

SECURING SUSTAINABILITY

NAURU'S NEW INTERGENERATIONAL
TRUST FUND AND BEYOND

ROLAND RAJAH

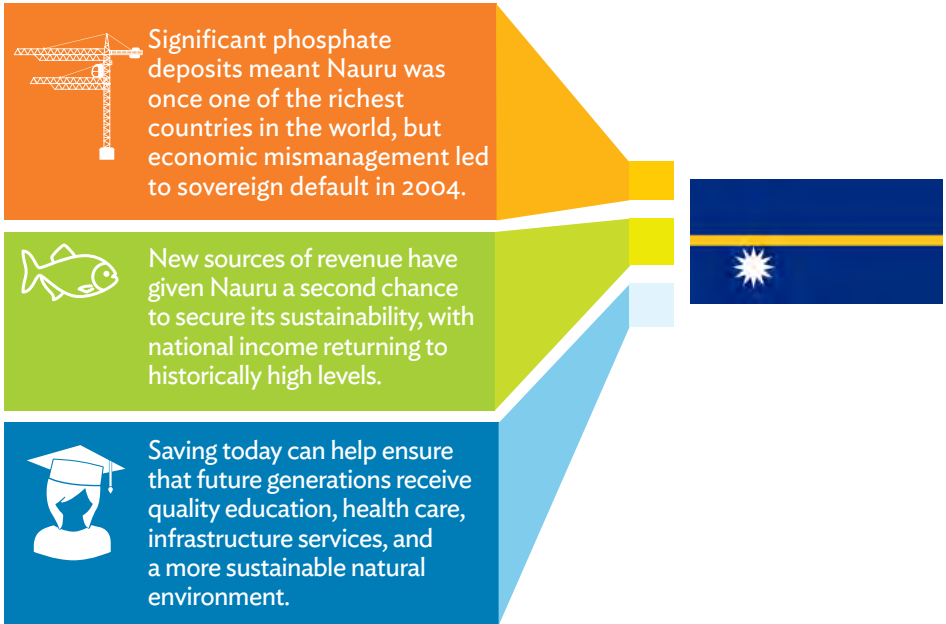
KEY FINDINGS AND RECOMMENDATIONS

Nauru is experiencing an economic boom, but its newfound income is unlikely to last forever. To protect some of this income for future generations, the Government of Nauru has established the Nauru Trust Fund (NTF).

This brief introduces the NTF and its key design features. It recommends that the government should increase its savings in the NTF, and compliment this with reforms to improve fiscal transparency and the quality of public spending.

COUNTRY PROFILE

Nauru is the world's smallest island country.



CONTENTS

- 5 Introduction
- 5 A History of Boom and Bust
- 6 A Second Chance for Sustainability
- 9 The New Nauru Trust Fund
- 11 Saving Windfall Income and Growing the Revenue Base
- 12 Sustainable financing for the future
- 13 Outsourcing good governance
- 14 Securing sustainability: the need for further reform
- 15 Priority 1: Establishing a sustainable fiscal strategy
- 17 Priority 2: Complementary public finance reforms
- 19 Conclusion

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As a remote and isolated microstate, Nauru has few opportunities to drive sustainable economic development.

INTRODUCTION

Nauru's history of boom and bust is commonly seen as a precautionary tale of both unsustainable mining and the failure of poorly managed public trust funds. Today, however, Nauru is again in an economic boom, presenting it with an important second chance to secure its economic future.

With technical assistance from the Asian Development Bank (ADB), the Government of Nauru and its key bilateral donors have established a new Sovereign Wealth Fund (SWF) to help promote fiscal sustainability: the Intergenerational Trust Fund for the People of the Republic of Nauru (referred to simply as the Nauru Trust Fund or NTF).¹ This policy brief introduces the NTF, discusses its key design characteristics, and outlines a forward agenda to build on this achievement.

The NTF is a critical first step. However, Nauru's sustainability challenges are stark, as it has again become heavily reliant on highly uncertain, and ultimately finite, revenue streams. To secure a more sustainable future, the NTF will need to be embedded within a more comprehensive and sustainable fiscal strategy and complemented by the continuation of broader reforms to strengthen public finances.

A HISTORY OF BOOM AND BUST

As a remote and isolated microstate, Nauru has few opportunities to drive sustainable economic development. In the early 1980s, it was one of the richest countries in the world on the back of its state-run phosphate industry. Sustainability was rightly a key concern and several public trust funds were established to save temporary windfalls for the future, under the umbrella of the Nauru Phosphate Royalties Trust (NPRT).²

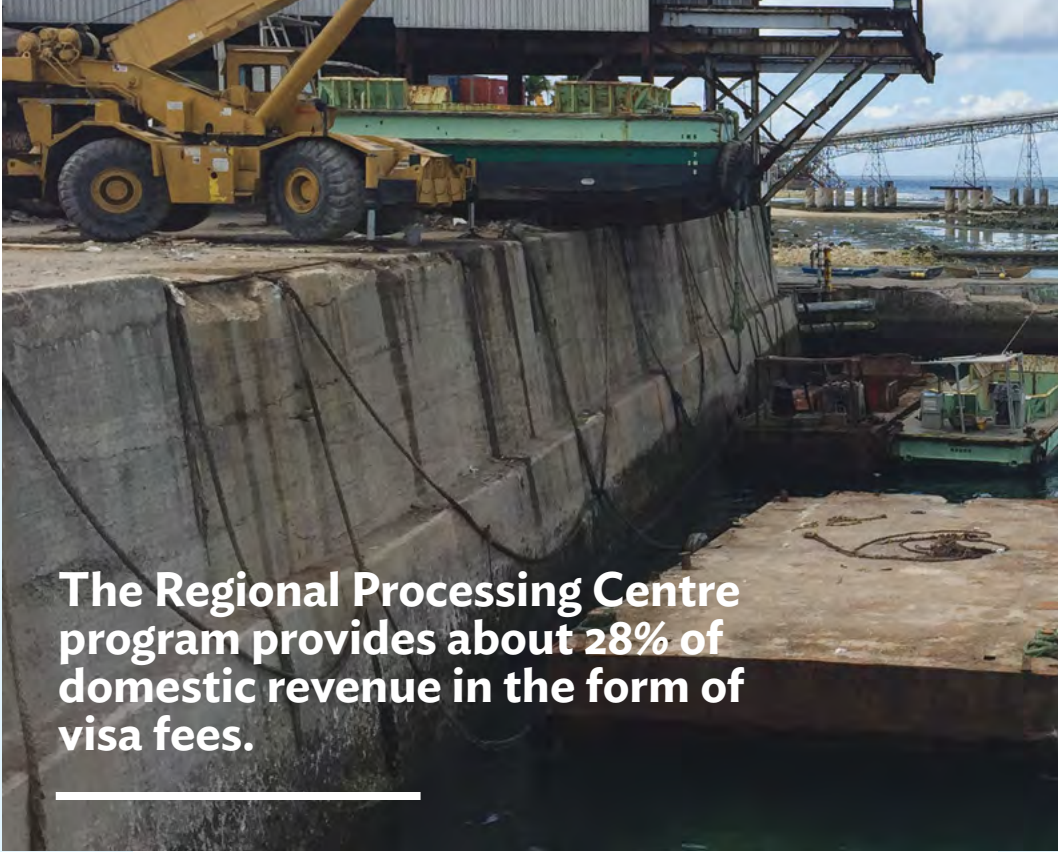
Relatively little is known about the NPRT, reflecting its nontransparent governance and weak managerial arrangements.³ However, it is clear that the trust was badly mismanaged and had a history of poor investment decisions.⁴ The NPRT had an estimated value of A\$1.5 billion in 1990. Upon entering receivership in 2004, its value was estimated at only A\$100 million (footnote 3).

¹ The NTF was legally established through the signing of a memorandum of understanding between the governments of Nauru and Australia in November 2015. It was declared an international organization under Australian law in February 2016, and began operation in May 2016.

² The NPRT held four separate funds: (i) the Long Term Investment Fund, (ii) the Land Owners Royalty Trust Fund, (iii) the Housing Fund, and (iv) the Rehabilitation Fund.

³ ADB. 2005. *Trust Funds in the Pacific: Their Role and Future*. Manila.

⁴ One of the most frequently cited examples is an investment that was made of A\$3 million in a failed West End musical, which was cowritten by one of Nauru's foreign financial advisors.



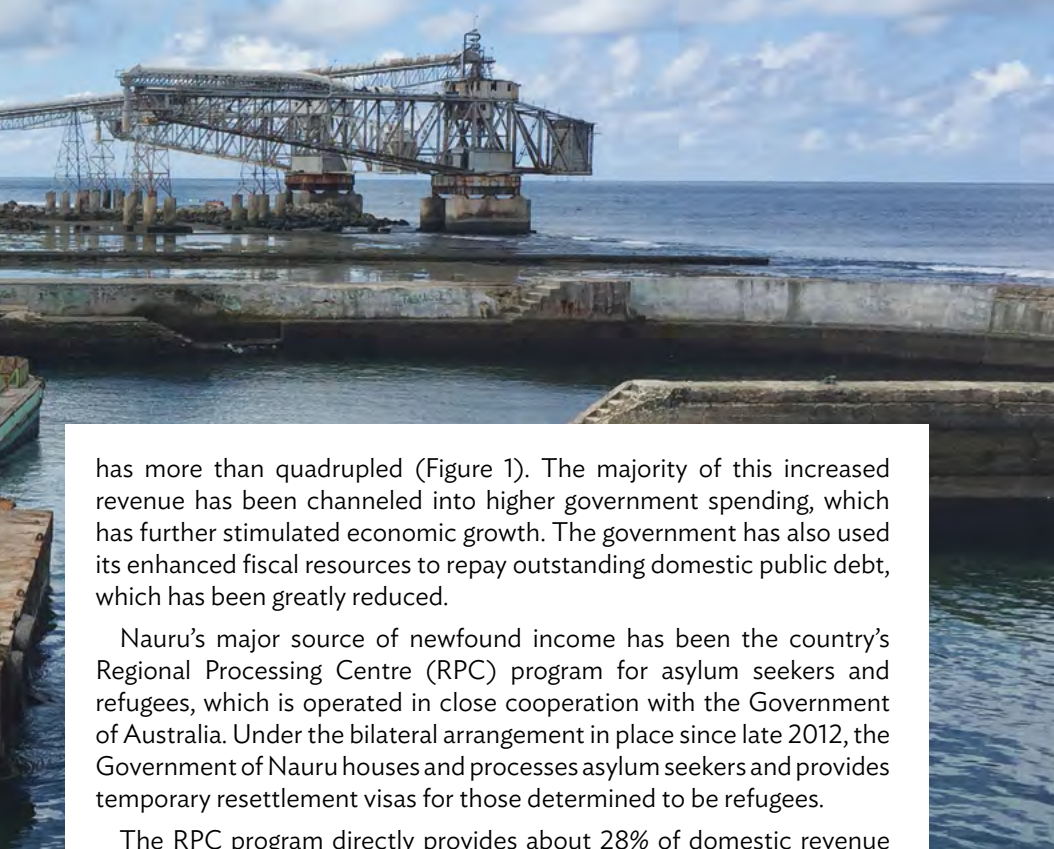
The Regional Processing Centre program provides about 28% of domestic revenue in the form of visa fees.

The poor design and management of the NPRT also interacted deleteriously with broader fiscal mismanagement. This included extensive borrowing against the trust's assets to fund recurring budget deficits. At the same time, government spending was directed largely toward consumption rather than investment purposes. Spending on education and training was very low. By the late 1990s, Nauru found itself increasingly in economic crisis, culminating in sovereign default in 2004.

A SECOND CHANCE FOR SUSTAINABILITY

Recently, Nauru has once again been in the midst of an economic boom. Since FY2012, the economy and government finances have benefited enormously from new sources of windfall income.⁵ These have displaced phosphate as the primary driver of Nauru's economy. Existing national account figures are of limited reliability. However, the economy is estimated to have expanded by around 17.3% per year from FY2012 to FY2016. Meanwhile, government domestic revenue

⁵The fiscal year (FY) of the Government of Nauru ends on 30 June. "FY" before a calendar year denotes the year in which the fiscal year ends, e.g., FY2016 ends on 30 June 2016.



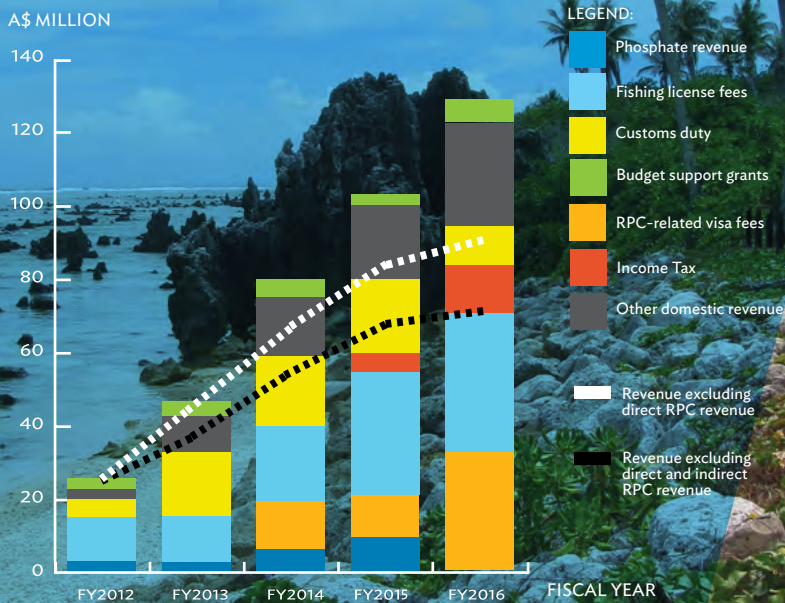
has more than quadrupled (Figure 1). The majority of this increased revenue has been channeled into higher government spending, which has further stimulated economic growth. The government has also used its enhanced fiscal resources to repay outstanding domestic public debt, which has been greatly reduced.

Nauru's major source of newfound income has been the country's Regional Processing Centre (RPC) program for asylum seekers and refugees, which is operated in close cooperation with the Government of Australia. Under the bilateral arrangement in place since late 2012, the Government of Nauru houses and processes asylum seekers and provides temporary resettlement visas for those determined to be refugees.

The RPC program directly provides about 28% of domestic revenue in the form of visa fees for asylum seekers and refugees paid for by the Government of Australia. However, the indirect revenue contribution of the RPC is also substantial due to its significant impact on Nauru's economic activity. This includes a boom in construction activity, the presence of numerous foreign contractors and service providers, significant local employment at elevated wages, increased air passenger traffic, and higher demand for imported supplies. Indirect RPC-related revenue could amount to a further 15%–20% or more of domestic revenue, particularly through increased customs duties and income taxes. Increased air passenger traffic has also provided a significant financial boost for the state-owned airline.

Nauru has also enjoyed record revenues from issuing licenses to fish in its territorial waters. This reflects improved regional coordination under the Vessel Day Scheme of the Parties to the Nauru Agreement and strong global market conditions. Fisheries revenue has more than tripled since FY2012 and now accounts for about 30% of domestic revenue. By contrast, phosphate mining has become an increasingly marginal source of income. The sector is in structural decline as remaining primary deposits are almost fully depleted while the mining of secondary deposits is yet to begin and faces uncertain prospects.

FIGURE 1: NAURU HAS EXPERIENCED A SURGE IN DOMESTIC REVENUE, BUT NOT ALL OF IT IS SUSTAINABLE.



Source: ADB estimates based on figures provided by the Nauru Department of Finance and Economic Planning.

The arrival of new windfall income has been very beneficial for current living standards, but it has again exposed Nauru to sharp fiscal sustainability concerns. In particular, RPC-related revenue accounts for half, or more, of total domestic revenue. It is likely to be relatively short-lived and, of equal concern, could cease or wind down unexpectedly.⁶ The current operational RPC arrangement is underpinned by a 5-year agreement with the Government of Australia that will expire in 2019. Although there is the potential to extend the agreement, this remains uncertain, and in any case it is not expected to continue indefinitely.

Even to the extent that the RPC program remains in place, the level of RPC-related activity remains uncertain and faces downside risks that could severely impact the government budget. Direct RPC revenue for visa fees depends on the number of asylum seekers and refugees on the island. This is not expected to increase, and risks falling should refugees be relocated to other countries for permanent resettlement, which is the intention of the RPC program. Similarly, indirect revenues are sensitive to the level of RPC-related activity and also face significant downside risks.

Highlighting these risks, in November 2016 the Government of Australia announced a prospective deal that would see refugees currently in Nauru permanently resettled in the United States.⁷ Expectations are that the deal could see around a third of refugees currently in Nauru resettled in the United States. However, significant uncertainties remain around the pace and scale of any implied reduction in RPC-related activity and its associated revenues.

Revenue from fishing licenses also presents some challenges for sustainable fiscal management. Fishing license revenue can be difficult to predict from year to year, though the Vessel Day Scheme has gone some way toward mitigating this. Moreover, the ability to sustain revenues at such levels in the long run remains uncertain, and depends on factors such as global market conditions and the continued success of regional fisheries cooperation. While phosphate revenues are currently depressed, should mining of secondary deposits deliver significant additional revenue in the future, this would also have to be carefully managed, given its finite and uncertain nature.

THE NEW NAURU TRUST FUND

Intergenerational equity and fiscal sustainability dictate that a significant portion of such windfall revenue should be saved for the future. Future generations should benefit from today's temporarily high income, while

⁶ The RPC first began operation in 2001. In 2007, a change in the policy of the Government of Australia led to the RPC's closure. The RPC was reopened in September 2012.

⁷ ABC News. 2016. Malcolm Turnbull, Peter Dutton Announce Refugee Resettlement Deal with US. 13 November. www.abc.net.au/news/2016-11-13/australia-announces-refugee-resettlement-deal-with-us/8021120

government spending needs to be kept at a broadly sustainable level to avoid the risk of experiencing a “fiscal cliff” should key revenue streams cease or fall significantly.

The NTF was established for this purpose. The objective of the NTF is to build up a sufficient principal value that can provide a future stream of budget financing to support investments in education, health, environment, and public infrastructure. The fund is financed by annual contributions from both the government and its key bilateral donors—the governments of Australia and Taipei,China. The NTF was capitalized in 2016 with an initial contribution totaling A\$30.7 million (equal to about 20% of gross domestic product [GDP]), with A\$20.4 million from the government and a total of A\$10.3 million from development partners (Australia; Taipei,China; and ADB). The NTF has a target principal value of A\$400 million.

The NTF will operate under an initial buildup phase, currently set at 20 years, during which no withdrawals from the fund are allowed. The long investment horizon is intended to help the NTF



Future generations should benefit from today's temporarily high income.

realize higher returns by allowing the pursuit of a growth-oriented investment strategy during the buildup phase. As determined by the NTF's governing committee, the fund will then enter a distribution phase whereby regular transfers will be made to support the state budget, while seeking to preserve the real value of the fund in perpetuity.

SAVING WINDFALL INCOME AND GROWING THE REVENUE BASE

Government transfers to the NTF during the buildup phase are governed by a specified "contribution rule." A minimum percentage of domestic revenue must be transferred to the fund each year, with the rate rising progressively with the level of domestic revenue to as high as 8% when domestic revenue is A\$90 million or more (in FY2016 constant Australian dollars). This structure is designed to promote intergenerational equity since fluctuations in domestic revenue tend to reflect fluctuations in windfall income. Allowances are made to postpone, reduce, or forgo annual contributions in



the event of external shocks outside of government control, subject to agreement by the NTF governing committee.

No contribution is required if domestic revenue is A\$24 million in constant FY2016 Australian dollars or lower, a level similar to annual domestic revenue in the years prior to FY2012. Yet a small contribution (at least 2% of domestic revenue) is required as long as domestic revenue is above this minimal level. The NTF contribution rule, therefore, requires some saving even in the absence of windfall income. The opportunity cost of saving in relatively lean years, in terms of deferral of government spending, is high when compared with saving during boom years. This opportunity cost must be compared with the financial returns that can be realized through investing in the NTF. As an isolated microstate with limited scope for sustained economic growth, pursuing financial returns through investing in the NTF provides a viable and sustainable strategy for Nauru to grow its revenue base in the absence of new sources of windfall revenue.

Bilateral donors intend to make regular annual contributions during the buildup phase, currently expected at around A\$5.2 million per year. While these funds are generally not additional to existing bilateral grant allocations to Nauru, diverting grants to the NTF is appropriate for the same reasons cited above justifying government saving. The government is also seeking other bilateral donors to contribute to the fund.

SUSTAINABLE FINANCING FOR THE FUTURE

Once the NTF enters the distribution phase, annual budget financing will be made available. To preserve the value of the fund, the size of the transfer will be capped at a specified percentage of the 3-year moving average of the principal value. This distribution percentage is to equal the fund's estimated real long-run annual rate of return (net of operating costs) less a yet-to-be-determined "sustainability gap."

The government will be required to submit to the NTF committee a program and budget setting out how the distributed funds will be used. The NTF committee will determine the size of the distribution, and whether the program proposed by the government is in line with the NTF's stated purpose.

The distribution policy balances the need for stable budget financing with the desire to safeguard the real value of the fund. Setting an

appropriate “sustainability gap” will be critical. Importantly, while there is policy flexibility to distribute less than the sustainable amount, there is no flexibility to exceed it—a relatively strong constraint relative to other SWF arrangements in the region.⁸

OUTSOURCING GOOD GOVERNANCE

As a result of the lessons from past mistakes, significant provisions have been made to ensure strong governance structures and professional fund management. This is effectively achieved through a significant outsourcing of both decision making and fund management.

Domestically, the Nauru Trust Fund Act 2012 authorizes the government to establish the NTF. However, the fund itself is established through memorandums of understanding between the government and the participating bilateral donors. It is these agreements that set out the design of the NTF. To prevent the types of past mistakes and abuses seen with the Nauru Phosphate Royalties Trust, the memorandums of understanding include restrictions on the types of investments that can be made and prohibit any borrowing against the assets of the NTF.

The NTF is governed by a committee consisting of representatives of the governments of Nauru, Australia, and Taipei, China. All committee decisions are to be made by consensus, including decisions on the duration of the buildup phase, fund investment, and the size of future distributions to the government. This arrangement effectively provides each committee member with a veto over key fund decisions. While this could potentially slow decision making, it provides a strong mechanism for incentivizing good fiscal management, encouraging greater donor contributions (since donors can protect their investments), and ensuring that decisions are aligned with the stated purpose of the fund.

Given Nauru’s capacity constraints, the NTF also relies on outsourcing to ensure professional management. The NTF operates as an international organization under Australian jurisdiction and uses service providers regulated in Australia for custodial, fund management, and accounting services. A large internationally active fund manager has been appointed. The NTF is required to produce both audited financial statements annually and an annual report, which must be tabled in the Nauru Parliament.

⁸ For example, the Timor-Leste Petroleum Fund allows the government to withdraw more than the estimated sustainable amount subject to parliamentary approval.



PHOTO CREDIT: MICHAEL KEW

SECURING SUSTAINABILITY: THE NEED FOR FURTHER REFORM

The NTF and the policy framework it establishes are an important step forward. However, Nauru's fiscal sustainability challenges are stark, and more ambitious reform is required to secure the country's economic future. The state budget remains highly exposed to negative shocks, both temporary (e.g., fluctuating revenue from the RPC, fisheries, and mining) and permanent (e.g., scaling down or closure of the RPC program). Avoiding being caught in a future "fiscal cliff" situation, where public spending in particular must be severely curtailed in a short period of time, should be a key priority. Nauru's sustainable national income is likely to be much lower than the present level. For instance, if direct RPC-related revenue is excluded, the fiscal balance falls from a surplus of 10.0% of GDP in FY2016 to a deficit of 11.8%. If indirect RPC-related revenue is also excluded, the deficit would be an estimated 25.7% of GDP. The government should focus on two broad reform priorities.



The distribution policy balances the need for stable budget financing with the desire to safeguard the real value of the fund.

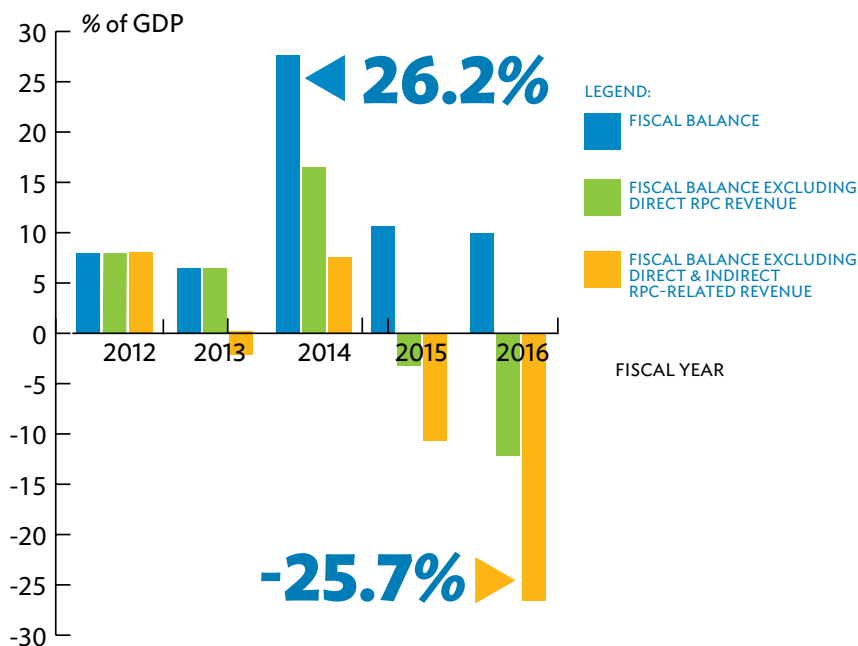
PRIORITY 1: ESTABLISHING A SUSTAINABLE FISCAL STRATEGY

The government can manage these risks by establishing a clear fiscal strategy that effectively saves revenue when it is unsustainably high, and by drawing upon these savings when revenue falls (either temporarily or permanently). High uncertainty around Nauru's key revenue streams means it is essential for the government to build adequate fiscal buffers to help smooth out potential shocks, stabilize government operations, and limit the impact on the economy. Temporary shocks can be managed by building and maintaining government cash reserves, which should be anchored to several months of projected spending. Managing a permanent shock is more difficult. In the short term, cash reserves can be used to help smooth the adjustment. However the overall scale of adjustment required would necessarily depend on the availability of more sustainable budget financing.

To secure greater long-term fiscal sustainability, the government should consider saving considerably more in the NTF than the minimum rate required under the contribution rule. In particular, the majority of RPC-related revenue (both direct and indirect) should be saved in the NTF. This would better spread the benefits of temporarily high revenue over time by making this available to finance future budgetary expenditure. Most importantly, this could help avoid being caught in a potential “fiscal cliff” in the event of a sudden closure, or near closure, of the RPC program. Currently, the government is only saving about a fifth of RPC-related revenue. Conversely, in the absence of sufficient NTF savings (either due to insufficient savings, poor investment returns, or the early onset of a negative shock), a permanent shock would need to be managed primarily through fiscal adjustment.

Saving the majority of RPC-related revenue would be similar to approaches commonly recommended for managing comparably

FIGURE 2: NAURU BUDGET IS OVERLY RELIANT ON UNSUSTAINABLE REVENUE FROM THE RPC.



GDP = gross domestic product, RPC = Regional Processing Centre.

Source: ADB estimates based on figures provided by the Nauru Department of Finance and Economic Planning.

short-lived and uncertain natural resource revenue.⁹ Importantly, the imperative for increased saving remains even if Nauru were to experience a partial reduction in RPC-related revenue (e.g., due to refugees gradually being successfully resettled in third countries) as any remaining revenue derived from the RPC should still be considered as unsustainable. Similarly, should mining of secondary phosphate deliver significant new revenue in the future, there is an imperative to save the majority of this, since secondary phosphate deposits are also finite and uncertain.

To secure greater long-term fiscal sustainability, the government should consider saving considerably more in the Nauru Trust Fund.

Pursuing this approach would require significantly reducing current levels of expenditure. Increasing domestic revenue collection could also be pursued to the extent possible. To operationalize this strategy, the government should establish a clear fiscal strategy and an associated medium-term fiscal framework that set out quantitative targets to guide fiscal policy toward greater sustainability.


PRIORITY 2: COMPLEMENTARY PUBLIC FINANCE REFORMS

A number of broader public finance reforms should simultaneously be pursued to complement the NTF and the broader fiscal sustainability strategy recommended above. These include the following:

- **Improve fiscal transparency.** International experience shows that transparency is critical to sound public financial management and the success of SWFs.¹⁰ However, the government has not released financial statements, audited or unaudited, since the early 1990s. This is particularly problematic since the NTF contribution

⁹ T. Baunsgaard et al. 2012. Fiscal Frameworks for Resource Rich Developing Countries. *IMF Staff Discussion Notes*. Washington, DC: International Monetary Fund. Such saving can also take the form of reducing public debt as well as public investment in physical and human capital. The optimal mix depends on the rate of economic return of the different options. In Nauru's case, weak public sector capacity, low absorptive capacity of the local economy, and limited scope for sustained growth suggest that such saving should primarily take the form of accumulating net financial assets.

¹⁰International Working Group of Sovereign Wealth Funds. 2008. *Sovereign Wealth Funds: Generally Accepted Principles and Practices: "Santiago Principles."* London.



Through a careful strategy of saving, investing, and spending wisely, Nauru can use its current economic boom to secure a more sustainable economic future for the nation and its citizens.

rule is based on the level of actual domestic revenue. It should be an immediate priority. The government should also ensure that the public has meaningful access to fiscal information, including budget documents, government financial statements, and key documents on the management and performance of the NTF.

- **Raise the quality of public spending.** While there is a need to contain overall spending, sustainability also requires that spending is efficient and directed to areas that promote sustainable development, particularly education, health, and infrastructure. Recent positive steps have included strengthened budget controls, procurement reforms, and reductions in energy subsidies, including the elimination of retail fuel subsidies. Future areas of focus should include ensuring competitive public procurement practices, strengthening budget prioritization, and continuing with electricity tariff reforms to reduce the need for public subsidies.



- **Ensure sustainable infrastructure management.** Significant capital investment has taken place since 2012, with more planned in the coming years, as the government and its partners have sought to address long-standing infrastructure deficiencies and to accommodate the presence of the RPC. Maintenance of this significantly expanded capital stock, particularly public infrastructure, needs to be a particular focus. The government could explore putting in place dedicated arrangements, such as an asset maintenance fund, for this purpose.

CONCLUSION

Through a careful strategy of saving, investing, and spending wisely, Nauru can use its current economic boom to secure a more sustainable economic future for the nation and its citizens. The establishment of the NTF is a critical first step in the right direction. The government now needs to integrate the NTF into a broader sustainable fiscal strategy, and continue with other reforms to strengthen its public finances. ■

SECURING SUSTAINABILITY

Nauru's New Intergenerational Trust Fund and Beyond

This brief argues that the Government of Nauru should establish a more sustainable fiscal strategy that includes increasing its savings in the new Nauru Trust Fund, and implement reforms to improve transparency and the quality of public spending.

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