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Too Much of a Good Thing? Prudent Management of Inflows under Economic Citizenship Programs

by Xin Xu, Ahmed El-Ashram and Judith Gold

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Prepared by Xin Xu, Ahmed El-Ashram and Judith Gold

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Abstract

Economic Citizenship Programs (ECPs) have recently been proliferating, with large and potentially volatile inflows of investment and fiscal revenues generating significant benefits for small economies, but also posing substantial challenges. This paper discusses recent developments and implications of such programs for fiscal discipline and the real economy, including risks to macroeconomic and financial stability, with a focus on small state economies. It discusses the prudent management of these programs, overviews strategies to minimize risks to various sectors, and addresses potential governance and integrity challenges. The paper proposes a framework for managing inflows and savings from ECPs to contain macroeconomic risks, and it recommends the establishment of a sovereign wealth fund (SWF) where such revenues are large and persistent.

JEL Classification Numbers: E62, F69, H27, Q32

Keywords: Economic Citizenship Programs, Citizenship-by-Investment, Economic Residency Programs, Immigrant Investor Programs, Golden Visa, Sovereign Wealth Fund (SWF), National Development Funds, Macroeconomic Stability, Dutch Disease, St. Kitts and Nevis, Pacific Island Countries.

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I. INTRODUCTION

1. The number of Economic Citizenship Programs (ECPs) has recently surged. An increasing number of countries are offering opportunities to obtain citizenship or residency in exchange for a substantial financial contribution to the domestic economy. ECPs (also referred to as Citizenship-By-Investment Programs) are particularly attractive to small states, for which inflows can be large enough to have a significant economic and fiscal impact, while an increasing number of advanced economies are also offering Economic Residency Programs. These programs are increasingly being mainstreamed, as high net-worth individuals consider citizenship/residency as a means to improving international mobility, tax planning, and family security while also seeking investment opportunities. Further, a growing number of intermediaries have recognized the business opportunities as more countries launch new programs that cater to such needs.

2. Given the shared advantages for interested individuals and host jurisdictions, ECPs are likely to continue to grow, but with important spillovers and downside risks for small states and the international community. In small states, the inflows to the private sector can have a sizable impact on economic activity, while the fiscal revenues, like other large windfall revenues from abroad, can be quite substantial. However, poor management of the revenue upsurge could exacerbate vulnerabilities. If large and persistent, investment and fiscal flows may lead to adverse macroeconomic consequences associated with Dutch Disease, including inflation and loss of competitiveness, and the crowding out of other private sector activity. Moreover, program inflows may be subject to a very high sudden-stop risk, related to rapid changes in advanced countries' immigration policies. Finally, if not administered with due diligence, ECPs can lead to security breaches and possibly facilitate illicit activities, such as tax evasion and money laundering, raising significant concerns for the international community and exposing the host jurisdiction to harmful reputational risks.

3. The paper discusses the macroeconomic implications of inflows under these programs, particularly in small states, and proposes a prudent management framework. Such a framework will aim to save the bulk of the inflows to the public sector—improving the fiscal and external positions —and also regulate inflows to the private sector. The paper addresses the importance of adopting a strong institutional governance framework to prevent possible abuse of such programs. Large and persistent inflows may warrant a dedicated mechanism to manage large savings, including through a Sovereign Wealth Fund (SWF). The paper is organized as follows. Section II overviews recent developments in the economic citizenship domain and discusses selected ECPs. Section III discusses macroeconomic implications and challenges of ECP inflows. Section IV discusses the appropriate policy response to address risks in each sector. Section V outlines options for channeling large ECP-generated savings and proposes the adoption of an SWF where saved resources reach a critical mass relative to the size of the economy. Section VI concludes.

II. THE NATURE AND SCOPE OF ECPS

4. There are many economic citizenship/residency programs around the world that provide citizenship or residency in exchange for substantial financial transfers. Programs vary substantially in their design, conditions, and cost. However, their commonality is that they allow either direct citizenship or provide a route towards citizenship in return for a sizable financial transfer, which can be in the form of an investment in the economy or a contribution to the public sector. Such programs have existed for decades. Advanced countries such as the US, UK and Canada have had "Immigrant Investor Programs" dating back to the mid-1980s to mid-1990s.[1] These programs grant residency status leading to citizenship in return for substantial investment, either in public debt instruments (e.g. Canada) or in the private sector.[2] Small states have offered a more direct route to citizenship without, or on the basis of very limited, residency requirements, including Cyprus, Dominica, St. Kitts and Nevis, and, in the past, Ireland and several Pacific Islands. All of these programs purport to stimulate growth and employment through attracting more foreign capital and investment by way of offering a citizenship/residency status to high net-worth individuals.

5. A relatively large number of new programs have been introduced recently after a long period of limited action in this economic sphere. In 2013 and 2014, Antigua and Barbuda and Malta launched new citizenship programs, while Grenada revived its previously retired program. Several European countries, including France, Greece, Hungary, Latvia, the Netherlands, Portugal and Spain have also recently introduced new residency programs by way of a significant investment with about half of the European Union member states now having a dedicated immigrant investor route.[3] These residency visas, dubbed the "Golden Visa" following the Portuguese program which carries the name, allow the recipients access to all 26 Schengen countries.[4] Further, some countries are also revising their existing programs to improve their competitiveness and appeal while other countries are trying to increase the programs' potential economic or fiscal contributions.[5] Cyprus amended its program to provide more investment options, including in government bonds, bank deposits

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[1] The number of US EB-5 investor visas increased five-fold from 2010 to 2013, but this still represents only 2 percent of annual immigration to the U.S.

[2] The Federal Canadian program was abolished in the 2014 Federal Budget as the program was found to have limited economic benefit.

[3] The Austrian government can confer immediate citizenship to foreign persons in the case of extraordinary merit, which can include substantial investments in the country under Article 10 (6) of the Austrian Citizenship Act. However, the Austrian government indicated that no citizenships have been granted under this provision since mid-2011.

[4] The Schengen Borders Agreement permits Schengen Visa holders to travel freely within the Schengen area as well as across Iceland, Norway, Switzerland, and Liechtenstein.

[5] For example, the U.K. Migration Advisory Committee (MAC) was asked by the U.K. government to review whether specific features of the program were delivering "significant economic benefits" to the nation.

and other financial instruments, in addition to its original real estate or other private investment option. Dominica has also recently introduced a real estate investment option in addition to its original requirement of a direct contribution to the government.

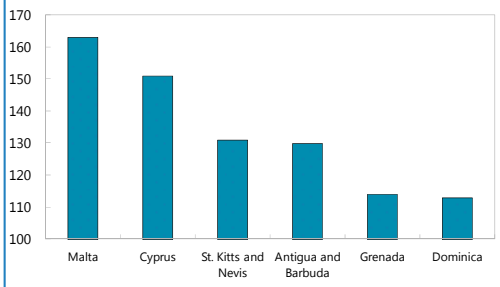
Table 1. Selected Economic Citizenship/Residency Programs Worldwide

	Country	Inception Year	Minimum Investment 1/	Residency Requirements 2/	Citizenship Qualifying Period 3/
Citizenship Programs	**Antigua and Barbuda**	**2013**	USD 250,000	5 days within a 5-year period	Immediate
	Cyprus	**2011**	EUR 2.5 million	No (Under revision)	Immediate
	Dominica	**1993**	USD 100,000	No	Immediate
	Grenada	**2014**	USD 250,000	No	Immediate
	Malta	**2014**	EUR 1.15 million	6 Months	One year
	St.Kitts and Nevis	**1984**	USD 250,000	No	Immediate
Residency Programs	**Australia**	**2012**	AUD 5 million	40 days/year	5 years
	Bulgaria	**2009**	EUR 500,000	No	5 years
	Canada 4/ 5/	**Mid-1980s**	CAD 800,000	730 days within a 5-year period	3 years
	Canada-Quebec 5/	**N.A.**	CAD 800,000	730 days within a 5-year period	3 years
	France	**2013**	EUR 10 million	N.A	5 years
	Greece	**2013**	EUR 250,000	No	7 years
	Hungary	**2013**	EUR 250,000	No	8 years
	Ireland	**2012**	EUR 500,000	No	N.A.
	Latvia	**2010**	EUR 35,000	No	10 years
	New Zealand	**N.A.**	NZD 1.5 million	146 days/year	5 years
	Portugal	**2012**	EUR 500,000	7 days/year	6 years
	Singapore	**N.A.**	SGD 2.5 million	No	2 years
	Spain	**2013**	EUR 500,000	No	10 years
	Switzerland	**N.A.**	CHF 250,000/year	No	12 years
	UK	**1994**	GBP 1 million	185 days/year	6 years
	US	**1990**	USD 500,000	180 days/year	7 years

Sources: Country authorities, UK Migration Advisory Committee Report, Henley and Partners, Arton Capital and other Immigration services providers.
1/ Alternative investment options may be eligible.
2/ Explicit minimum residency requirements under immigrant investor schemes; residency criteria to qualify for citizenship may differ.
3/ Including the qualification period for permanant residency under residency programs.
4/ Program suspended since February 2014.
5/ Although not specific to the immigrant investor program, retaining Permanent Residency requires physical presence of 730 days within a 5-year period.

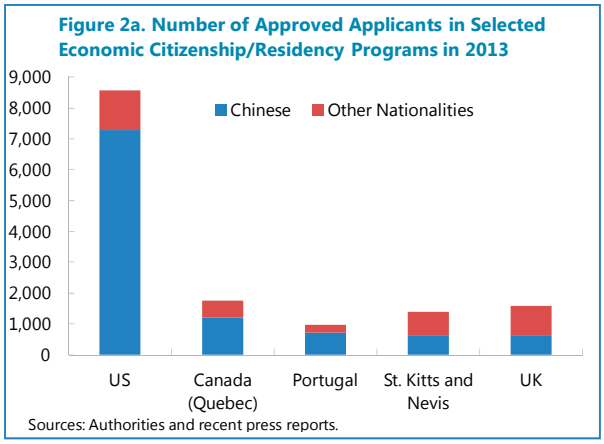
6. The surge in interest in these programs may reflect a combination of growing wealth in emerging markets and an increase in global uncertainties and security issues. The increasing number of high net-worth individuals outside industrial countries would appear to be the critical factor on the demand side. The main reasons for the rise in demand from this group include: i) the desire for easier travel in the face of growing travel restrictions and encumbrances for nationals of non-advanced countries post 2001 World Trade Center attacks; ii) the search for a safe haven in the context of a deteriorating geo-political

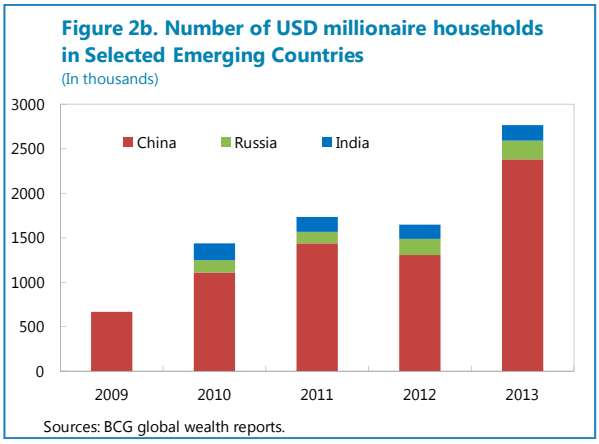
Figure 1. Visa Free Restriction Index of Selected Countries with ECPs 1/



1/ Higher ranking means higher visa-free access.
Sources: The Henley & Partners Visa Restriction Index 2013.

climate and increased security concerns, and iii) other considerations, like estate/tax planning.[6] While accurate statistics are sparse, press reports and observations of trends in several countries indicate a surge in clients from China, followed by Russia, and a steady rise in clients from the Middle East, although to a much lesser degree.[7]





7. Citizens from advanced countries also represent an important share of applicants to some citizenship programs, generally motivated by lower tax regimes. Many small states have historically acted as tax havens that offered low or zero tax rates on personal and/or corporate income, secrecy laws on banking and few or no restrictions on financial transactions. Some ECPs have marketed their favorable tax treatment in an attempt to attract high net-worth clients seeking global tax planning. This includes countries in the Caribbean as well as several EU members, which offer a relatively more favorable tax treatment within the EU to resident firms and individuals.[8,9] However, more recently, tax havens have come under increased pressure from the OECD and the G20 to share tax and banking information to combat international tax avoidance, money laundering, and the financing of terrorism. Thus, the use of these citizenship/residency investor schemes for purposes of tax avoidance may become increasingly difficult as more advanced countries adopt anti-avoidance

[6] A Financial Times article (October 8, 2014) cites concerns about political changes, economic crises, and the pursuit of a safe haven as key motivations for Chinese citizens seeking a Golden Visa in Portugal.

[7] Chinese nationals have reportedly received 75-80 percent of Portugal's Gold Visas and 81 percent of the US EB-5 investor visas in 2013. A report by the Economist magazine (March 1, 2014) indicates that about half of the U.K.'s "economic" visas between 2009 and 2013 were granted to Chinese and Russian citizens. St. Kitts and Nevis reports similar trends.

[8] Economic citizenship programs in Cyprus and Malta as well as investor residency programs, in Bulgaria, Hungary, Ireland and Portugal, feature preferential tax treatments. For example, in 2008, Bulgaria introduced a 10% flat tax rate on all income levels, one of the lowest in the EU, while in Portugal, investor residents may enjoy tax exemptions on foreign income, including pensions, for up to 10 years, under specific circumstances.

[9] Slemrod (2008) characterizes both tax havens and citizenship programs, among others, as examples of the commercialization of state sovereignty that is more prevalent in small states where it is more difficult to raise revenues through alternative ways.

provisions in their tax legislation and enact financial transparency laws similar to the US Foreign Account Tax Compliance Act (FATCA). This has made it more difficult for US tax payers to conceal assets in offshore accounts through increased reporting requirements by foreign financial institutions.

8. The rise in demand has coincided with, or perhaps has been in response to, an increase in service providers. There are now many international firms providing legal and other services to individuals that facilitate the process of obtaining a second passport or a residency visa. These firms hold frequent conferences around the world providing a forum for discussion among interested clients and intermediaries. These firms offer comparative analysis on the relative merits of various programs, providing a rating system. Some of these firms also have close relations with ECP countries advising them on the design and administration of such programs. The Investment Migration Council (IMC), based in Geneva, was launched in October 2014 by a group of service providers to assist in setting high quality standards for their services and facilitate further growth and expansion of this industry.

9. The growth in ECP associated inflows can have large macroeconomic consequences in some small states. The inflows in St. Kitts and Nevis, and to a lesser extent in Dominica, have grown to a significant share of GDP, affecting aggregate demand and raising questions about risks to macroeconomic stability and fiscal sustainability. Other programs that were launched more recently also have sizable macro-relevant inflows. In Portugal, inflows under the Golden Visa program may account for as much as 13 percent of estimated gross FDI inflows for 2014, while in Malta total expected contributions to the general government (including the National Development Fund (NDF) and central government) from overall potential applicants, capped at 1,800, could reach the equivalent of 40 percent of 2014 tax revenues.[10]

10. Significant governance and integrity challenges have emerged in the past, causing some programs to be discontinued.[11] Risks related to international security and financial integrity are reported to have contributed to the discontinuation of citizenship programs in Belize, Grenada and Nauru after the 2001 World Trade

Table 2. Suspended Citizenship Programs

Country	Periods	Reason for Suspension
Ireland	1980s-1998	Insufficient economic benefit
Grenada	1997-2001	Security concerns after 9/11
Belize	1995-2002	Security concerns after 9/11
Nauru	1990s-2003	Security concerns after 9/11

Sources: Press reports and country authorities

[10] The number of applications that are expected to be processed and approved annually by the Malta program is estimated to be within the range of 50 to 100 per year.

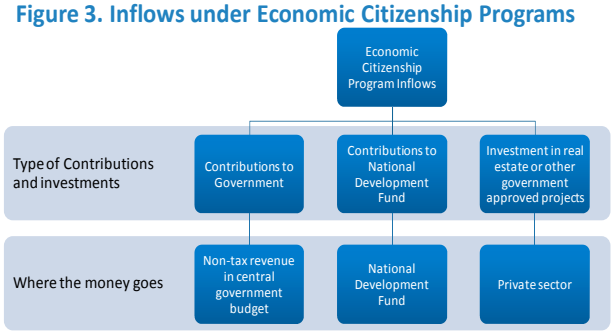
[11] Van Fossen (2007) provides an extended summary of governance and corruption issues that plagued the Pacific Islands' experience with the sale of passports through ad hoc schemes.

Center attacks.[12,13] Ireland also discontinued its ECP in 1998 and initiated a Parliamentary review which concluded that the program did not provide sufficient economic benefits to justify its reintroduction.[14] More recently, there have been reports reflecting integrity concerns regarding some programs. The Financial Crimes Enforcement Network (FinCEN) issued an advisory in May 2014 relating to concerns about the St. Kitts and Nevis program while the Canadian government imposed visa requirements on citizens of St. Kitts and Nevis in November 2014. In Portugal, investigations of the administration of the Golden Visa program have raised concerns of corruption leading to the resignation of a senior government official.[15] The rapid emergence and growth of such programs may exacerbate risks of abuse and corruption, and raise the possibility of curtailed visa-free access to advanced countries.

III. The Macroeconomic Impact of ECP Inflows

11. ECPs generate a host of inflows. Depending on the program, there are mainly three types of inflows: i) contributions to government relating to registration or application fees, as well as fees to cover processing and due diligence costs; ii) non-refundable contributions to governments or quasi-government funds (e.g. National Development Funds (NDFs)); and iii) investments in the private or public sector, which can be often sold or redeemed after a specific time horizon. Investments in the private sector are mainly in the form of real estate, but can also be in other government-approved projects. Some programs also include options for buying public debt instruments. Programs can consist of any single investment option, or a combination of two, or all three options. For example, in Dominica, until recently, the ECP only allowed for contributions to the government, while Malta's program requires contributions to general government, including the NDF, a real estate purchase/lease, and an investment in financial instruments.[16]

Figure 3. Inflows under Economic Citizenship Programs



Source: Authors.

[12] Comoros' Economic Citizenship Program was terminated in September 2013 for reasons that relate to the conduct of the program and its objectives. The paper does not discuss the Comoros program because it is materially different from other ECPs.

[13] Grenada revived its citizenship program in 2013.

[14] Notwithstanding, Ireland introduced an Economic Residency Program in 2012. A debate in the Irish Upper House of Parliament pointed to issues with the conduct of the original citizenship program.

[15] In November 2014, 11 individuals, including the head of Portugal's border agency and the president of the country's registration and notary institute, were detained with corruption allegations regarding the administration of the Golden Visa program.

[16] Malta's program requires an official sector contribution of €650,000 (70 percent of which goes to its National Development and Social Fund with the rest directed to central government), either the purchase of a residential

(continued…)

12. The macroeconomic impact of these inflows depends on the design of the program, and their magnitude and management. In small states, large ECP inflows could have significant spillovers to nearly every sector. Comprehensive data are not readily available as many of the programs have just been launched. Information on some countries, mainly St. Kitts and Nevis and Dominica, suggests a sizable benefit (Box 1). Anecdotal evidence and press reports also indicate substantial inflows in other economies (mainly Portugal). Programs with private investment options would have a direct real sector impact, particularly on the construction and real estate sector, including through the development of tourist accommodation. Contributions to the government and to the NDF, when spent or invested, could also impact the real economy. At the same time, to the extent that the contributions to the public sector are saved, they can yield measurable improvements in key macroeconomic balances, in particular the fiscal balance. The external accounts are also affected, in particular, the capital account, which would benefit from increased private capital transfers (contributions to NDFs), and FDI (ECP-related real estate investments).

Table 3. Investment Requirements of Selected Citizenship Programs 1/
(In US dollars unless otherwise indicated)

Options	Contributions and investment	Antigua and Barbuda	Dominica[2]	Grenada	St. Kitts and Nevis	Cyprus[2]	Malta
I	Contributions to Government	50,000	100,000	50,000	...	...	€ 195,000
	National Development Fund (NDF)	250,000	...	200,000	250,000	€ 2,500,000	€ 455,000
				OR			AND
II	Contributions to Government	50,000	50,000	50,000	50,000	...	...
	Private Investment	Real estate: 400,000 Business: 1,500,000	Real estate: 200,000	Real estate: 250,000	Real estate: 400,000	Real estate/ Business/ Financial instruments: €5,000,000	Real estate: €350,000 and financial investment €150,000

Sources: Country authorities.
[1] Per main applicant, amounts vary for each additional dependent across different programs.
[2] Program currently under revision.

13. Inflows under these programs are potentially volatile and particularly vulnerable to sudden-stop risks, exacerbating macroeconomic vulnerabilities in small states. The underlying asset generating such inflows is the visa free access/residency rights granted to foreign investors through the program, the potential loss of which could trigger a sudden stop. More specifically, a change of visa policy in advanced economies is a significant risk

property of at least €350,000, held for a minimum of 5 years, or the lease of a residential property with a rental of at least €16,000 per annum. In addition, an investment in financial instruments (e.g. government bonds) of at least €150,000 is required.

that can suddenly diminish the appeal of these programs and, if concerted action is taken, can even suspend their operation. Increasing competition from similar programs in other countries or a decline in demand from source countries can also rapidly reduce the number of applicants. The potential volatility of inflows can generate a host of real, fiscal, external and financial sector vulnerabilities discussed below.

Real sector impact:

14. The foremost impact of ECP investments is on the real sector, where it can bolster economic momentum. Programs with popular real estate or private investment options generate a direct positive stimulus, resembling the impulse created by a surge in FDI.[17] These inflows boost private sector activity and employment, and can, in some cases, raise growth by a substantial amount. In St. Kitts and Nevis, for example, the inflows into the real estate sector are fueling a construction boom, which has pulled the economy out of a four-year recession. Investment in the construction of new homes/units has a larger macroeconomic impact than the acquisition of existing property, which is mostly a feature of programs in European countries. Nonetheless, the rapid increase in Golden Visa residency permits in Portugal has reportedly bolstered the performance of the property market leading to a steep rise in prices of luxury real estate.[18] While the impact of new construction on employment and income would be expected to be much larger, acquisition of existing property would still make a significant contribution by supporting the real estate market, household balance sheets, and, consequently, banks' loan portfolios and collateral assets.

15. Notwithstanding the benefits, large scale investments in a small economy also pose substantial real sector risks. A large and too rapid influx of private investment through the program to finance real estate construction could also lead to wage and asset price pressures in a small state context, with potential negative repercussions to the rest of the economy. Further, the quality of new construction could decline as the result of demand pressures if regulation of real estate projects does not keep pace. This could eventually undermine the tourism sector since much of this construction, in most Caribbean countries, is related to expanding tourist accommodation, both in the form of rooms and villas.

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[17] The discussion focuses on real estate investment as it is the most common private sector investment channel in ECPs.

[18] Real estate market surveys by Confidencial Imobiliario (CI) and the Royal Institution of Chartered Surveyors (RICS) in Portugal report a substantial increase in luxury property prices in Lisbon of about 54 percent in 2013. This is reported partly in connection to the large inflow of property investments through the Golden Visa program, which has attracted a total of EUR1.11 billion since its inception in October 2012 through end-December 2014.

Fiscal sector impact:

16. ECP inflows to the public sector create significant challenges to fiscal management that are comparable to those created by natural resource revenues and external grants.

- Like other windfall earnings from abroad, ECP inflows complicate fiscal management. The increase in government ECP revenues can reduce the fiscal deficit to the extent it is not spent, but their economic impact differs from that of a tighter fiscal policy since they do not reflect any contractionary impact on domestic activity. Hence, fiscal policy can be more expansionary than a given fiscal balance would suggest, leading to a more expansionary path even when the fiscal balance has improved.
- Another key concern is fiscal reliance on volatile and difficult-to-forecast ECP revenues, which could lead to sharp fiscal adjustments, if and when the inflows diminish. As in resource rich countries, these inflows can easily lead to relaxing fiscal discipline, and could be used to substitute taxes (creating incentives to reduce rates and/or increase exemptions), slacken efforts to improve tax administration, and increase current and capital spending, leading to unfavorable dependency and higher risks of overheating.
- NDF funded by ECP inflows can further distort the measurement of public sector activity and also contribute to fueling excess domestic demand. In many instances, the NDFs operate independently, supporting quasi fiscal activities, while not reporting their revenues, expenditure, and public investment. In addition to their macroeconomic impact, this can result in dual investment budgeting, leading to fragmented and uncoordinated public investments, redundancy, and the funding of marginal projects.

External and financial sector impact:

17. ECP flows can also increase external vulnerabilities. A large increase in aggregate demand, whether generated by an increase in private or public spending of ECP inflows, will increase imports, particularly in small open economies, which generally have high import content. With the bulk of the inflows coming through the capital account (NDF contributions and private investments), the increased level of imports may more than offset the initial improvement in the current account generated by ECP fiscal receipts. The higher current account deficit and the overreliance on ECP inflows for balance of payments financing may weaken external stability and magnify the risk of sharp balance of payment adjustments if ECP flows diminish. Moreover, macroeconomic overheating may generate shifts in the real exchange rate, negatively impacting the country's external competitiveness over the long run.

18. Large ECP inflows can also adversely impact financial stability in small states. ECP funds can generate an expansion in monetary aggregates, particularly as the government

accumulates savings from the ECP in the form of deposits with the domestic banking system.[19] While some increase in liquidity may be welcome, large inflows of ECP-related deposits in small state economies may present new financial risks, reflecting the banking systems' limited and undiversified options for credit expansion. Risks to financial stability may be magnified under a higher-than-optimal expansion in the construction and real estate sectors that raises concerns over long term sustainability. In such cases, a sudden stop of ECP inflows might prompt a correction in the property market, which could have implications for bank balance sheet quality, particularly if prudential regulations to monitor bank lending, collateral quality and system exposures are lacking during the boom phase.

Governance and regulatory challenges:

19. The governance challenges of ECPs are critical to the broader macroeconomic picture given the risk they create to the sustainability of these programs. Cross-border security risks associated with the acquisition of a second passport are likely to be the main concern of advanced economies. A decision to preclude such risks through canceling visa-free privileges to holders of these passports will wipe out the earning potential of the ECP country and deliver a negative shock to its economy.[20] Reputational risks are also magnified since weak governance in one country could easily spillover to others as advanced economies are less likely to differentiate between different ECP countries. In addition, poor or nontransparent administration of the programs and their associated inflows, within the individual program countries, could lead to the emergence of strong public and political resistance that could complicate, or even terminate, these programs. These challenges, if not properly addressed, pose a significant risk to the continuity of these programs.

IV. Managing Macroeconomic Risks of ECP Inflows

20. Appropriate macroeconomic policies can reduce and contain risks created by large ECP inflows in small economies. The earlier discussion identified key macroeconomic risks and vulnerabilities triggered by these inflows. This section will discuss policy options that can mitigate these adverse implications while allowing small economies to capitalize on the possible benefits. A prudent macroeconomic management framework will involve elements of prudential regulation together with a robust fiscal framework designed to save the bulk of the contributions to the public sector, to ensure macroeconomic stability and fiscal sustainability. Measures will also be needed to contain external risks and safeguard the financial system. Finally, establishing a strong governance framework and transparency will be critical to preserving the integrity and sustainability of these programs.

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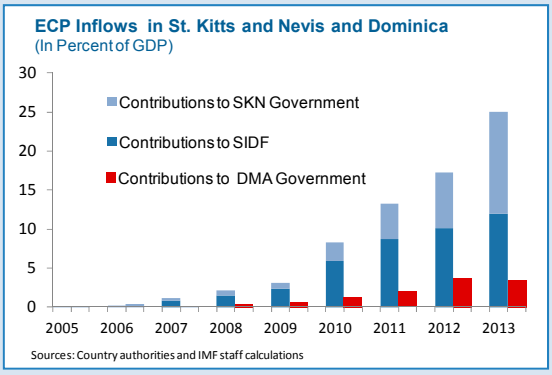
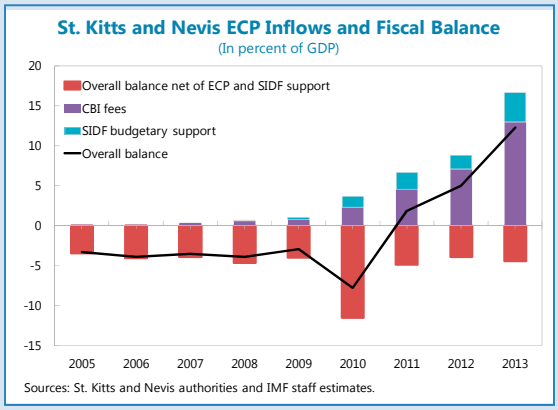
[19] In countries where there is no national central bank, as is the case in the East Caribbean Currency Union states, where many ECPs are active, governments hold significant deposits in the domestic banking system.

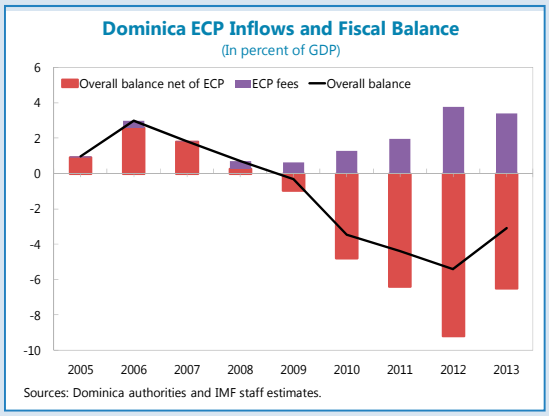
[20] The loss of visa-free access to all native citizens is an additional cost, increasing travel impediments to all nationals, including higher risk of refused entry.

Box 1. Economic Citizenship Program Inflows in Two Small States

Inflows under existing Economic Citizenship Programs (ECPs) have been significant in some small states. St. Kitts and Nevis' and Dominica's ECPs, established in 1984 and 1993 respectively, are among the oldest programs in the world. Inflows under these programs experienced a surge starting 2010. ECP receipts, in the form of fees to the budget increased from less than 1 percent of GDP in 2008 to an estimated 13 and 3.4 percent of GDP in St. Kitts and Nevis and Dominica, in 2013, respectively. Moreover, in St. Kitts and Nevis, there are further ECP inflows to the NDF, the Sugar Industry Diversification Foundation (SIDF), estimated at about another 12 percent of GDP in 2013, in addtion to inflows to the private sector for real estate development.

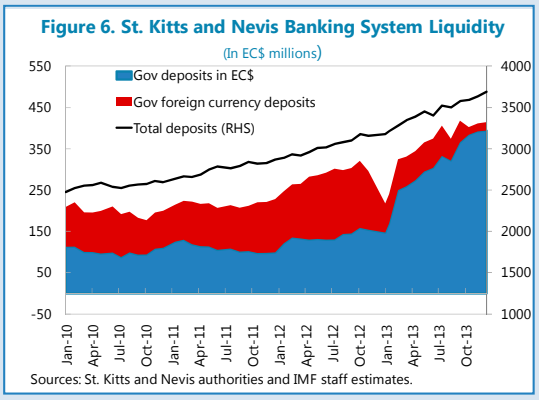






Differences in the size of inflows are reflected in their economic impact in the two countries. Benefiting from much higher ECP inflows, St. Kitts and Nevis was able to save a large share of ECP receipts and SIDF income, while still accommodating support to the budget of about 5½ percent of GDP (including SIDF transfers to the budget). At end-2013, the accumulated central government deposits were about 20 percent of GDP and additional SIDF assets were estimated at 25 percent of GDP. In Dominica, ECP receipts have provided an important source of funding for the authorities to implement their budget priorities.

The strong ECP inflows in St. Kitts and Nevis have supported economic recovery, improved key macroeconomic balances and boosted bank liquidity. These inflows have benefited real estate and tourism developments, and fueled a pickup in construction. The fiscal balance has substantially improved to a surplus of about 12 percent of GDP in 2013, notwithstanding an increase in total spending of about 2 percent of GDP. The external account has also strengthened and bank liquidity increased substantially. However, the strong accumulation of deposits from ECP inflows has complicated liquidity management in the domestic banking system in light of the limited and undiversified domestic investment opportunities.



Containing the risk to the real economy:

21. ECP flows should be used to support macroeconomic activity without generating overheating pressures or unsustainable dependency. In recessions, ECP inflows may help stimulate the economy and support the overall recovery. This is particularly pertinent given the still weak growth dynamics in the Caribbean and Europe where many of the new citizenship and residency programs have been launched. Inflows can also generate a positive adjustment in potential output—through expanding capacity in tourist-type accommodation in tourism dependent countries like the Caribbean states. However, economies operating closer to their potential may be at greater risk of adverse economic pressures and possible distortions to their property markets. Thus, inflows should be managed dynamically in line with the business cycle.

22. Prudent fiscal policy can play an important role in moderating the expansionary impact on the real economy but it may need to be complemented with prudential regulation. The majority of countries with citizenship and residency programs are part of currency unions, with restricted use of monetary policy as a macroeconomic policy lever.[21] Thus, the burden of macroeconomic management will largely lie on fiscal policy. While a conservative fiscal stance will avoid exacerbating overheating pressures, mainly by containing the fiscal expansion financed from ECP revenues, the use of prudential regulation can more effectively mitigate risks to the real economy by directly regulating the pace of inflows to the private sector. Regulatory measures can include annual caps on ECP applications or ECP approved investments so as to limit a too rapid and distortionary influx of investments to the construction sector.

23. An effective regulatory framework should also seek to limit distortions in incentives for capital accumulation and prevent the emergence of rigidities in domestic property markets. Because the acquisition of the passport may distort market-based incentives for ECP-funded investments, additional oversight and regulation may be needed to preclude investments of suboptimal economic value or inadequate quality. In contrast to regular FDI, where investment decisions are based strictly on competitive rates of return, and contribute to economic efficiency, investors in ECP-funded projects may be willing to invest at less favorable rates or may acquire assets for more than their intrinsic value as the result of the inclusion of the acquisitions of a passport/residency permit in their investment decision. Investment projects undertaken under such circumstances may thus face sustainability issues (e.g. by expanding hotel capacity beyond market potential, or by building lower quality facilities). In addition, ECP requirements of a minimum investment value may create

[21] Antigua and Barbuda, Dominica, Grenada and St. Kitts and Nevis are part of the Eastern Caribbean Currency Union, which operates under a quasi-currency board arrangement. Cyprus and Malta are members of the Euro Area. The bulk of the countries offering Economic Residency Programs are also part of the Euro Area.

segmentation and rigidities for the existing stock of real estate assets, mainly through introducing a floor for the pricing of eligible properties as well as triggering shifts in demand across different market segments. Prior appraisal of ECP target properties together with the careful regulation of ECP-related construction may help limit distortions to price and demand dynamics in the real estate market, preserve the quality of developments and ensure the expansion in tourist capacity is consistent with the tourism strategy, where such exists.

24. Modifying the design of an ECP is another option to help pace inflows to the private sector and mitigate their distortionary impact on the real estate market. This could be achieved by raising the relative cost of investment through the real estate route, to tilt the composition of inflows toward the public sector, where inflows could be saved for future sustainable use.[22] Alternatively, other program options may be introduced like investing in new private business development, which could help spread the inflows to other economic sectors, without creating excessive pressures in the construction and real estate sectors. In the case, where by design, the government (or the public sector) would be the main beneficiary, the task of fine-tuning the fiscal impulse to take account of the economic cycle is made simpler and eliminates issues related to distortions in the real estate market. However, when all or most inflows are directed to the public sector it may be more difficult to achieve certain macroeconomic objectives, like increasing private sector employment or expanding tourism capacity. This may also reinforce public sector dominance, which is already prevalent in many small states, and it may encourage inefficient allocation of resources, through an increase in spending on less efficient public sector projects.

Containing the risk to the fiscal sector:

25. An appropriate medium-term fiscal framework focused on sustainability is critical to the optimal management of ECP inflows. Akin to economic management models of resource-rich economies, such a framework would be designed to insulate the budget from revenue windfalls, which could lead to a too rapid and an unsustainable increase in current and capital expenditure, through building buffers by saving the inflows and reducing public debt, where debt is already high. This would contain risks to the budget from the volatility of these inflows, especially in the case of a sudden stop scenario. And as noted above, containing public sector spending of the windfall revenues would also be the key policy lever to minimize demand pressures created by large ECP inflows. At the same time, the strategy would provide scope to support public investment in a sustainable manner, and accommodate countercyclical spending and relief measures in the case of natural disasters.[23]

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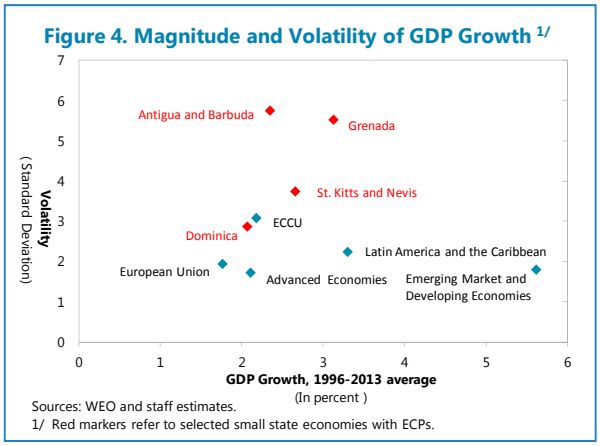
[22] Examples of such programs include the original program in Dominica, which featured the government as the sole beneficiary of ECP inflows with no private sector or real estate development options. Also, in Malta, at least 70 percent of total contributions go to the public sector.

[23] This would not preclude the concept of saving for intergenerational equity, but it may be premature to consider this as an objective in itself.

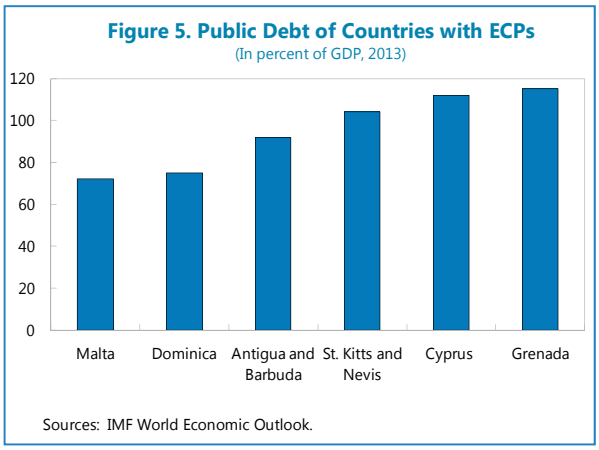
26. The fiscal framework should be anchored by the fiscal balance, net of ECP receipts. As in resource rich economies, the overall and primary fiscal balances provide only partial information as they do not reveal the extent to which the fiscal position is improved by the external revenue windfall, providing inadequate information about the direction and sustainability of fiscal policy, and its impact on the economy. Hence, where ECP flows are significant, the non-ECP primary and overall balances would offer a more accurate reflection of the change of the fiscal impulse, akin to the role of non-oil fiscal indicators in anchoring fiscal policy in oil producing countries.[24]

27. Critical elements of a sustainable fiscal framework include a strategy that would target the accumulation of savings while accommodating a somewhat higher level of public investment.

- ***Building sufficient fiscal buffers should be a priority.*** Small state economies are extremely vulnerable to a range of exogenous shocks, such as external developments in key economic partners, commodity price fluctuations and natural disasters. As a result, they face high volatility in economic growth and fiscal revenues, well above the world average. The recent experience during the global financial crisis together with the series of shocks triggered by natural disasters could help estimate optimal precautionary buffers for small state economies (Box 2).



- ***Reducing high public debt, in highly indebted countries, to sustainable levels.*** This is particularly relevant as, in some cases, the debt service cost on some of the public debt can exceed the potential rate of return on savings.[25] Reducing debt could lessen the negative impact of the debt overhang on growth, expand borrowing capacity, and improve the fiscal balance. Tradeoffs between increasing savings and reducing debt



[24] Both measures should be presented in the fiscal accounts. For further information, see Medas and Zakharova (2009), IMF working paper (WP/09/56).

[25] This may not be true for countries where debt is mostly concessional and where large deficits in infrastructure may allow for an overall investment return that is higher than cost of debt.

depend on the cost of debt, the return on saved assets, institutional capacity to manage a growing financial wealth and sound debt management principles (IMF, 2014).[26] Other factors may include the need for a certain level of sovereign debt instruments to promote financial market development, and provide investment and liquidity management instruments for domestic financial institutions and social security funds, which face very limited investment options in small states.

- ***Supporting higher public investment without jeopardizing macroeconomic stability.*** Recent literature demonstrates that, in credit-constrained, capital-scarce developing economies, productive domestic capital spending could yield higher returns than foreign investments (including by an SWF), and should also be considered as part of an optimal strategy to manage a resource revenue windfall.[27] This should be done through a sustainable investment approach—where a combination of raising public investment and saving some of the resources in a stabilization fund to support ongoing maintenance is used to preserve investment efficiency.[28] A conservative scaling-up schedule for public investment that is consistent with both development needs and macroeconomic conditions would allow for saving some of the revenue windfall in a stabilization fund. It would be critical to avoid an overly large and rapid scaling up of public investment which could lead to more instability, lower investment efficiency, and higher risk of exchange rate pressures. The magnitude of domestic investment should be assessed within a broader macroeconomic context, taking into account the impact on long-term growth and fiscal sustainability.[29]

28. The critical challenge for a sustainable fiscal framework will be to operationalize these principles. Commitment to increasing buffers, reducing debt, and supporting a judicious increase in public investment will be fruitless if it cannot be translated into practical strategies. A comprehensive, yet simple and transparent, framework to guide savings and spending decisions would be instrumental in implementing the above strategy (Box 3).

29. The existence of an NDF funded by an ECP could further complicate fiscal policy design and implementation. As noted, autonomously functioning NDFs could lead to an inaccurate interpretation of the fiscal stance and fiscal impulse (Box 4). To minimize risks of intensifying demand pressures and funding of low-priority public investment projects, the role of NDFs should be carefully defined. All revenues should be channeled through the

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[26] See IMF Paper (2014), "Sovereign Asset-Liability Management-Guidance for Resource-Rich Economies".

[27] Takizawa et al. (2004), Venables (2010), van der Ploeg and Venables (2011), and Araujo et al. (2012)

[28] For example, in Grenada, proposed guidelines for investment operations funded by ECP resources require that spending on a project be undertaken only after sufficient funds are secured to finance the project to completion and through its maintenance over the medium-term.

[29] The sustainable investment approach, introduced by Berg et al (2012), suggests that the magnitude of scaling up public investments should be aligned with the explicit financing needs to maintain the capital stock and, thus, needs to be capped to the degree that it will not require a distortionary fiscal adjustment later to cover recurrent costs of maintaining capital.

national budget and support for public investment and social projects should be in full coordination with the government's policy objectives, within the context of a unified budget and public investment program. This would allow for comprehensive accounting of the nation's earnings, a more accurate reflection of the "true" fiscal activity, and a more optimal allocation of resources. It should also provide for transparent accounting of ECP flows to the public sector, including how they are being used (Box 5). For example, Grenada's Fund program includes a structural benchmark that would require it to consolidate ECP funded NDF operations as part of the government accounts and clarify their relationship with the budget (Box 6).

Box 2. Optimal Stabilization Buffers—the Case of St. Kitts and Nevis

Estimating stabilization buffers from ECP revenues is complicated by difficulties in projecting ECP flows. In resource-rich economies, methods like Value-at-Risk or DSGE model-based approach are used to estimate the optimal balance in the stabilization fund or the "buffer", which provides insurance against potentially large cyclical developments and negative shocks with a high degree of confidence. However, these models require long-term data series and forecasts of resource revenue volatility, which are not readily available for ECP inflows (IMF, 2012). This box provides a simple and illustrative framework to estimate the optimal size of precautionary savings in ECP countries, using St. Kitts and Nevis as an example.

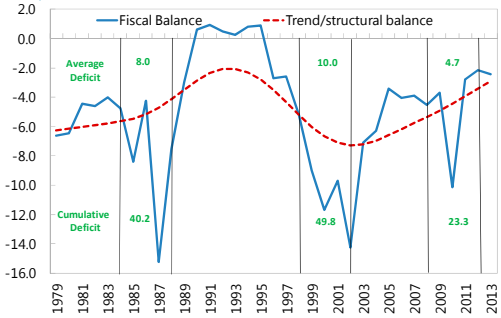
Fiscal Balance Net of ECP (1979-2013)
(In percent of GDP)

	Overall Balance	Cyclical Component 1/
Mean	-4.9	0.0
Standard Deviation	4.1	3.2
Maximum	0.9	3.7
Minimum	-15.2	-10.5

Sources: St. Kitts and Nevis authorities and staff estimates.
1/ HP filter with frequency at 100.

An adequate precautionary buffer for St. Kitts and Nevis may be between 20 to 50 percent of GDP:

- **Coverage of cyclical developments suggests a minimum buffer of about 20 percent of GDP.** The long term average fiscal balance, net of ECP receipts, over the past three decades (1979-2013) is about -5 percent of GDP, with the standard deviation of around 3 percent of GDP using the HP filter, reflecting both cyclical factors and natural disaster shocks. A buffer that is large enough to accommodate a three to five-year business cycle with a two standard deviation negative shock would require savings of about 19 to 32 percent of GDP.



Sources: St. Kitts and Nevis authorities and staff estimates.

- **Evidence of historical large negative shocks suggests a larger buffer may be warranted.** There are three historical episodes, i.e. 1984-1988, 1998-2002 and 2008-2012, during which the economy endured several large hurricanes, compounded by external shocks such as the September 11, 2001 attacks and the recent global financial crisis.[1] The cumulative fiscal deficit for each of those periods, of about 40, 50 and 23 percent of GDP, respectively, would provide an upper bound of the stabilization needs for similar events in the future.

[1] Including four large hurricane events, i.e. Hurricane Hugo in 1989, Hurricane Georges in 1998, Hurricane Lenny in 1999, and Tropical Storm Omar in 2008.

Box 3. Illustrative Guidelines for Building and Utilizing ECP Fiscal Buffers

The medium-term fiscal framework would aim to build precautionary balances from ECP budgetary receipts, while accommodating some acceleration in public investment and permitting withdrawals for stabilization and exceptional needs. The fiscal framework would be based on medium to long-term macroeconomic modeling reflecting a range of assumptions regarding inflows and economic growth, and it would provide guidance for withdrawals to meet cyclical budgetary shortfalls and exceptional spending needs, guided by notional limits. The fiscal projections would be anchored by the non-ECP primary balance consistent with the government's medium-term public debt objective.

- ***Budgetary support and saving accumulation:*** A critical feature would be establishing a norm for the budget, to allow some expansion in public investment, consistent with macroeconomic stability. This norm would be based on historical ECP inflows, and the government savings objective. If the ECP is new, budget support should be a fraction of a conservative projection of ECP inflows, so that the bulk of the windfall would be saved to build buffers and limit the potential for a weakening in the fiscal position should inflows remain modest or suddenly diminish. The norm should be periodically reviewed, and revised down when inflows substantially decline.
- ***Savings drawdown for stabilization:*** These could be for revenue shortfalls or an increase in spending on the social safety net or on stimulative packages during an economic downturn. The underlying principle is that saving drawdowns should cover temporary rather than permanent budget gaps, to prevent a build-up of unsustainable fiscal reliance on ECP revenues. While it may be difficult to distinguish between cyclical and long-term developments, the drawdowns should be time bound, which would help ensure that longer-term developments are addressed by structural measures. For example, the norm could specify financing for a revenue shortfall in the first year, say 80 percent, 60 percent in the second year, and 30 percent in the third year. This norm would also depend on the magnitude of the accumulated assets. The key is that ECP savings should not be used to finance discretionary policy decisions such as an increase in tax concessions or a reduction in the VAT, or cover an unexplained shortfall in revenues, which should be compensated by other measures.
- ***Savings drawdown for exceptional spending:*** In case of a natural disaster, precautionary balances would be available for salvage and reconstruction efforts. Even in these exceptional circumstances, withdrawals should be capped to avoid rapidly depleting the savings fund. The response to a natural disaster could, for example, encompass a withdrawal to cover 100 percent of the fiscal cost related to natural disaster relief and reconstruction but not exceeding a set share of the fund's total assets to ensure accumulated savings are not exhausted in a single shock. For the durability of this arrangement, the cap should be based on a consensus view and reviewed periodically.
- ***Savings drawdown for large public investment/infrastructure projects:*** A share of the savings could be used to support exceptional public sector infrastructure projects, where there are ample funds to also cover ongoing maintenance costs. The social and economic return of the project should be rigorously evaluated against return benchmarks to ensure the project is financially viable and that its return exceeds the opportunity cost of the invested funds.[1] Moreover, the substantial increase in capital spending should take into consideration the underlying macroeconomic momentum, to avoid contributing to overheating and growing cost pressures.

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[1] See World Bank Policy Research Working Paper: "Sovereign Wealth Funds and Long-term Development Finance—Risks and Opportunities", February 2014.

Box 4. Treatment of ECP Inflows in Fiscal Accounts

The surge of ECP inflows has created a new revenue stream that needs to be accurately reflected in the fiscal accounts: These recommendations are in line with best practices.

- **Application fees**, in line with the 2001 Government Finance Statistics Manual, should be recorded transparently in government budgets as non-tax revenue**.** These are revenues earned on account of providing this asset, of which a small part reflects fees-for-service, covering the cost of government processing, due diligence, etc. Similarly, government spending to deliver the latter services should be identified transparently in expenditures, under goods and services.
- **Contributions to National Development Funds** are public sector revenues that should also be booked in government accounts when they are first received. Such payments should be recorded transparently and recognized as increasing government's earning capacity. The mechanism in some existing programs, whereby these contributions go directly to NDFs rather than being channeled through the budget, means that the full stream of income to government is not fully captured. In general, best practice would be to record all contributions to government directly in the budget, and then channel them to be spent (or saved) in line with government priorities, as direct government expenditure or—in the case of NDFs, for instance—as budget transfers to off-budget agencies.
- **Inflows to the private investor** will affect public finances to a much lesser extent. The main channel will be through an increase in stamp duty for the transfer of real estate assets. Notwithstanding the small fiscal impact, records of the size of private sector transactions should be maintained by the government, so that their impact on activity and on the balance of payments can be fully understood. Other fiscal impact will be through the increase in income tax (from construction companies and real estate agents) and personal income tax (from construction workers).

Containing risks to the external and financial sector:

30. Careful monitoring of external sector developments will be needed to reduce the risk of the emergence of unsustainable imbalances. Large ECP inflows can contribute to significant widening of the current account deficit. Absent the option to adjust the exchange rate, as is the case in most small state economies, the country's foreign exchange reserves may come under pressure in a sudden stop scenario, particularly if the deterioration was mostly the result of higher spending on consumer goods imports.[30] The proposed ECP management framework, which would manage and regulate inflows to private sector and contain the expansion of public sector spending, should limit wage pressures and the expansion in consumption spending, which, in very open small states, would otherwise deeply worsen the current account. This would help reduce shifts in the real exchange rate that could have broader implications for external competitiveness and lead to unfavorable external sector dynamics. On the other hand, the pick up in capital goods imports in response to large inflows of ECP-funded foreign direct investment is less alarming as this is less likely to create persistent imbalances. More generally, prudent accumulation of foreign exchange

[30] Most small states have inflexible exchange rate regimes. "Microeconomic Issues in Small States and Implications for Fund Engagement", IMF, February 20, 2013, Pg. 29

reserves from ECP inflows should act as a buffer and help smooth the impact of balance of payments shocks, including those emerging from a slowdown in ECP receipts.

31. Heightened financial sector oversight is critical to maintaining financial system stability. As the ECP resources make their way through the system, bank balance sheet exposures need to be carefully monitored to safeguard against the emergence of weak credit standards or significant currency or maturity mismatches. This is particularly relevant as ECP beneficiaries, including the government and real estate developers, rapidly accumulate deposits in the system. While this will improve bank liquidity, the small size of the economies, and limited lending opportunities will put pressure on bank profitability and asset liability management. This may also manifest itself in a sizable increase in NFA as banks seek alternative channels for investment.[31] In this context, strengthening prudential regulation will be important to preserve banks' financial soundness indicators. This should include regular stress testing of individual banks and more frequent onsite inspections. Macroprudential policy tools, like caps on credit growth, restrictions on foreign currency loans or simply tighter capital requirements, may also be needed to dampen the pro-cyclical flow of credit. These together with a well-coordinated economic management policy should help mitigate systemic risks arising from the rapid influx of resources to the financial system.

32. Investing ECP-related fiscal savings abroad would enhance financial stability, and help preserve the quality of invested assets. Implementing the recommendations of the proposed framework may result in substantial growth of government deposits in the domestic banking system, where no national central bank exists. Investing the bulk of these savings abroad under a formalized investment framework would ease the profitability pressures at domestic banks and safeguard their balance sheets against maturity and currency mismatches. Additionally, the savings will not be exposed to the same idiosyncratic risks, which would help the government to tap these assets swiftly in the event of large shocks, like natural disasters, without creating pressures on the domestic banking system. Equally important, the quality of invested assets is more likely to be preserved through a more comprehensive investment process, which should ideally be subject to a prudent governance framework, and adequate oversight of regulatory and legislative bodies. We discuss features of such investment framework in the following section.

[31] In St. Kitts and Nevis, net foreign assets of the commercial banking system increased almost six folds since 2010 to reach around 70 percent of GDP in 2014.

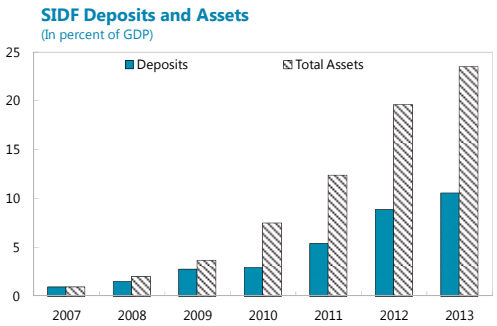
Box 5. The Sugar Industry Diversification Foundation in St. Kitts and Nevis

The Sugar Industry Diversification Foundation (SDIF) is one example of a National Development Fund (NDF) that is a beneficiary of ECP inflows. As part of the ECP reform program involving external consultants, the SIDF was established in 2006 as an independent foundation, funded by contributions from the ECP, to support the development and diversification of the economy away from the sugar industry, by providing training and conducting research. Its focus was expanded in 2011 to include support to the Government's efforts to diversify the economy and maintain stability, and to finance or undertake the development of new and existing industries, projects or enterprises. Benefiting from the recent surge in ECP inflows, SIDF's income increased substantially from less than 1 percent of GDP in 2007 to an estimated 12 percent of GDP in 2013, and accumulated assets were estimated at about 24 percent of GDP at end-2013. Of these, about half (11 percent of GDP) were cash and deposits in domestic banks, and the rest invested in loans, bonds and equities. Meanwhile, its expenditure grew modestly until 2013, when it surged due to increases in grants to Government and others.

SIDF Operations
(In percent of GDP)

	2007	2008	2009	2010	2011	2012 est	2013 est
Income 1/	0.9	1.5	2.4	5.9	8.7	10.1	11.9
Expenditure 1/	0.1	0.3	0.8	2.5	3.4	2.8	9.0
Investment proceeds to Gov.	0.0	0.0	0.0	1.0	0.7	1.5	1.7
Capital grants to Gov.	0.0	0.1	0.3	0.4	1.4	0.2	4.0
Grants to others 2/	0.0	0.1	0.2	0.8	0.5	0.1	2.4
Other expenditure 3/	0.1	0.2	0.2	0.3	0.8	0.9	0.9
Surplus	0.8	1.2	1.6	3.4	5.3	7.3	2.9

Sources: St. Kitts and Nevis authorities and staff estimates.
1/ Net of Processing and due diligence fees.
2/ Including electricity and airlift subsidy, support to PEP and other social programs.
3/ Administrative cost, including marketing fees, management fees and other spending.



Sources: 2007-2011 data from SIDF financial statements, 2012-2013 from authorities and staff estimates.

The SIDF provides budgetary support and undertakes direct social spending, which have had a sizeable impact on economic activity. Its budgetary support consists of investment proceeds and capital grants, which totaled about 5.7 percent of GDP in 2013. Moreover, SIDF directly funds a variety of social programs, as well as targeted economic programs. The former includes training activities for unemployed and young graduates, while the latter includes electricity and airlift subsidies. The SIDF also supports subsidized credit activities through the banking system by providing zero interest deposits, which are leveraged by banks to provide targeted credit facilities at lower-than-market rates. The total amount of these facilities was about 1.5 percent of GDP by end-2013, which would generate subsidies of about 0.05 percent of GDP per year.

SIDF Direct Social and Economic Spending
(In Percent of GDP)

Direct Support	**2010**	**2011**	**2012**	**2013**
Training activities	0.0	0.04	0.0	1.7
Airlift Support	0.4	0.2	0.0	0.0
Electricity Subsidy	0.0	0.0	0.0	0.7
Totals	0.4	0.24	0.0	2.4

Sources: SIDF and staff estimates.

A comprehensive picture of public sector revenues and expenditure in St. Kitts and Nevis needs to consider the consolidated accounts of the Central Government and the SIDF. The consolidated accounts show substantially stronger revenue, expenditure and a higher overall balance. In 2013, SIDF's income net of flows that are already incorporated into the budget—investment proceeds and capital grants—would have boosted non-tax revenue from 19 to 25 percent of GDP, fiscal expenditure would have been higher by about 3-3.5 percent of GDP, and the fiscal surplus would have increased from 12 to 15 percent of GDP. More importantly, the consolidated accounts show a very rapid increase in total spending. The need to integrate the operations of autonomous NDFs, like the SIDF, under a comprehensive fiscal framework is thus critical.

Consolidated SIDF and Central Government Account
(In percent of of GDP)

	2010	2011	2012 est	2013 est
Total Revenue and Grants	**34.7**	**43.2**	**44.3**	**52.2**
Government	30.2	36.6	36.0	45.9
SIDF 1/	4.5	6.6	8.3	6.3
Total Expenditure	**38.8**	**36.1**	**32.0**	**36.9**
Government	37.8	34.8	31.0	33.6
SIDF 1/	1.1	1.3	1.0	3.3
Total Overall Balance	**-4.2**	**7.1**	**12.3**	**15.2**
Government	-7.6	1.8	5.0	12.3
SIDF	3.4	5.3	7.3	2.9

Sources: St. Kitts and Nevis authorities and staff estimates.
1/ Net of investment proceeds and capital grants to the budget.

Box 6. The National Transformation Fund in Grenada

Grenada launched a Fund-supported program in June 2014 that includes conditionality on the operations and governance of the **National Transformation Fund (NTF)**. The NTF is an off-budget NDF funded by ECP applications. The NTF is owned by the government, but governed by an independent Board of Directors that consists of both public and private sector representatives. [1, 2] The NTF is allowed to transfer funds to the government for arrears repayment and investment projects. These will be recorded as grants in the fiscal accounts of the central government. The remaining resources will be managed independently by the public-private Board.

Governance of the NTF. The authorities have committed to approve stand-alone regulations for the NTF to: clarify its relationship with the budget; enhance government oversight and ensure the integrity of the program through rigorous reporting requirements and comprehensive institutional, governance and investment frameworks (a structural benchmark under the Extended Credit Facility (ECF)). In addition, the recently revised public financial management legislation also provides for transparency of NTF operations by requiring consolidated reporting of public accounts, including special funds such as the NTF, and external audits. Inflows into and investments by the NTF will also be reported to Parliament and made public every six months.

Management of NTF resources. To ensure that NTF funds are managed judiciously to avoid an unsustainable scaling up of public investment that could undermine the fiscal position or macroeconomic stability, the NTF regulations will include policy guidelines on the use of NTF resources and require rigorous project evaluation and selection. This includes budgeting of projects only after sufficient funds are secured to finance the project to completion and its maintenance over the medium-term. Both the NTF and the budget will be required to report on how NTF-financed capital spending complies with these criteria.

[1] Grenada's ECP features either a donation to the NTF or investments in the private sector (real estate or other government approved projects). Under either option, applicants pay a fee to the government.

[2] The Board includes the Chairman of the ECP committee, a representative of the Ministry of Finance, a representative from the Attorney General's Chambers and two members from the private sector chosen by the Minister of Finance.

Addressing the governance and regulatory challenges:

33. Perhaps the most critical challenge is preserving the credibility of ECPs to ensure their sustainability. A rigorous due diligence process for citizenship applications is essential to mitigating potentially serious integrity and security risks**.** All applications should be subject to strong oversight and comprehensive background checks, including establishing a risk profile to identify and assess the criminal background of the applicant. The program should make it clear, by law, that certain criminal convictions are grounds for refusal of the application. Additionally, a comprehensive AML/CFT framework needs to be set in place to curtail the use of investment options as routes for money laundering and financing criminal activity.[32] Building sufficient capacity to implement these safeguards is integral to the success of the overall ECP management framework.

[32] See IMF policy paper (February 2014); "Review of the Fund's Strategy on Anti-Money Laundering and Combating the Financing of Terrorism".

34. A high level of transparency regarding ECP applicants will enhance program reputation as well as sustainability. This could include making publically available a list of newly naturalized citizens. More generally, complying with the OECD's Global Forum on Transparency and Exchange of Tax Information, including its peer review, and strengthening international cooperation, particularly with the applicant's country of origin or residence, will facilitate the verification process, reduce the incidence of program misuse for purposes of tax evasion or other illicit activities, minimize the risks of adverse international pressure and safeguard program continuity.[33] Countries with similar programs should enhance collaboration among themselves to raise the standards for oversight and ensure suspicious applicants are singled out. This is particularly critical since granting citizenship to undesirable candidates in one country risks tarnishing the reputation of all such programs. Collaboration between ECP countries could also try to limit a possible race to the bottom, given competition in a relatively homogenous market of ECPs, particularly in the Caribbean. While some of the measures intended to reduce tax avoidance and increase transparency may temporarily hurt the attractiveness of ECPs, they would strengthen their reputation and sustainability over the long term.

35. A clear governance and accountability framework for the management of the program and its inflows should help establish and maintain the support of the national populace. Since the granting of citizenship is a privilege earned by birth, descent or a selective immigration process, the public should expect to share in the benefit of conferring such a privilege on a selected few on the basis of economic considerations. In other words, the economic benefit should accrue to the nation as a whole and should be viewed as a national resource that indeed may not be renewable if the nation's good name is tarnished by mismanagement. Consistent with this, countries should adopt a clear and transparent accountability framework for the management of both ECPs and the resources earned through them. National Funds that receive ECP resources should have a clearly defined accountability framework in their relevant legislation, charter, or management agreement. More generally, the number of citizenships granted, the amount of revenues earned, and their use, including the amounts saved, spent or invested, should be subject to financial audits, and be publicly available at regular intervals. All agents involved in the process, including financial and non-financial institutions (e.g. immigration agents and real estate developers), should be effectively supervised to ensure that the risk management systems in place are not bypassed. The relevant governance body should ensure that passports are obtained within the official program arrangement and that the program is properly designed to eliminate any potential integrity issues that could imperil its continuity.

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[33] The OECD's Global Forum on Transparency and Exchange of Tax Information conducts a two-stage peer review of (i) whether a country's legal framework complies with international standards; and (ii) the implementation of this framework.

V. Institutional and Operational Framework for Saving

36. Appropriate management of ECPs, combined with their growing popularity, could lead to a relatively rapid accumulation of savings by the public sector requiring the adoption of a framework to manage the accumulated assets. Small states have access to a number of investment channels to manage large foreign exchange savings. These can be managed as an investment account at the central bank to capitalize on the existing institutional framework and asset management expertise of the country's own central bank or monetary authority.[34] This should help minimize fees and avoid expensive long-term investment management contracts. Countries can also benefit from the asset management and advisory services of the Bank for International Settlements or the World Bank Treasury.[35,36] The primary benefit of these options is that they involve a conservative investment strategy focused on maintaining the value of the investment rather than maximizing returns, while providing for relatively strong governance in the management of these resources.

Table 4. Summary of Potential Investment Channels for SWFs in Small State Economies

Investment Channels	Benefits	Considerations
A Central Bank-managed Investment Account	– Existing expertise and established investment and risk management frameworks. – High accessibility and less time consuming to set up. – Management costs are likely to be lower than external managers.	– Investment returns are likely to be commensurate to these earned on the general central bank reserve account.
World Bank Treasury-Reserve Advisory and Management Program	– Broader asset management experience. – Established methodology and standard investment guidelines. – Targeted technical assistance to build domestic capacity for investment monitoring and management. – World Bank mission to assess best investment strategy.	– Management fees may be higher than the central bank, lowering net nominal returns – Minimum portfolio size is US$100 million. – Cap on size of managed portfolio of about 20 percent of international reserve balance.
Bank for International Settlements (BIS)	– Investment in a broader asset pool under a specific investment mandate or in an open-end fund (BIS investment pool).	– only accessible through an account with the central bank or monetary authority.

Sources: IMF and World Bank

[34] This is also true for countries in currency unions, which may be able to make arrangements with their regional central banks.

[35] The World Bank has a minimum threshold of US$100 million for managing external assets. It also provides external asset management and comprehensive training services to official sector clients aimed at helping them build domestic capacity to monitor and manage external investments.

[36] Another option may be an account at the Federal Reserve Bank of New York, which offers correspondent and custodial banking services to international monetary authorities.

37. If ECP flows persist and grow, countries could consider establishing a Sovereign Wealth Fund (SWF) to manage the saved revenues optimally. An SWF helps to ring-fence ECP generated resources, separately from the wider pool of foreign exchange reserves, which should help define the size of primary reserve buffers and protect savings from significant rundowns over time. An SWF can also strengthen fiscal management by reinforcing and enhancing the implementation of the fiscal framework through formalizing saving and withdrawal rules, which would strengthen the management of ECP revenues in the budget. The creation of an SWF could also help build a stronger governance framework and provide for higher level of accountability and transparency of the management of the inflows. Finally, it can help generate a higher return on saved resources by mobilizing them out of very liquid government deposits. While the majority of SWF revenues are resource based, there are also SWFs with initial endowments sourced from current account surpluses (China, Korea and Singapore) or external grants (Marshall Islands, Micronesia and Palau). The experience of several small island countries that have established SWFs to manage their highly volatile revenue and grants may be particularly instrumental for establishing ECP-funded SWFs in small state economies (Box 7).[37]

Table 5. SWFs in Small Island Countries

Name	Inception	Objectives	Source	Value 1/	
				USD mil	% of GDP
Kiribati Revenue Equalization Reserve Fund	1956	Stabilization; Savings	Resource and Budget surplues	613	**350**
Papua New Guinea Mineral Resources Stabilization Fund 2/	1974-2001	Stabilization; Savings	Resource	N.A.	**N.A.**
Tuvalu Trust Fund	1987	Stabilization; Savings	Grants	123	**345**
Tonga Trust Fund	1988	Stabilization; Development	Sale of passports; lease of satellite space	N.A.	**N.A.**
Palau Compact Trust Fund	1994	Budgetary Self-reliance	Grants	149	**64**
Marshall Islands Compact Trust Fund	2004	Budgetary Self-reliance	Grants	166	**96**
Micronesia Compact Trust Fund	2004	Budgetary Self-reliance	Grants	255	**78**
Timor Leste Petroleum Fund	2005	Stabilization; Savings	Resource	11768	**187**
Trinidad and Tobago Heritage and Stabilization Fund	2007	Stabilization; Savings	Resource	4500	**18**

Sources: IMF Article IV reports and Le Borgne and Medas (2007), IMF WP/07/297.
1/ As of end-2012.
2/ A new SWF being introduced in Feburuary 2012, will be operational in 2014.

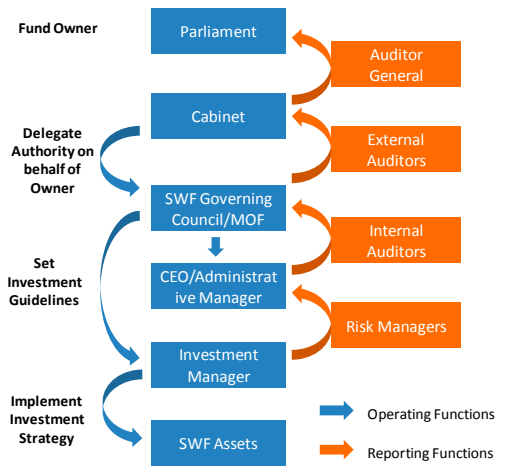
[37] See Le Borgne and Medas (2007) for more information on Pacific Island Countries' experience with SWFs.

38. The sustainability of the inflows and the burden of establishing and managing an SWF are critical considerations. Establishing and managing an SWF in a small-state economy may prove challenging in light of the limited institutional capacity in many countries and the significant costs relative to the expected fund size. These costs may be even more disproportionate to the potential benefits if the inflows prove temporary and unsustainable, which is particularly relevant given the highly unpredictable nature of ECP inflows. Thus, it may be a necessary prerequisite to amass a critical level of savings that represents a significant share of GDP, given the small size of these economies. Moreover, the building of such savings would provide a basis to suggest that the fiscal framework is sufficiently robust to sustain the operations of an SWF. Further, the operational burden of an SWF and the potential capacity constraints can be partly overcome by establishing it as a separate government account, rather than a separate legal entity with its full organizational structure. A more streamlined structure is particularly important in a small state context and that would imply reliance on available human resources and the existing administrative system (at the ministry of finance and the central bank).

39. A comprehensive SWF framework should consider integrating the operations of existing NDFs. Economies that already have Trust Funds or Development Funds that are being financed from ECP revenues could either use such funds as the basis for an SWF or integrate their operations with a newly established SWF under a broader fiscal framework. This would allow a consolidation of the public sector's financial assets, a more transparent accounting of the total fiscal earnings from ECPs, and a coordinated system of investment budgeting and prioritization.

40. A clear governance and accountability framework needs to be developed within the chosen organizational structure of the SWF.[38] The Government should typically appoint a governing council, or, in the case of a streamlined structure, a steering committee within the Ministry of Finance, to oversee the management of the SWF. The council or the committee, will be responsible for setting the strategic objectives, investment guidelines, and risk limits, and will also oversee the operational management of the Fund. The day-to-day management would be the responsibility of a CEO or, in the case of a government account, an administrative manager who would oversee the investment

Figure 6. Typical Governance Structure of Autonomous SWFs



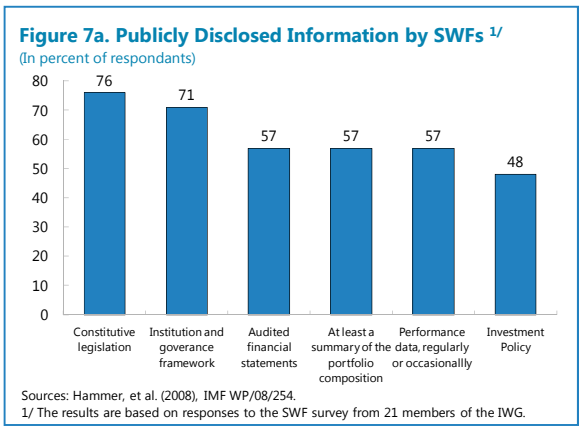
Sources: Authors.

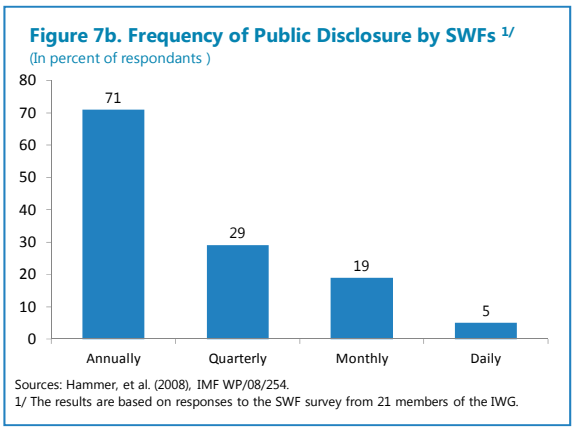
[38] For more information on the governance and operational framework of SWFs, see Hammer et al (2008).

risk and monitor asset management operations at the central bank. The chain of responsibility should be governed by an accountability framework which needs to be clearly defined in the relevant SWF legislation, or in the MOF regulatory guidelines for the SWF investment account. Autonomous SWFs, or the MOF in the case of less autonomous Funds, should be clearly accountable to Parliament on all matters relating to the Fund such as the revenues, withdrawals, changes to investment strategy, investment risks and costs.

41. Prudent operational guidance, sound investment guidelines and a clear transparency policy will help the SWF gain and maintain broad political and social consensus. Operational guidelines, including saving and withdrawal rules, should be carefully designed to ensure the SWF meets its objectives. Detailed investment guidelines, set in coordination with the selected investment manager of the fund, should also ensure SWF investments are confined to appropriate levels of risk. Meanwhile, transparency in the SWF's management and its operation would provide the basis for earning public trust and safeguarding the SWF's credibility, especially in the early days of its existence.[39] The annual report and financial statements should also be prepared and audited in a timely fashion and in accordance with recognized international or national accounting standards and the Santiago Principles.[40] A legal and institutional framework aligned with best international practices should successfully incorporate these elements.

42. If an SWF structure is not feasible, the government should endeavor to implement equally prudent standards of governance and transparency in managing saved resources. The level of outstanding ECP resources and the magnitude of accumulation and drawdown should be adequately and timely disclosed by both the government and the central bank. Financing deficits through ECP resources should be also clearly identified along with compensatory policy measures to stem the depletion of accumulated savings.





[39] Trinidad and Tobago's Heritage and Stabilization Fund is one example of SWF that attracted broad social support and is highly valued by its society.

[40] See International Working Group of Sovereign Wealth Funds, 2008, Sovereign Wealth Funds: Generally Accepted Principles and Practices (GAPPs) 11 and 12.

Box 7. Lessons from SWFs in Pacific Island Countries

The Pacific Island Countries (PICs) have a relatively long history in managing SWFs, offering mixed lessons. The more successful ones are those well integrated with the budget process, operated within a sound fiscal framework, with clear and flexible operational rules and strong institutions.

Links to the budget process. Timor-Leste and Kiribati SWFs are the most integrated with the budget. Timor-Leste's fund functions as a financing fund and is part of the broader fiscal framework used for financing the non-oil balance. Most of the other PICs' funds have complicated the budget process. The Marshall Islands and Micronesia funds operated outside of the budget during the initial period, which contributed to a depletion of usable cash reserves and gave rise to borrowing needs when these countries were facing weak fiscal positions. The disappointing performance of the Papua New Guinea's (PNG) and Nauru's SWFs were the result of the funds' objectives being inconsistent with the fiscal policies being followed. In PNG, while SWF assets grew from 3 percent of GDP in 1990 to nearly 9 percent of GDP in 1998, public debt soared—rising by more than 30 percentage points of GDP over the same period, and the government eventually used the fund assets to repay debt and closed the fund.[1] In general, the PICs' funds have avoided extra-budgetary activities. However, in some cases, the assets of the funds have been used as collateral for government borrowing with little or no oversight (Tonga, Marshall Islands, PNG, and Nauru).

Clear operational rules with flexibility. Some PICs have anchored their funds' withdrawal rules on sustainable income in order to address long-term sustainability concerns, while allowing for some flexibility for stabilization purposes. In Timor-Leste, withdrawals from the fund are linked to a sustainability benchmark for the non-oil deficit with operational flexibility to allow withdrawals to exceed the guideline with parliamentary approval. On the other hand, SWFs that operated under more rigid rules have caused some countries to contract expensive short-term debt and/or accumulate arrears. For example, the operational rules of the Marshall Islands and Micronesia Compact Trust Funds did not allow disbursements prior to FY2023, with caps on withdrawals afterwards, leading to an increase of public debt even though the SWF continued to accumulate assets. In the case of PNG and Tonga, the operational rules of the funds were breached or had to be changed.

Strong governance and transparency. Most PICs' SWFs have a clearly defined governance structure with detailed roles and responsibilities of the governance body, management team and advisory committees while transparency in oversight and reporting are limited in most countries. Only Timor-Leste and Tuvalu consistently publish annual reports. Marshall Islands and Micronesia have stringent quarterly reporting requirements but the reliability of the information has been questioned. Other funds (e.g., Kiribati, PNG, and Tonga) do not provide information to the public on a regular or consistent basis, and in most cases the information provided does not allow a proper assessment of fund performance adversely affecting the credibility of these funds.

Proper Investment guidelines. PICs' investment strategies have varied, particularly regarding risk. Some of the new funds (Timor-Leste, Marshall Islands, Micronesia) have, in the first stage, adopted investment strategies similar to those followed for managing foreign exchange reserves held for prudential reasons. Others funds have adopted a more aggressive strategy based on investments concentrated in specific asset classes—e.g., Nauru's asset portfolio was mostly invested in lumpy real estate projects, while Tonga's portfolio consisted entirely of investments in three U.S. companies operating in the life insurance, energy, and internet sectors. The undiversified strategies, together with mismanagement, and the use of assets as leverage for borrowing, resulted in large financial losses.

Sources: Le Borgne, E., and P. Medas, 2007, "Sovereign Wealth Funds in the Pacific Island Countries: Macro-Fiscal Linkages", IMF Working Paper No. 07/297.

[1]A new fund was introduced in February 2012 and is expected to become operational in 2015.

VI. Conclusion

43. ECPs create potential benefits, but also risks, in particular for small states. Inflows under these programs can be very substantial, with their impact widely felt across all economic sectors. They can significantly boost private sector investment and economic activity in small states, many of which are still recovering from the repercussions of the 2008/09 financial crisis. They can also increase fiscal revenues, and contribute to improving the overall fiscal performance. However, if not managed carefully, these inflows will lead to similar challenges that have confronted resource-rich economies for decades, including possible boom-bust cycles and loss of external competitiveness. Moreover, the high sudden stop risk of these inflows poses even a greater challenge than the high volatility associated with resource revenues.

44. Prudent management of the program and the associated financial inflows can contain these risks while allowing countries to profit from their positive impact. Critical measures include monitoring and regulating the inflows into the private sector to ensure that the magnitude of the inflows is consistent with economic absorptive capacity to contain price pressures. The bulk of fiscal revenues should be saved, to alleviate excessive demand pressures, and to prevent the buildup of fiscal dependence on these inflows. ECP-generated savings can be channeled into precautionary balances to help these countries deal with exogenous shocks—which small states are significantly more vulnerable to—and more rapidly reduce high levels of public debt. Scaling up public investment in a sustainable manner may also increase potential growth, but projects should be subject to careful screening to ensure they deliver sufficiently positive economic and social return, and that they are consistent with macroeconomic sustainability. Finally, prudent management should carefully address governance and integrity risks through ensuring a rigorous due diligence process, a strong AML/CFT framework and a transparent administration of the program.

45. Establishing an SWF, to manage large ECP fiscal savings, could further strengthen fiscal management and safeguard financial stability while providing for the potential to enhance returns on accumulated savings. If done in line with best practices, an SWF would reinforce a strong governance framework in the management and the investment of saved resources, and increase transparency. This could raise the credibility of ECPs within the host nations, improve prospects for better management of the inflows and allow for the future sustainable use of these resources for the benefit of the citizens of the host country.

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APPENDIX 1

Table A1. SWFs in Pacific Island Countries

Country	Name	Inception	Objectives	Revenue Sources	Withdrawal Rules
Kiribati	Revenue Equalization Reserve Fund	1956	Stabilization and savings. Maintain the 1996 real per capita value of the Fund (guideline since 1996)	Phosphate revenue (exhausted in 1979), budget surpluses, and investment income	Discretionary transfers to the budget.
Marshall Islands	Compact Trust Fund	2004	Help achieve budgetary self-reliance as US grants to the budget set to expire by 2023	Mainly US grants along with a Marshall Island initial contribution. Taiwan agreed in May 2005 to provide US$40 million in contributions to the Fund	In 2024 and thereafter, the income revenue from the previous year can be transferred up to a limit equivalent to the annual grant assistance in 2023 (in real terms). Prior to 2024 no disbursement is allowed and the Fund's assets cannot be used as collateral.
Micronesia	Compact Trust Fund	2004	Help achieve budgetary self-reliance as US grants to the budget set to expire by 2023	US grants (grants are increasing over a 20 year period after which they stop) along with a contribution from Micronesia	Same as above
Nauru	Phosphate Royalties Trust Fund	1968	Long-term fiscal sustainability in anticipation of the exhaustion of phosphate resources	Phosphate revenue	At the discretion of the Board of Trustees.
Palau	Compact Trust Fund	1994	Help achieve budgetary self-reliance as US grants to the budget expired in 2009	US grants	Withdrawals of up to US$5 million inflation-adjusted per year from 2000 to 2009; and US$15 million inflation adjusted per year from 2010 onwards.
Papua New Guinea	Mineral Resources Stabilization Fund	1974 (closed in 2001) 1/	Stabilization	Mineral revenue	The managers of the fund provide recommendations on the annual levels of disbursements that are sustainable for five years. The Board's recommendation on the amounts to be transferred to the budget would not vary by more than 20 percent, although the Minister of Finance had the option to vary the amounts by an additional 10 percent.
Timor Leste	Petroleum Fund	2005	Long-term fiscal sustainability and inter-generational equity	All petroleum revenue (i.e., includes revenue emanating directly or indirectly from petroleum resources) and investment income	Withdrawals from the Fund can exceed a "sustainable income" (as defined by law) under certain conditions and subject to Parliamentary approval. Total transfers in a fiscal year cannot exceed a ceiling set by parliament as part of the approval of the budget.
Tonga	Tonga Trust Fund	1988	Accumulate reserves for use in exceptional circumstances and for major development	Sale of Tongan passports to foreigners; revenue from lease of Tongan satellite space	Unknown
Tuvalu	Tuvalu Trust Fund (TTF)	1987	Maintain the real value of the fund's principal in perpetuity (using the Australian CPI). Help smooth budgetary revenue volatility	Donors and Tuvalu transfers to the TTF. A secondary account, Consolidated Investment Fund (CIF), receives transfers from TTF.	A distribution from the Tuvalu Trust Fund to the CIF is only possible when the market value of the fund exceeds the maintained value, being the real value as measured by the Australian CPI. Withdrawals from the CIF are at discretion of the Ministry of Finance, although there is a Target Minimum Balance (16 percent of the maintained value of the TTF).

Sources: Le Borgne, E., and P. Medas, 2007, "Sovereign Wealth Funds in the Pacific Island Countries: Macro-Fiscal Linkages", IMF WP/07/297.

1/ A new fund was introduced in February 2012 and is expected to become operational in 2015.