation for dealing with the economic and social challenges that lie ahead.

Key issue: How to strengthen and protect the formal and informal machinery of government accountability and participation of civil society in policy formulation, without weakening the authority of the parliamentary process.

Proposed responses: Increase the flow of public information on issues of economic and social development, develop and maintain regional linkages on governance issues, establish specific consultative forums on subjects of public concern, and publish the public sector performance reports proposed above.

Conservation of Physical Assets¹⁴

Conserving—and enlarging when possible—the asset base of the economy is a critical area of economic management. Kiribati has a narrow range of physical assets from which to generate monetary and other income: the bought and made assets of the public and private sectors, the sparse land and fragile environment of the atolls, and the living and nonliving marine resources (Box 2.3). The principles of sustainable yield and conservation of asset value are contained in economic management, but the extent of their application to different classes of asset varies greatly.

Maintenance of Fixed Assets

The public sector does not have a good record of maintaining infrastructure, buildings, or equipment in South Tarawa and elsewhere. Like many developing countries, Kiribati has allowed important economic assets¹⁵ to deteriorate to the point of failure, and has then replaced and often enlarged them with the help of foreign grants or concessional loans. This has been in several respects a defensible strategy, in that it enlarges the base of investible resources available to Kiribati to include foreign savings provided by aid donors and lenders, saves recurrent funds for other uses, and eventually provides an upgrade or modernization as well as restoring services.

But over time, this practice encourages a culture of inadequate provision and execution of maintenance, burdens the economy with progressive deterioration of infrastructure and services, and deprives the emerging private sector of a valuable source of contract work.¹⁶ It also leaves the country vulnerable to a potential change in donor willingness to fund what is, in effect, accumulated (undone) maintenance. Economic and social assets need to be properly maintained out of current income, and reserves need to be accumulated by charging adequate depreciation rates to provide for future asset replacement. It is unwise to assume that donors will continue to fund these predictable requirements.¹⁷

Box 2.3: Making Good Use of Resources

Small and remote economies have to be particularly astute in using their resources. Mismanagement can have disastrous consequences. Kiribati has made good developmental use of three strategic assets—the Revenue Equalisation Reserve Fund (RERF), the land resources of the Line Islands, and the extent of its Exclusive Economic Zone (EEZ)—to lay the foundations for economic growth. If Kiribati had been less prudently governed since independence, the value of these assets might by now be much diminished. The challenge of how best to use them in the years ahead is the kind of problem that any developing country government would like to have.

The RERF was formed originally by setting aside government revenue from the phosphate mine on Banaba (Ocean Island) so as to help balance the recurrent budget after independence. It has grown through a combination of competent investment management, conservative fiscal policies, and favorable market conditions into a substantial fund that provides solid underpinning to Kiribati's fiscal position and international reputation.

The Line and Phoenix Islands account for 60% of Kiribati's total land area. They were not traditionally inhabited by the Kiribati people or anyone else, although ocean voyagers from Polynesia and further afield had visited them over the centuries. The Phoenix group has proved hard to occupy on a permanent basis because of uncertain rainfall, but since independence a successful government resettlement program has moved several thousand people from the Gilbert group to the Line Islands, where a higher standard of living and a more promising economic future are now attracting a steady flow of self-propelled migrants. In Annex D is an account of modern-day Kiritimati.

Kiribati has three EEZs, formed by Banaba and the Gilbert group to the west, the Phoenix group in the center, and the vast spread of the Line Islands to the east and southeast. The total sea area enclosed is 3.5 million square kilometers (km²), second in size in the Pacific only to that of French Polynesia. The three zones, with "high seas" areas dividing them, sprawl 5,000 km from east to west along and south of the equator. Climatic conditions in recent years have brought migratory tuna and distant-water fishing fleets in large numbers, and government licensing revenues have risen sharply, amounting to \$46 million in 2001, half of total revenue. Similar results were expected in 2002. The Government has pursued a more independent line on access negotiations than most outside observers recommended, but so far the financial outcomes have been very satisfactory. This success itself generates concern about the sustainability of recent revenue levels, as Kiribati authorities realize.

Key issue: How to ensure timely maintenance of social and economic assets in the public sector.

Proposed responses: Clearly identify and fully cost asset maintenance in budget outputs and work programs, protect budget allocations to maintenance, increase the contracting of maintenance work to private enterprise, and highlight the execution of planned maintenance in performance monitoring reports.

Environment

Environmental management is the most discussed but least implemented aspect of asset conservation (Box 2.4). Many reports have been written and meetings held, drawing attention to the extreme vulnerability of Kiribati, and especially the public and private infrastructure and buildings in urban areas of South Tarawa, to the effect of changes in climate that are apparently under way.

Kiribati cannot alter the speed or direction of climate change. Doubts about the precise nature and extent of the change should not stand in the way of increasing the country's capacity to respond and adapt to the broad nature and direction of change. The most pressing need now is to establish workable machinery of coordination and direction among the many agencies that presently claim partial responsibility for aspects of the environment, and then to draw together the available understanding of what is happening and develop workable strategies of management and adaptation.

Key issue: How to consolidate the fragmented stock of environmental knowledge and institutional responsibility into an effective system of advocacy and implementation.

Proposed response: Designate a single coordinating authority within the Government and assign to it, by law, overriding powers for design and implementation of policies on managing the physical environment and adapting to climate change.

Box 2.4: Environmental Management: Many Reports, Little Action

In the last decade, Kiribati has prepared the National Environmental Management Strategies (1992), the National Biodiversity Strategy Action Plan (2000), the National Adaptation Programmes of Action on Climate Change (2001), the National Report to the World Summit on Sustainable Development (2002) and, most recently, a Priority Environmental Concerns report prepared for the Kiribati International Waters Programme. There is no shortage of reports, but so far little discernible outcome.

The issues identified in those reports are becoming ever more pressing because of the rapid increases in urban population pressure on South Tarawa, and the vulnerability of all Kiribati islands to coastal erosion and flooding from super tides and storm surges during El Niño Southern Oscillation periods. The main areas of concern are groundwater depletion; increased salinization and pollution from sewerage and animal excreta; marine life and seawater contamination from human and solid waste; overfishing of reefs and lagoons; nondegradable waste disposal; coastal erosion and beach mining; deforestation; and breakdown of traditional subsistence production systems, resulting in social costs for treatment of malnutrition and nutrition-related diseases.

Surveys of the coastline of South Tarawa have shown considerable movement over a few decades, with important implications for the construction and placement of physical infrastructure. Deforestation is also a major problem on South Tarawa. The few tree species that do exist are important as sources of food, medicines, dyes, oils, fuel, compost, building materials, shade, and habitat for birds, and are essential for the protection of the shoreline from erosion and storms.

The costs of damage from extreme weather attributable to climate change could be catastrophic. Studies undertaken for the World Bank suggest these could reach \$12–24 million annually if 2050 climate change scenarios were

Box 2.4 (continued)

to happen in today's socioeconomic conditions. In a strong storm surge, up to half of South Tarawa could be inundated, with capital losses of several hundred million dollars. Such impacts are far from certain, but it would be irresponsible to ignore the risk they present. There are a number of ways in which the extent of potential losses can be minimized. Many of these "adaptation measures" have been recommended in the reports listed earlier, but implementation is scarcely noticeable.

The International Waters Programme identified coastal protection and conservation as top priority. Consultations for this report confirmed concerns over land scarcity and coastal erosion related to climate change and sea level rise, made worse by population density and unregulated beach mining. Kiribati is entirely coastal. Most activities take place on or close to the shorefront. Public understanding of wave and current dynamics is limited, and hopes that the coastline will naturally recover from human damage derive from pre-urbanization experience. South Tarawa is under severe environmental stress and is affected by significant erosion, pollution, and damage to marine coastal biodiversity.

Proper management of coastal activities in areas under threat is now an urgent issue. Currently, various government ministries and departments have responsibilities and activities for the coastal area. These need to be integrated into a centralized management system that would oversee all coastal-related activities and incorporate them into a climate-change adaptation program. Legislation would be required to define coastal management zones and the functions of the designated coastal management agency. The agency would develop and implement a management plan that integrates coastal protection and conservation issues with cost-effective ways of adapting to climate change. Such integration would reach into all aspects of economic and social development, and call for considerable technical and political skills.

Marine Resources

The conservation and sustainable use of living marine resources are critical to Kiribati's economic future, and this is the sector of the economy with the greatest potential for further development.

Monetization of the domestic economy and the impact of the international tuna industry¹⁸ put pressure on the resource management capabilities of the Government at several levels and require effective interagency collaboration (e.g., tourism and fisheries). Increasing demand for food fish, the export trade in live fish for home aquariums, and the sports fishing business on Kiritimati all require active management and the enforcement of restrictions on catch and types of gear. The impossibility of achieving success without community participation is already understood.

Focused policies, dedicated staff, and well-managed use of external technical assistance have laid a strong research base in inshore fisheries and fish farming, and have extended Kiribati's natural asset endowment to include new marine products. Seaweed production and export are well established, and the potential for commercial farming of black pearl oysters is undergoing pilot testing with encouraging results. With a clearer definition of public and private sector roles as proposed in the present report, there is a real prospect of attracting substantial private capital into this sector.

The tuna industry presents continuing challenges to the analyzing, negotiating, and management skills of the Kiribati authorities, both in resource management and in the provision of onshore¹⁹ services including the possibility of private investment in (job-creating) processing facilities for export. The central and western Pacific stocks of surface-swimming tuna are not presently considered to be overfished, but pressure on them is increasing as other stocks worldwide diminish. Relations with the Forum Fisheries Agency, although cordial and close, have been colored by Kiribati's reluctance to disclose full details of its relations with foreign fishing nations, and its preference for a bilateral rather than a multilateral approach to access negotiations.

The establishment of the Western Pacific Tuna Commission will extend resource management to the high seas zones between and around national exclusive economic zones (EEZs). Kiribati will

be able to enhance its knowledge and influence in regional tuna management by participating in this Commission alongside other resource-owning Pacific states and distant-water fishing nations.

A special concern is the sustainability of the level of payments received for licensing foreign fishing vessels to operate in the EEZ. At \$46 million, this amounted to half of all government revenues in 2001. Asian fishing nations have accounted for half to two thirds of license revenues in recent years, with the United States accounting for most of the balance. Recently signed agreements with the European Union (EU) for access by European purse seiners give hope that this level of license revenues could be exceeded in 2003. Nevertheless, the economic value of the fishery, and the rent that foreign fishers will pay for access to it, depends on climatic and market factors outside Kiribati control. A conservative approach is appropriate in allocation of current revenues and projection of future income. This is apparent in the budget estimates, which are normally below the “best hopes” level. However, unless this is formalized in an appropriation of the excess to reserve, awareness that the budgeted figure will probably be exceeded can lead to a loosening of fiscal restraints and the dispersal of all available revenue.

Key issues: How to conserve fish stocks other than tuna that are under pressure from domestic food and export demand, how to manage the “development transition” from government-funded research to privately-funded commercial production, and how to maximize sustainable economic benefits from the tuna stocks of the EEZ.

Proposed responses: *For the tuna fishery*, without compromising the ability to negotiate bilaterally, strengthen regional collaboration and information exchange in resource management, while seeking onshore processing investments by reputable foreign enterprises with market access. *For other fisheries*, strengthen lagoon and inshore resource management capabilities in collaboration with fishers, island authorities, and communities; make the results of fish farming research available on negotiated terms to selected private investors; and promote private enterprise operation of fishing, fish farming, and trading

activities. *For revenue*: develop a “core” and “windfall” revenue model for EEZ licensing revenues and save the windfall component into reserve.

Sustainable Use of Financial Reserves

The conservation and developmental use of financial reserves dominate discussions of the economy. The success of the RERF in underpinning government finance and economic stability is known through the region and further afield. There are also substantial reserves in the Kiribati Provident Fund (KPF), the deposits of the Bank of Kiribati (BoK), and the unknown²⁰ but probably significant financial assets held overseas by Kiribati nationals. These classes of savings all have roles in the development of the economy, but the constraints on their use are different and need different strategies to unlock them without exposing them to unacceptable risk of loss.²¹

Reserves of the Financial System

KPF's accumulated funds, invested overseas, are the compulsory savings of its contributors, in effect held in trust for their retirement. The Government guarantees the Fund, but for public peace of mind and to safeguard its assets, the management keynote must be prudence, balanced by the reasonable pursuit of income for distribution to contributors. KPF has, therefore, been a relatively passive participant in economic development. As the financial system develops and elements of a local capital market appear, it will become possible for part of KPF's funds to be invested domestically in low-risk, income-generating securities and term loans, particularly in infrastructure development. With total funds in excess of \$60 million and growing, investment of up to 25% of KPF assets in the domestic economy would make available \$15 million in long-term capital for suitably high-grade purposes.

BoK is 75% owned by the Australian and New Zealand Bank (ANZ) and 25% by the Government. Until 2000, the BoK was a 51/49 joint venture between Westpac Bank and the Government.

BoK has unlent reserves invested in money market funds overseas, fluctuating around \$50 million, which are more than 10 times the value of its loan assets and many times larger than even the most conservative management would wish. These funds represent the deposit balances of the Government, PEs, the private sector, churches, and the general public. In the nature of commercial banking, where depositors can withdraw demand deposits any time, a proportion of BoK's assets have to be held in liquid (readily available) form. But the present level of domestic lending at around \$5 million is clearly well below any prudential limits. A steady growth of lending up to two thirds of total assets, an increase of \$30–35 million in terms of the present balance sheet, would still be conservative and, given reasonable risk management, would substantially improve the BoK's earnings.

Increased use of the existing deposit base and the resulting scope for paying higher interest rates on deposits would enable BoK to attract back into the economy private savings presently held overseas. There are no data on the amounts involved, but it is reasonable to assume that significant funds are held overseas by individuals and enterprises, some of which would come home if the financial rewards were attractive. In due course, a market in short-term government debt may be developed, accessible to institutions and individuals.

Several reports²² in recent years have identified constraints on the greater domestic use of financial reserves. These include the need for prudential regulation of the financial system (in part to enable competitive entry to the system), difficulties in using interests in land as security for bank loans, and the need for access to bank credit by small and new enterprises. Action is under way on all these matters. Advice has been sought from the Pacific Finance Technical Assistance Centre on legislation to establish prudential supervision of all financial institutions. BoK and the Development Bank of Kiribati (DBK) are now both able to take security over leasehold land and the Government is setting up a guarantee corporation to enhance the bankability of potential borrowers.²³ Both DBK and BoK report strong demand for credit from existing and start-up small businesses. When legislation is in place for supervision of the financial system and a supervisor appointed, it will become possible

for competition to develop in all or parts of what has so far been an effective monopoly of banking business by BoK.

What remains is to steer major infrastructure and export-oriented developments toward BoK and KPF as potential sources of funds. Air and sea transport, telecommunications, and power generation are key needs of the economy. If they are allowed to earn realistic revenues (including targeted service subsidies where justified), the relevant PEs will be able to afford commercial finance for capital projects, thus relieving public funds of their investment needs.²⁴

The role of foreign savings via official development assistance and private, foreign direct investment is discussed in Box 2.5.

Key issue: How to protect the system's stability and safeguard public deposits while increasing the use and improving the efficiency of domestic credit in financing economic growth.

Proposed responses: Establish a prudential regulatory framework for financial institutions, promote competition within the regulatory framework, improve the access of new and small businesses to bank credit, and promote medium- and long-term domestic financing of income-earning infrastructure projects.

Revenue Equalisation Reserve Fund

The amount of government savings in the RERF is the most striking monetary statistic in the Kiribati economy. The fund was established more than 40 years ago by annually setting aside and investing part of colonial government revenues from phosphate mining. The aim was to generate investment income to balance the Government's future recurrent budgets—on the assumption that external aid for development would continue to be available to independent Kiribati. The fund was worth \$68 million by independence²⁵ in 1979, \$200 million in 1989, and \$636 million at the end of 2001.

Box 2.5: Tapping Foreign Savings: Official Aid and Private Investment

In the global economy, the financing of development is not restricted to domestic savings. Just as Kiribati invests its savings in other economies by holding over \$700 million of financial assets overseas, so the public and private savings of other economies are available to Kiribati through two channels, official development assistance and private, foreign direct investment.

Use of foreign savings broadens the capital base of the Kiribati economy and develops professional and commercial contacts through which valuable technical know-how and market access can be channeled into Kiribati. The strategic economic risks attached to foreign involvement in the Kiribati economy have been a cause of concern to governments since independence. Such risks can be contained through transparent aid agreements, a sound regulatory environment for domestic and foreign investment, and a competent and honest public service.

Access to external assistance follows membership “in good standing” of the regional and international community. In February 2002, The United Nations Development Programme published a United Nations (UN) Common Country Assessment for Kiribati. This is a comprehensive and up-to-date account of the social and economic circumstances of Kiribati, with—among its other merits—a refreshing awareness of the burden that international obligations place, at least in principle, on small countries such as Kiribati. That report lists 14 UN conferences held in the last decade in which Kiribati has participated and 7 major international conventions in force that have policy implications for Kiribati. Like most of its neighbors, Kiribati has apparently taken little or no specific action to implement agreed international goals, but has not committed any significant defaults.

Official Development Assistance (ODA)

Kiribati has made good use of ODA. Australia, Japan, and ADB are Kiribati’s largest sources of development assistance. Major bilateral programs from Australia, the European Union, Japan, and the People’s Republic of China (PRC) have funded or are committed to projects in education, health, water and sanitation, air and sea port development, sports facilities, and telecommunications (Japan and the PRC also pay rent or do works in return for the use of Kiribati territory for space-related facilities, but that is not ODA). Japan and Australia also fund experts in fisheries and other sectors,

(continued)

Box 2.5 (continued)

and the PRC provides doctors to reinforce the health service. Australia funds programs in economic and financial planning and institutional strengthening.

In addition, Britain, Canada, New Zealand, and the United States have all made valuable contributions to Kiribati development. New Zealand is “piloting” a small-scale migration scheme with interesting longer-term potential (described elsewhere in this report). Britain’s long-running Voluntary Service Overseas program has concluded that it has failed to achieve its goal of building local capacity, and is preparing to withdraw from Kiribati. The US Peace Corps maintains around 40 volunteers, mostly as secondary school teachers.

The Asian Development Bank is funding the rehabilitation and upgrading of the South Tarawa water and sanitation system, and is planning to cofinance with the Government an Outer Island Development Fund to improve infrastructure and services away from Tarawa. As long as Kiribati is eligible for highly concessionary loans and total external debt remains small (say, less than 30% of annual GDP), it makes sense to use such loans rather than draw on the Revenue Equalisation Reserve Fund. The World Bank is discussing with the Government the possible use of assistance from the Global Environment Fund to finance adaptation measures to improve Kiribati’s ability to deal with the effects of climatic change. Kiribati benefits from a wide range of technical and financial assistance from UN and regional agencies, both to government departments and to domestic nongovernment organizations engaged in economic and social development—for example, United Nations Fund for Population Activities support for the Family Health Association.

While the impact of external assistance on government expenditure and economic activity is clearly substantial, it is hard to quantify. The structure of the published government budget (see discussion in Chapter 4) reveals actual expenditures only for the local-funds contribution to the Development Fund, from which under the Public Finance Act the Government’s development program is funded (budget documentation problems of this nature are not unique to Kiribati, and arise in part from the way aid is allocated and disbursed by donors). Estimates by the Statistics Office suggest

Box 2.5 (continued)

that around one third of total government expenditures is through the Development Fund, equivalent to about \$30 million in 2001, most of this from external grants and loans.

Foreign Direct Investment (FDI)

FDI has been less successful. Kiribati is at a disadvantage in global/regional competition to attract private capital from overseas because of its “endowed handicaps” of remoteness, narrow resource base, small physical and economic size, and vulnerability to climate change. The country’s access to concessional long-term loans and grants for infrastructure development is intended in part to offset these handicaps to private investment. But Kiribati does have unrealized potential for foreign investment in marine resources, specialized tourist development, and some aspects of infrastructure and financial services. The problems appear to lie in a number of additional “human-made handicaps” that have been identified in external and internal studies over several years. These include slow, complex, and unclear processes; unhelpful official attitudes; and the presence in the relevant sectors of PEs that do not welcome competition. The same problems also hold back existing local private investors from increasing their investments and expanding their operations (see also Chapter 5).

It lies within the power of the Government to solve these problems, and it has received more than enough reports and recommendations on the subject. The present report again argues that action in these areas is necessary to reduce the present dependence on government and build a sustainable base for the future growth of the economy. Such arguments are accepted with reservations, if at all. There is reasonable concern at official and political levels, based on observation of other small countries’ experiences, that one or more powerful foreign investors might corrupt and subvert the processes of government, effectively hijacking Kiribati’s sovereignty.

Kiribati needs foreign private investment, but it needs it on fair, transparent, and enforceable terms within a robust legal system and under the monitoring of honest and competent officials. These requirements can readily be met by the Government from its own resources, supplemented by regional assistance if needed.

The value of the Fund doubled between 1994 and 2001. This extraordinary performance, driven by a booming market and a depreciating Australian dollar, was not sustainable. The authorities in Kiribati were among many stock market investors who were tempted to think otherwise. An inevitable correction back toward long-term values began in 2001 (Table 2.1).

Table 2.1: RERF Value, 1992–2001

	1992	1993	1994	1995	1996	1997	1998	1999	2000	2001
End- year value (\$ million)	296	353	318	368	372	459	570	602	658	636
Annual growth (%)	12	19	-10	16	1	23	24	6	9	-3
Earnings* (\$ million)	17	14	14	17	16	17	20	21	24	23
Gov't. drawing (\$ million)	6.5	5.5	4.4	7.5	13.6	8.0	0.0	(5.0)	0.0	12.6

* Interest and dividends.

Source: Ministry of Finance and Economic Planning, and Statistics Office Bulletin.

During the 1980s, drawings on the RERF provided 20–40% of total government revenues, as expected. Strong growth in fishing license revenues reduced the need for RERF drawings from 1990 (except for 1996, when revenue fell sharply and RERF drawings almost doubled) and since 1997 there have been no drawings. The underlying trend in government expenditure²⁶ during this period has, however, been strongly upward. If climatic or other changes cause a sharp drop in fishing license revenues, pressure will fall first upon the Government's limited cash reserves and then upon the RERF to fill the revenue gap.²⁷

Until recently, conservative fiscal policies have protected the RERF. Governments since independence have generally been reluctant to draw on the RERF, preferring to accumulate funds against an uncertain future. The experiences of other countries—and some recent fiscal indicators in Kiribati—suggest that over time these disciplines may weaken in the context of monetization. It is very much easier to spend savings than to accumulate them. The legal status of the RERF is that of a Special Fund under the Public Finance (Control and Audit) Act, with rules for operating the Fund made by the Minister subject to parliamentary approval. The degree of discretion given to the Minister and Ministry of Finance and

Economic Planning (MFEP) officials is remarkable, and in almost any other country would have led to disaster long ago.

To protect long-term sustainability and to assist budget planning, a limit on annual drawing from the Fund was set by the Government in 1996.²⁸ The real value of the Fund in domestic currency per head of population was to be maintained at 1996 levels of just over \$4,500. The limit on annual drawing was set at \$12.6 million (roughly 20% of the 1996 GDP). The value of the Fund has grown more rapidly than expected, for reasons already noted. By end 2001, the value of the Fund per head was \$7,000, equivalent to about \$6,400 in 1996 prices, 40% above the minimum required by the 1996 policy. As noted above, falls in financial markets worldwide affected the fund in 2001.

Surplus funds in the RERF not needed to maintain Fund value or recurrent budget support can be reinvested, drawn and held as cash reserves, or used for development projects. This brings a risk of funding poorly prepared projects, just because money is available. The standards of appraisal applied to nationally funded projects need to be at least as high, and the criteria at least as demanding, as those applying to aid-funded projects.²⁹ The opportunity cost to the people of Kiribati of using RERF funds now is future investment income foregone.

Because export opportunities are limited, and the scope for processing and manufacturing enterprises likely to remain limited, pressure will increase for government spending to create economic activity as the population grows. This will endanger the long-term capacity of the Fund to sustain the budget. Prudential and economic concerns indicate a need to replace the RERF's Special Fund status and 1996 drawing rules by a stronger and more comprehensive set of safeguards.

When the current instability in financial markets passes and the underlying value of the RERF can be more clearly seen, a new benchmark can be established for the value to be maintained in reserve for the economic underpinning, future-assuring role of the Fund. That minimum fund size needs to be redefined, established, and better protected, and the process by which the Government has access to fund earnings for budget purposes needs to be more realistically circumscribed. This can best be done by restructuring

and enhancing the legal status and upgrading parliamentary supervision of the reserve funds.

Key issue: How to protect the RERF's ability to underpin future budgets while providing more flexibility of access to reserves for funding recurrent and development expenditures.

Proposed response: Legislate the separation of the RERF into a protected fund (National Reserve Fund) to provide long-term budget underpinning and an accessible fund (Government Reserve Fund) fed by the protected fund to finance recurrent and/or development budget needs, and strengthen parliamentary supervision of the operations of both funds.³⁰