



Report and Recommendation of the President to the Board of Directors

Project Number: 48478-001
February 2016

Proposed Policy-Based Grant Nauru: Fiscal Sustainability Reform Program

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Asian Development Bank

CURRENCY EQUIVALENTS

(as of 5 February 2016)

Currency unit	–	Australian dollar (A\$)
A\$1.00	=	\$1.3889
\$1.00	=	A\$0.7199

ABBREVIATIONS

ADB	–	Asian Development Bank
FMIS	–	financial management information system
MOF	–	Ministry of Finance
NTF	–	Nauru Intergenerational Trust Fund
NUC	–	Nauru Utilities Corporation
NPRT	–	Nauru Phosphate Royalties Trust
PFM	–	public financial management
RPC	–	Regional Processing Centre
SOE	–	state-owned enterprise
TA	–	technical assistance

NOTES

- (i) The 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., FY2015 ends on 30 June 2015.
- (ii) In this report, “\$” refers to US dollars, unless otherwise stated.

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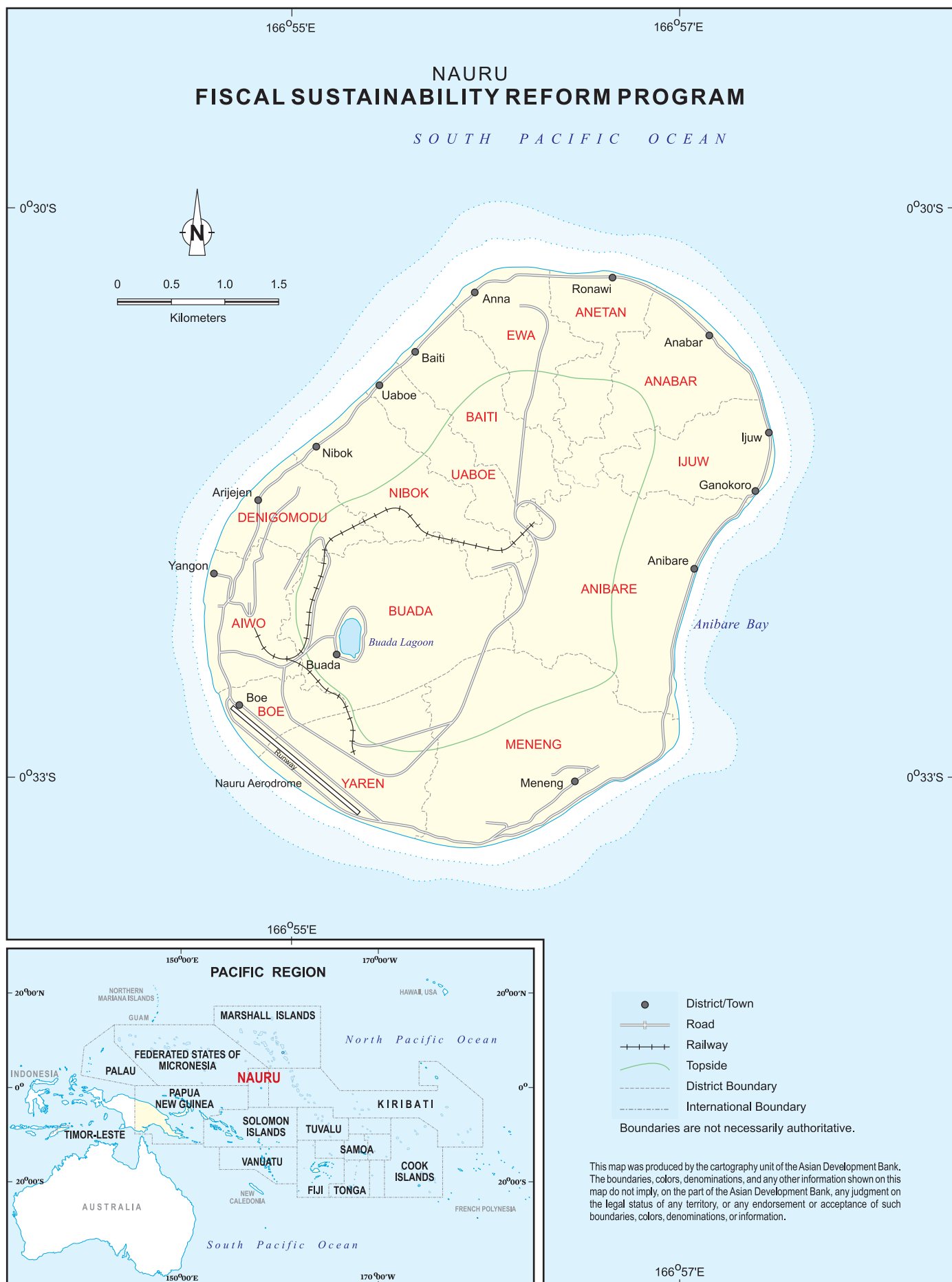
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PROGRAM AT A GLANCE

1. Basic Data		Project Number: 48478-001	
Project Name	Fiscal Sustainability Reform Program	Department /Division	PARD/PAUS
Country Borrower	Nauru Government of Nauru	Executing Agency	Ministry of Finance
2. Sector	Subsector(s)	ADB Financing (\$ million)	
✓ Public sector management	Public administration		2.00
		Total	2.00
3. Strategic Agenda	Subcomponents	Climate Change Information	
Inclusive economic growth (IEG)	Pillar 1: Economic opportunities, including jobs, created and expanded	Climate Change impact on the Project	Low
4. Drivers of Change	Components	Gender Equity and Mainstreaming	
Governance and capacity development (GCD)	Public financial governance	No gender elements (NGE) ✓	
Knowledge solutions (KNS)	Knowledge sharing activities		
Partnerships (PAR)	Bilateral institutions (not client government)		
Private sector development (PSD)	Official cofinancing Conducive policy and institutional environment		
5. Poverty Targeting		Location Impact	
Project directly targets poverty	No	Nation-wide	High
6. Risk Categorization:	Low		
7. Safeguard Categorization	Environment: C Involuntary Resettlement: C Indigenous Peoples: C		
8. Financing			
Modality and Sources		Amount (\$ million)	
ADB		2.00	
Sovereign Program grant: Asian Development Fund		2.00	
Cofinancing		1.80	
Australian Grant - Grant		1.80	
Counterpart		0.00	
None		0.00	
Total		3.80	
9. Effective Development Cooperation			
Use of country procurement systems		Yes	
Use of country public financial management systems		Yes	



I. THE PROPOSAL

1. I submit for your approval the following report and recommendation on a proposed policy-based grant to Nauru for the Fiscal Sustainability Reform Program.¹

2. The program aims to promote fiscal sustainability for Nauru. It builds on earlier reforms, supported by the Asian Development Bank (ADB) and other development partners, to improve public financial management (PFM) and state-owned enterprise (SOE) performance, and to establish the Nauru Intergenerational Trust Fund (NTF) to save unexpected gains, or windfalls, in public revenue for the future.

II. THE PROGRAM

A. Rationale

3. **Development context.** Nauru is ADB's smallest member country and one of the most remote islands in the world. It is a single island of 21 square kilometers with a population of about 10,800, concentrated along a narrow coastal belt. There is little potential for agriculture and the country is heavily dependent on imports for basic necessities. While Nauru possesses two significant natural resources—phosphate deposits and the oceanic resources of its exclusive economic zone—opportunities for diversification are limited. Remoteness and diseconomies of scale translate into high operating costs, which limit opportunities for private enterprise and domestic job creation, and hamper efforts to deliver basic public services. The public sector dominates the economy and employment. Nauruan institutions are thinly resourced and relatively weak, with a high dependence on foreign advisors. Overall development progress has been mixed.² Education and health outcomes have improved during 2013–2015 but are still poor by international standards. An estimated 24% of the population lives below the basic needs poverty line.³

4. **Recent economic and fiscal performance.** After suffering an economic collapse in the late 1990s to early 2000s, Nauru's economy began to recover in 2007 and since then, the country's per capita income has recovered much lost ground. Gross national income per capita is estimated at A\$15,641 (fiscal year [FY]2014). Phosphate exports resumed in 2007 and the Regional Processing Centre (RPC) for asylum seekers (operated under a bilateral agreement with the Government of Australia) was reopened in 2012, having first operated during 2001–2007. The RPC has contributed to a surge in local economic activity, domestic employment, and government revenues (including direct payments to the state budget under a bilateral agreement).⁴ Government finances have also benefited from windfall fishing license fee revenues (due to higher fee rates under a regional arrangement⁵), while payments to local landowners for the liquidation of the Nauru Phosphate Royalties Trust (NPRT) since 2013 have

¹ The design and monitoring framework is in Appendix 1.

² Government of Nauru. 2012. *Millennium Development Goals: Nauru Progress Report 1990–2011*. Suva.

³ Government of Nauru. Nauru Hardship and Poverty Report: Analysis of the 2012/13 Household Income and Expenditure Survey. Unpublished.

⁴ The bilateral agreement covers the period 2015–2019 with the possibility for a 5-year extension.

⁵ Nauru receives and sells an annual allocation of fishing vessel days under the Vessel Day Scheme, operated under the Parties to the Nauru Agreement, which comprises eight Pacific Island countries. Increased fees reflect high market demand while the scheme caps the supply of vessel days to protect the sustainability of regional fisheries.

further added to aggregate demand.⁶ These positive developments raised economic growth to 19.5% on average during FY2012–FY2014, while domestic revenue tripled in nominal terms.

5. The windfall revenue has been directed toward increased expenditure and improving the government's balance sheet (Table 1).⁷ Personnel, goods and services, and special projects—including programs for school feeding, community works, and community housing—have absorbed the majority of increased spending. Fuel subsidy costs have been kept in check, with the elimination of retail fuel subsidies in FY2015, but remain a large share of the budget due to continued fuel subsidies for the state-owned power company. The government has targeted balanced budgets on a cash flow basis. Public debt has fallen 23.7% since FY2012.

6. In FY2015, damage to the port mooring facility, Nauru's main gateway for international cargo, caused real GDP to contract by an estimated 10.0%, with phosphate exports falling by two-thirds. The mooring system is structurally vulnerable to damage and has typically received only ad hoc repairs. Inflation also jumped due to the disruption to inbound supplies coupled with strong demand growth, the elimination of retail fuel subsidies, and a falling Australian dollar (the local currency). Despite these setbacks, Nauru's income remains at a high level by historical standards and the economy is expected to recover strongly in FY2017 when the mooring system is expected to be fully restored.

Table 1: Nauru Macro-Fiscal Performance and Outlook, FY2013–FY2016

Item	FY2013	FY2014	FY2015 (e)	FY2016 (f)
Real GDP (% change)	15.4	17.5	-10.0	3.0
Inflation (%)	0.5	3.0	11.4	6.6
Budget balance (% of GDP)	0.3	2.3	0.1	0.1
Adjusted balance ^a	12.6	20.3	10.5	12.6
Total revenue (\$ million)	59.8	87.4	95.6	82.2
Selected expenses (% of total revenue):				
Personnel costs	21.9	17.5	24.2	24.7
Net fuel expenses ^b	16.4	8.1	9.2	8.2
Debt repayments	14.6	22.7	5.2	2.1
Goods and services (excl. fuel)	10.2	9.9	18.5	18.6
Special projects ^c	5.2	4.4	8.0	17.0
NTF set-aside	0.0	5.4	4.3	9.0
Nominal GDP (\$ million)	114.3	130.4	118.0	111.6

(e) = estimate, (f) = forecast, FY = fiscal year, GDP = gross domestic product, NTF = Nauru Intergenerational Trust Fund.

^a Budget balance, excluding financing items.

^b Fuel purchases and fuel subsidies to a power utility, less fuel sales.

^c Special projects in the Government of Nauru chart of accounts plus the Community Housing Scheme.

Source: Government of Nauru budget documents (various years) and Asian Development Bank staff estimates and projections.

7. **Government development strategy.** Nauru's National Sustainable Development Strategy, 2005–2025 highlights the country's vision of "a future where individual, community, business and government partnerships contribute to a sustainable quality of life for all

⁶ The government began liquidating the NPRT in mid-2013 and has thus far made A\$90 million in payments to Nauruan landowners, the beneficiaries of remaining NPRT claims. The remaining NPRT assets could provide up to a further A\$30 million in liquidation payments.

⁷ Economic and Fiscal Analysis (accessible from the list of linked documents in Appendix 2).

Nauruans.”⁸ The current government’s economic reform strategy is based on the National Sustainable Development Strategy and focuses on achieving the long-term goals of (i) a stable, trustworthy, fiscally responsible government; (ii) provision of enhanced social, infrastructure, and utility services; and (iii) development of an economy based on multiple sources of revenue.

8. **Policy challenges.** The overarching challenge facing Nauru is to effectively manage windfall income to build a sustainable economic future. Nauru’s heavy reliance on uncertain windfall revenues (Table 2) gives rise to concerns about long-term sustainability, the quality of public expenditure, and macroeconomic stability. RPC-related income remains highly uncertain, while collections from customs and excise duties and the new employment and services tax are also sensitive to RPC-related developments. Fisheries and phosphate revenues face high short-run volatility, and phosphate reserves are expected to be exhausted in the next 20 years.

Table 2: Sources of Revenue Uncertainty
(% of domestic revenue^a, unless otherwise stated)

Item	FY2015 (e)	FY2016 (f)	Issues
Fishing license fees	32.1	25.3	Short-run volatility, uncertain sustainability
RPC-related payments	21.6	30.5	Short life span, risk of sudden cessation
Customs and excise duties	19.9	16.8	Sensitive to level of RPC activity
Employment and services tax	6.0	10.1	Most taxpayers are linked to RPC
Phosphate royalties and dividends	0.9	3.8	Short-run volatility, finite reserves
Domestic revenue ^a (\$ millions)	73.2	68.1	

(e) = estimate, (f) = forecast, FY = fiscal year, RPC = Regional Processing Centre.

^a Net of fuel sales and reimbursable RPC-related costs.

Source: Government of Nauru budget documents (various years) and Asian Development Bank staff estimates and assessment.

9. To achieve greater intergenerational equity and fiscal sustainability, a large portion of windfall revenues need to be saved for the future. High inflation at present shows the limits to effectively absorbing significant fiscal expansion. Acute infrastructure bottlenecks, including Nauru’s inadequate and damaged port facilities and unreliable and inefficient power supply, are a critical supply-side constraint. PFM deficiencies, particularly weak expenditure controls and problematic cash management, further undermine the returns to scaled-up public spending. The potential for negative revenue shocks, both short-term and permanent, is also a major concern. Nauru has no access to debt financing, which means careful fiscal planning within a medium-term perspective is required to maintain adequate fiscal buffers. Broadening the revenue base to improve fiscal stability and sustainability is a priority.

10. **Public financial management.** In 2011, ADB technical assistance (TA) helped the government to develop and adopt a PFM action plan to guide its reform efforts during 2011–2015 and coordinate support from development partners.⁹ The action plan focused on achieving a basic overall PFM system as soon as practically possible. Considerable progress has been made, including (i) the introduction of a fully automated financial management information system (FMIS), Technology One, to replace the existing manual system; and (ii) the establishment of a public procurement policy that outsources all government and SOE procurement for items over A\$5,000 (except bulk fuel procurement, which has been privatized).

⁸ Government of Nauru. 2005. *National Sustainable Development Strategy, 2005–2025 (As Revised 2009)*. Yaren.

⁹ ADB. 2008. *Technical Assistance for Strengthening Governance and Accountability in Pacific Island Countries (Phase 2)*. Manila (TA 6499 REG).

The government also undertook reforms to broaden the revenue base, including establishing the Nauru Revenue Office in 2011, introducing a new revenue administration act in 2014, and adopting a new tax policy framework in 2014 which identified several new tax measures to be introduced in stages over the coming years. While progress has been made on several fronts, a considerable medium-term agenda remains. In the near term, the priority is to further operationalize the FMIS, strengthen expenditure controls, improve cash management, move toward medium-term budgeting, and introduce new revenue-raising measures.

11. **Utilities reform.** Subsidized power provision is a major fiscal burden, while power provision remains unreliable and system efficiency remains low.¹⁰ Weak management and the use of outdated and inefficient diesel generators have been critical issues.¹¹ Addressing this situation will reduce fiscal costs, strengthen the enabling environment for private sector development and government operations, and improve the delivery of basic services to households. Recent reforms have helped to improve service delivery, and power outages are now reported to be less frequent and generally scheduled. The Nauru Utilities Corporation (NUC) was corporatized in 2011 and a new chief executive officer was appointed in 2012 on a performance-based contract. Power tariffs were also increased to better reflect economic cost. These reforms need to be deepened and built upon by extending the performance-based management system, strengthening financial management, and ensuring proper asset maintenance.¹² Comprehensive tariff reform to move toward greater cost recovery while balancing equity concerns is also vital to sustainability.

12. **Nauru Intergenerational Trust Fund.** Large windfall revenues, limited scope for sustained economic growth, and heavy dependence on development assistance suggest that a trust fund arrangement can help in achieving a sustainable economic future.¹³ As also happens in a number of other Pacific countries, such as Kiribati and Tuvalu, trust funds can play a major role in economic stability and fiscal management. The government has sought to establish the NTF since 2009. While originally intended to provide a mechanism for saving and investing phosphate income for the long term, it has since become a critical necessity for saving broader and much larger windfall revenues, including those from the RPC and fisheries. The government has also sought bilateral development partners to join the fund as contributing members to help build its principal value and ensure the fund is well governed. ADB TA has been helping to ensure the NTF is well designed to avoid the pitfalls of Nauru's experience with the NPRT.¹⁴ Poor governance, weak management, lack of professional investment advice, and absence of transparency saw the NPRT experience severe financial losses while the government simultaneously engaged in unsustainable borrowing against the fund's assets.

13. The NTF will be governed by a committee that includes the government and the original contributing governments.¹⁵ The NTF itself is to be based in Australia and all service providers—including the custodial bank, investment advisors, accountant, and auditor—are to be registered in Australia and subject to supervision and regulation from Australian regulatory

¹⁰ Sector Assessment (Summary): Energy (accessible from the list of linked documents in Appendix 2).

¹¹ An ADB project grant, with cofinancing from the European Union and Government of Australia, will finance two fuel-efficient generators. ADB. 2015. *Additional Financing: Electricity Supply Security and Sustainability Project in Nauru*. Manila.

¹² ADB. 2014. *Quarterly Summary Report on Approved (A) Project Preparatory Technical Assistance Not Exceeding \$1,500,000; (B) Technical Assistance Projects Not Exceeding \$225,000; and (C) Technical Assistance Cluster Subprojects (April–June 2014)*. Manila (TA 8631).

¹³ Analysis of the Nauru Intergenerational Trust Fund (accessible from the list of linked documents in Appendix 2).

¹⁴ ADB. 2013. *Technical Assistance for Pacific Economic Management (Phase 2)*. Manila (TA 8565 REG).

¹⁵ The NTF is governed by a memorandum of understanding signed in November 2015 between the Government of Nauru and the Government of Australia.

bodies. Provisions such as restricting the type of investments that can be made (to be approved by the governing committee) and prohibiting any borrowing against the assets of the NTF are also made to prevent other historical mistakes and abuses. The NTF will also be required to produce audited financial statements and undergo regular performance reviews.

14. **ADB's value addition, lessons learned, and program modality.** The goals of the National Sustainable Development Strategy are consistent with ADB's Interim Pacific Approach, 2015 and ADB's country operations business plan, 2016–2018 for Nauru.¹⁶ ADB support is closely aligned with the government's reform agenda and key policy challenges. ADB's 2012 Public Financial Management Reform Program, the first policy-based operation in Nauru, supported key reforms closely related to the proposed program, including the introduction of the FMIS; the establishment of a new public procurement system; the adoption of the new tax policy framework; and the undertaking of key reforms for SOEs, including the NUC.¹⁷ ADB TA has supported the design and establishment of the NTF (footnote 14). ADB project assistance is providing new, more efficient power generators for the NUC and ADB TA is supporting institutional strengthening and tariff reform (footnote 12). Future ADB project assistance is focusing on developing a new, more resilient and higher capacity port. ADB activities have been closely coordinated with Nauru's other key development partners, notably the Pacific Financial Technical Assistance Centre and the Government of Australia.¹⁸ The latter also provides support to improve the delivery of social services, a key complement to the program.

15. The policy matrix fully supports the government's policy agenda and is supported by all of Nauru's major development partners, including the Government of Australia. The policy actions are part of an ongoing reform agenda and policy dialogue between the government and its development partners, including ADB. The program has sought to incorporate lessons from ADB's experience with policy-based lending in the Pacific, including (i) ensuring reforms are politically as well as technically feasible, (ii) avoiding complexity and excessive use of conditionality, (iii) responding to reform opportunities, and (iv) combining TA with policy-based operations for complex and politically sensitive reforms.¹⁹

16. ADB proposes a stand-alone policy-based operation that requires all policy actions to be accomplished before grant effectiveness. Disbursement will be conditional upon the opening of the NTF account at a designated custodian bank based in Australia and after the government has made its own initial contribution to the NTF account. In this way the program will help the government to secure its full initial contribution to the NTF in the context of a tight fiscal situation. While there is broad political commitment in Nauru to having a trust fund, short-term political realities imply that contributions to the NTF can be vulnerable to pressures for increased government spending. Demonstrating its commitment, the government has set aside funds for the NTF in the FY2016 budget as well as the preceding two fiscal years. This amounts to A\$20.4 million in total or 18% of estimated total revenue in FY2016.

B. Impact and Outcome

17. The program impact will be an improved sustainable quality of life for all Nauruans. The program outcome will be improved fiscal sustainability.

¹⁶ ADB. 2015. *Interim Pacific Approach, 2015*. Manila. This extends the validity of ADB. 2009. *ADB's Pacific Approach, 2010–2014*. Manila; ADB. 2015. *Country Operations Business Plan: Nauru, 2016–2018*. Manila.

¹⁷ ADB. 2012. *Report and Recommendation of the President to the Board of Directors: Public Financial Management Reform Program*. Manila.

¹⁸ Development Coordination (accessible from the list of linked documents in Appendix 2).

¹⁹ ADB. 2011. *Policy-Based Programs for the Pacific Islands*. Manila.

C. Outputs

18. The program will consolidate and build upon earlier reforms supported by ADB in PFM, SOE performance, and fiscal policy management. The three outputs encompass nine policy actions, all of which have been accomplished. The accomplishment of all policy actions are conditions to effectiveness. These are set out in the policy matrix (Appendix 4) along with future reform priorities that will be included in post-program monitoring.

19. **Output 1: Improved public financial management.** The program has supported the continuation of reforms begun in 2012 to improve budget execution and financial controls and to mobilize domestic revenue. Much progress has been made, but weak expenditure controls and problematic cash management practices continue to undermine overall expenditure quality. Weak controls have constrained the ability of the Ministry of Finance (MOF) to ensure that funds are spent as budgeted, while problematic cash management has undermined operational efficiency and further distorted the pattern of public spending. The budget has also continued to operate without a medium-term perspective, a critical weakness given the uncertain and vulnerable nature of Nauru's public finances. A medium-term fiscal framework is needed to help the government achieve an appropriate balance between consumption spending, productive investment, and public saving for both the long and short term i.e., building a fiscal buffer (footnote 7). Following earlier revenue reforms, a nonresident employment and services tax is the first new tax measure to be introduced as envisioned under the government's tax policy framework.

20. The MOF has implemented five policy actions under output 1:

- (i) **Output 1.1.** The accounts payable and bank reconciliation functions of the FMIS were made fully functional in October 2015 and March 2016 respectively. This allows the government to minimize arrears in recurrent spending and advance accounts, and improve timeliness and completion of financial statements.
- (ii) **Output 1.2.** Quarterly financial progress reports were produced and submitted to the finance minister in November 2015. This allows the government to improve financial reporting with commitments shown and minimize extrabudgetary expenditure.
- (iii) **Output 1.3.** Weekly in-year budget reports that include cash flow budget statements were produced and made available to all ministries in February 2015, helping to reduce overexpenditure and improve cash flow forecasting and monitoring.
- (iv) **Output 1.4.** Aggregate revenue and expenditure projections for FY2016–FY2018 were prepared in November 2015. These allow the government to improve the annual budget process and prepare multiyear budget forecasts that are linked to sector and infrastructure investment strategies.
- (v) **Output 1.5.** The Nonresident Employment and Services Tax Bill came into force in September 2014. In FY2015 the tax is estimated to have generated A\$5.4 million in revenue. The FY2016 budget targets A\$10.4 million in collections.

21. **Output 2: Efficient service delivery by the Nauru Utilities Corporation.** The program supported the deepening of reforms at the NUC. The NUC was further commercialized through the development of a business strategy and the extension of an integrated performance-based management system for all staff. While NUC preventive maintenance practices have been inadequate, with maintenance carried out on an emergency or ad hoc basis, the situation has been improving since April 2014 with the appointment of a new generation manager, funded by the Government of Australia. Financial management capabilities were strengthened through the introduction of an FMIS. While an asset inventory was introduced, additional improvements were required, particularly to integrate the fixed assets register with the fixed asset management

module under the NUC's new FMIS. The development of an asset maintenance plan will help foster improved financial and operational efficiency and will be important as the NUC undertakes new capital investment, through an ADB project grant, to install additional, more efficient diesel generators (footnote 11). Effective financial information and costing for asset maintenance will enable the government, with support from ADB TA, to develop an informed approach to planned tariff reform (footnote 12).

22. Two policy actions implemented by the NUC are supported under output 2:

- (i) **Output 2.1.** An NUC strategic plan was developed and the following were implemented:
 - (a) A performance-based management system was applied to all employees, linking employee performance to the achievement of the NUC business strategy.
 - (b) Mind Your Own Business financial accounting software was introduced, which captures all transactions and records them under the appropriate budget headings, and produces timely and credible management reports.
 - (c) A short-term program for asset rehabilitation was developed to upgrade the high-voltage power network.
- (ii) **Output 2.2.** A strategic maintenance plan for NUC assets was developed and adopted to provide for the maintenance and upgrade of NUC's power distribution network, metering equipment, and water production and delivery.

23. **Output 3: Improved funding mechanism for future service delivery.** The program supported the establishment of the NTF as a mechanism for saving windfall revenues. The NTF was established through the signing of a memorandum of understanding between the governments of Nauru and Australia. The specific purpose of the NTF is to build up a sufficient principal value—through financial contributions and a long-term investment strategy—that can provide a future stream of public revenue to support investments in education, health, environment, and public infrastructure. The intention is for there to be a buildup phase, prospectively to FY2033, before the NTF enters a distribution phase.²⁰ Specific frameworks under the NTF agreement govern government contributions during the buildup phase and maximum NTF distributions during the distribution phase (footnote 13). Government contributions will be based on realized domestic revenue in the preceding year, with the share contributed rising with revenue levels to reflect intergenerational equity principles. Annual distributions from the NTF will be determined by the committee but will be subject to a formula-based maximum intended to help preserve the principle value of the fund in perpetuity.

24. The government has demonstrated its commitment by setting aside A\$20.4 million as its initial contribution to the NTF, including A\$5.0 million each in FY2014 and FY2015, and A\$10.4 million in FY2016. The Government of Australia has committed an initial contribution of A\$5.0 million (inclusive of A\$2.5 million cofinancing for the program) and intends to contribute up to A\$2.5 million annually thereafter. The government is also in discussion with other bilateral partners to be contributing members.

25. The MOF implemented two policy actions under output 3:

- (i) **Output 3.1.** A memorandum of understanding between the governments of Nauru and Australia to establish the NTF was signed in November 2015.
- (ii) **Output 3.2.** A budget allocation of A\$20.4 million was made as the government's initial contribution to the NTF, including A\$10.4 million to be paid from FY2016

²⁰ The NTF committee will determine when the distribution phase is to begin based on the ability of the NTF to provide a material amount of budget financing in perpetuity. A principal value of A\$400 million is currently targeted.

revenues and A\$10.0 million to be paid from cash set-asides from the two previous financial years. These set-asides are also a condition for disbursement.

D. Development Financing Needs

26. The government has requested a grant not exceeding \$2 million from ADB's Special Funds resources to help finance the program. The government has also requested grant cofinancing from the Government of Australia equivalent to \$1.8 million.²¹

27. ADB is basing the size of its \$2 million grant on Nauru's future service delivery financing needs, which remain substantial, and the cost of its reform program, which amounted to around \$3 million in 2013–2015.

E. Implementation Arrangements

28. **Program management.** The MOF, as the executing agency, has overseen timely implementation of the agreed policy actions by the implementing agencies, and is responsible for program administration, disbursements, and records maintenance. The MOF, through the Departments of Treasury and Revenue, was the implementing agency for output 1, and through the Departments of Planning and Aid, and Treasury, was the implementing agency for output 3. The NUC implemented output 2. Ongoing TA projects (footnotes 12 and 14) helped the government fulfill program conditions. The program implementation period was from June 2014 to June 2016.

29. **Tranches and disbursement.** The grant will be provided in a single tranche. ADB will transfer the grant proceeds directly into the account of the NTF held at a designated custodian bank based in Australia, immediately after the NTF account has been opened and after the government has made its own initial contribution of A\$20.4 million to the NTF. The government will finance the local currency cost relating to the implementation of the program and other activities consistent with the objectives of the program, and will provide the necessary budget appropriation to finance costs relating to the implementation of reforms under the program. The proceeds of the grant will be disbursed in accordance with ADB's simplification of disbursement procedures and related requirements for policy-based grants.²²

30. The government will keep ADB informed of policy discussions with other multilateral and bilateral aid partners that may have implications for the program and will provide ADB with an opportunity to comment on any resulting policy proposals. The government will take ADB's views into account before finalizing and implementing any such proposal.

31. **Program performance monitoring and evaluation.** The government will monitor the implementation and outcome of the program using the set of indicators and targets in the design and monitoring framework agreed between the government and ADB. For each of the agreed indicators, progress will be measured against the baselines in the framework. The responsible implementing agencies will support the review of agreed actions to determine progress and identify constraints. ADB will provide policy dialogue and TA support to support post-program implementation.

²¹ Funds will be deposited directly into the NTF bank account as outlined in Schedule 2 of the draft grant agreement.

²² ADB. 1998. *Simplification of Disbursement Procedures and Related Requirements for Program Loans*. Manila.

III. DUE DILIGENCE

32. The program's major benefit will be its contribution to Nauru's long-term fiscal sustainability, which will in turn help maintain macroeconomic stability and ensure delivery of essential public services. These objectives are essential to inclusive economic growth in Nauru, while improving the environment for job creation and poverty reduction.

A. Economic and Financial

33. Recent windfall revenues have greatly improved Nauru's fiscal position, which remains dependent on a narrow set of highly uncertain income streams that need careful management to avoid serious fiscal problems (footnote 7). During FY2012–FY2014, a large share of windfall revenue was used to improve the government's balance sheet. However, more recently, debt repayments have slowed and the state budget has become increasingly reliant on vulnerable and unsustainable revenue streams. The reform measures included in the policy matrix will help to address these issues. An economic and fiscal assessment, undertaken by ADB staff, replaces the IMF assessment letter as Nauru is not an IMF member (footnote 7).

B. Governance

34. The government's ability to implement its budget is integral to the success of the program. Gaps in financial controls and domestic resource mobilization have been minimized through the program (paras. 19–20). ADB's Anticorruption Policy (1998, as amended to date) was explained to and discussed with the government. The specific policy requirements and supplementary measures are described in the legal documents.²³ Consistent with its commitment to good governance, accountability, and transparency, ADB reserves the right to investigate, directly or through its agents, any alleged corrupt, fraudulent, collusive, or coercive practices relating to the program.

C. Poverty and Social

35. The program will contribute to poverty alleviation by supporting sustainable, equitable, and inclusive long-term economic growth built on (i) improved PFM, (ii) better service delivery by the NUC, (iii) reduced subsidies to the NUC, (iv) increased domestic resource mobilization, and (v) saving of windfall revenues to fund future service delivery.²⁴

D. Safeguards

36. Program activities are confined to policy and institutional reforms, and none of the activities will result in or lead to involuntary resettlement or affect indigenous peoples. No adverse environmental impacts have been identified. Safeguard categories for environment, involuntary resettlement, and indigenous peoples are all C.

E. Risks and Mitigating Measures

37. The program's overall risk is rated *medium*. The key risks and related mitigating measures are summarized in Table 3. Fiduciary risks have been addressed through the PFM reform activities (paras. 19–20). Risks and mitigating measures are described in detail in the risk

²³ Grant Agreement (accessible from the list of linked documents in Appendix 2).

²⁴ Summary Poverty Reduction and Social Strategy (accessible from the list of linked documents in Appendix 2).

assessment and risk management plan.²⁵ Integrated benefits and impacts are expected to outweigh the costs.

Table 3: Key Risks and Mitigating Measures

Risk	Mitigating Measures
Political consensus on reform is not maintained	The program was designed in close consultation with the government and requires government to make its full budgeted initial contribution to the NTF. The program is anchored to the NSDS, which enjoys broad political support.
Nauru experiences adverse economic shock(s)	The NTF framework contains provisions for lower, delayed, or no government contribution in the event of unforeseen negative shocks.
Institutional weaknesses limit further reform progress	Development partners actively coordinate to provide technical support for implementation of key reforms.

NSDS = National Sustainable Development Strategy, NTF = Nauru Intergenerational Trust Fund.

Source: Asian Development Bank.

IV. ASSURANCES

38. The government has assured ADB that implementation of the program shall conform to all applicable ADB policies, including those concerning anticorruption measures, safeguards, gender, procurement, consulting services, and disbursement as described in detail in the grant agreement. The government has agreed with ADB on certain covenants for the program, which are set forth in the grant agreement. The grant will become effective after ADB is satisfied that all conditions for the release of the program tranche, as specified in the policy matrix and set out in Attachment 2 to Schedule 2 of the draft grant agreement, have been complied with to the satisfaction of ADB. No withdrawals will be made from the grant account until the government has established the NTF account at a designated custodian bank based in Australia and after the government has made its own initial contribution to the NTF account.

V. RECOMMENDATION

39. I am satisfied that the proposed policy-based grant would comply with the Articles of Agreement of the Asian Development Bank (ADB) and recommend that the Board approve the grant of \$2,000,000 to the Government of Nauru for the Fiscal Sustainability Reform Program, from ADB's Special Funds resources; and such other terms and conditions as are substantially in accordance with those set forth in the draft grant agreement presented to the Board.

Takehiko Nakao
President

29 February 2016

²⁵ Risk Assessment and Risk Management Plan (accessible from the list of linked documents in Appendix 2).

DESIGN AND MONITORING FRAMEWORK

Impact The program is aligned with the goals and objectives of Nauru's National Sustainable Development Strategy, 2005–2025, ^a which aims to improve the “sustainable quality of life for all Nauruans” through the following: <ol style="list-style-type: none"> 1. A stable, trustworthy, and fiscally responsible government. 2. The provision of enhanced social, infrastructure, and utility services. 3. The development of an economy based on multiple sources of revenue. 			
Results Chain	Performance Targets and Indicators with Baselines	Data Sources and Reporting	Risks
Outcome Improved fiscal sustainability	a. Additional government contributions to the NTF exceed \$20.0 million by 2018 (2015 baseline: \$14.6 million) b. 50% of the NUC's operational costs recovered through tariffs by December 2018 (2014 baseline: tariffs covered 20% of operational costs)	NTF annual report, government budget papers, ADB macroeconomic assessments	Political commitment to fiscal consolidation and trust fund contributions weakens Severe financial, fisheries, and phosphate market fluctuations and/or external shocks undermine revenue and NTF performance
Outputs 1. Improved public financial management 2. Efficient service delivery by the NUC 3. Improved funding mechanism for future service delivery	1. FMIS produces a government balance sheet by 2017 (2015 baseline: none) 2. Strategic maintenance plan for NUC assets approved and allocations for operations and maintenance included in the annual budget by 2017 (baseline: not applicable) 3. NTF made operational with a sound governance, economic, and financial framework design, including the appointment of a custodian bank and investment manager by 2016 (baseline: not applicable)	1. FMIS reports, government budget papers 2. Certified NUC asset maintenance plan 3. NTF annual reports	Broad reform consensus weakens because of political pressure Capacity constraints and staff turnover reduce the continuity and quality of reform implementation Political interference in the management of the NUC Waning commitment to reform implementation and compliance at the administrative level
Key Activities with Milestones Not applicable.			
Inputs ADB: \$2 million (grant) Government of Australia: \$1.8 million equivalent (grant)			

ADB = Asian Development Bank, FMIS = financial management information system, NTF = Nauru Intergenerational Trust Fund, NUC = Nauru Utilities Corporation.

^a Government of Nauru. 2005. *National Sustainable Development Strategy, 2005–2025 (As Revised 2009)*. Yaren. Source: Asian Development Bank.

LIST OF LINKED DOCUMENTS

<http://adb.org/Documents/RRPs/?id=48478-001-2>

1. Grant Agreement
2. Sector Assessment (Summary): Public Sector Management
3. Sector Assessment (Summary): Energy
4. Contribution to the ADB Results Framework
5. Development Coordination
6. Country Economic Indicators
7. Summary Poverty Reduction and Social Strategy
8. Risk Assessment and Risk Management Plan
9. List of Ineligible Items

Supplementary Documents

10. Economic and Fiscal Analysis
11. Analysis of the Nauru Intergenerational Trust Fund

DEVELOPMENT POLICY LETTER

REPUBLIC OF NAURU

Department of Finance

January 20, 2016

Mr. Takehiko Nakao
President
Asian Development Bank
6 ADB Avenue
Mandaluyong, Metro Manila
Philippines

Dear President Nakao,

Subject: Fiscal Sustainability Reform Program Grant to Nauru

The Government of Nauru is firmly committed to keeping the country on the path to fiscal stability over the medium term. *"A future where individual, community, business and government partnerships contribute to a sustainable quality of life for all Nauruans"* is at the heart of our national development plan, called the National Sustainable Development Strategy (NSDS), 2005–2025, and our reform efforts over the past decade.

Nauru is a very small and geographically remote island. We have a total land area of 21 square kilometers and a population of approximately 10,000. Our small size, remoteness and a narrow set of resources translate into severe structural challenges to economic development. Subsequently, opportunities for private sector development are extremely limited, as is the government's ability to fund and deliver public services. We are heavily exposed to economic shocks. Lack of access to debt financing means it is critical that we maintain fiscal discipline to ensure sufficient fiscal buffers to protect budget stability.

Recent Macroeconomic Performance

Nauru has experienced an economic resurgence in recent years. Phosphate mining resumed in 2007 and provided a timely offset to the closure of the Regional Processing Centre (RPC) for asylum-seekers that year. Revenue from fishing licenses has increased significantly in recent years owing to the Vessel Day Scheme under the Nauru Agreement. Finally from mid-2012 the RPC was reopened. Recent estimates suggest real economic growth averaged

A handwritten signature in black ink, consisting of stylized, cursive letters.

20.7% over FY2008 to FY2014. However, economic growth is expected to slow over the coming years as activity at the RPC and windfall revenues stabilize at current levels.

The government's fiscal position improved considerably over the same period. The budget for FY2016 targets a balanced budget. We have directed a significant portion of increased fiscal resources towards reducing public debt levels. Most of this reflects reductions in domestic debt, in particular the near full payment of outstanding salary arrears.

Government Response and Development Partner Support

The NSDS, which was updated in 2009, contains five long-term goals that drive the government's reform agenda: *a stable, trustworthy, fiscally responsible government; provision of enhanced social, infrastructure and utilities services; development of an economy based on multiple sources of revenue; rehabilitation of mined out lands for livelihood sustainability; and development of domestic food production.*

Under the NSDS, the government has delivered fiscal discipline, reduced government debt, introduced finance sector reforms, started to restructure poorly performing state-owned enterprises, and implemented vital public financial management reforms. We acknowledge the importance of continuing these reforms, particularly those related to improving public financial management quality and the delivery of critical power and water services through the Nauru Utilities Corporation. However, our ability to sustain these reforms whilst at the same time ensure regular delivery of public goods and services are constrained by our heavy reliance on highly volatile and unpredictable external revenues such as fishing license fees and development assistance. There is also a great deal of uncertainty around the future of the RPC, which plays a significant role in the local economy and is the second largest single employer after Government. We believe that the establishment of a Nauru Intergenerational Trust Fund (NTF) as a tool to better manage donor funds and windfall revenues will be a critical next step towards ensuring future fiscal stability and sustainability. The NTF will provide a source of budget revenue post-2033 for investments in education, health, environment and infrastructure. It will help to smooth out windfall income streams in the medium term and replace or supplement finite and volatile future revenue streams (for example, phosphate mining, visa fees, and fisheries revenue).

In any event, this Government is committed to continuing with vital reforms in public financial management, state-owned enterprise performance and service delivery, and fiscal management. We are working closely with our development partners, in particular ADB, the Government of Australia and the Pacific Financial Technical Assistance Center on these reforms to establish a stronger fiscal foundation for long-term growth.

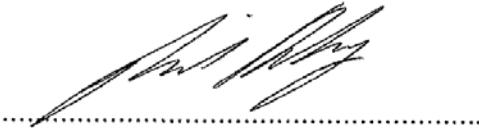


Government of Nauru's Request

I therefore seek ADB's favorable consideration of a policy based grant of US\$2 million, which is to be disbursed in a single tranche in 2016 in line with the policy reform milestones contained in the policy reform matrix. The program will support this Government's efforts to achieve fiscal sustainability. Its main feature is the establishment of the NTF, complemented by reforms to improve public financial management and efficient delivery of power and water services. The implementation of the program will help to strengthen our public financial management system (Output 1), realize fiscal savings and efficiencies in the power sector through improved performance of the Nauru Utilities Company (Output 2), and put in place a mechanism for the government to save windfall revenues for future generations (Output 3).

The implementation of these reform actions will also give direction to future public sector management reforms, as well as the support that ADB and other development partners can provide, and help us to achieve fiscal stability while keeping the economy on a higher growth path. I am confident that our strong ownership, supported by financial and technical assistance from ADB and the other development partners, will assist us to achieve our vision for Nauru.

Yours sincerely,



Hon. David Adeang

Minister for Finance



POLICY MATRIX

Expected Output	Policy Reform Action	Responsible Agency and TA	Verification Measure	Post-Program Monitoring FY2016–FY2018
NSDS Goal: Stable, trustworthy, fiscally responsible government				
Output 1: Improved Public Financial Management	<ol style="list-style-type: none"> 1. The accounts payable and bank reconciliation functions of the financial management information system will be made fully functional. 2. Quarterly financial progress reports will be produced and submitted to the Minister for Finance regularly. 3. Weekly in-year budget reports that include cashflow budget statements will be produced and made available to all ministries regularly. 4. Aggregate revenue and expenditure projections for FY2016–FY2018 will be prepared. 5. The Employment and Services Tax Bill will have been approved by the Parliament and come into force. 	<ol style="list-style-type: none"> 1–4. Treasury Department (DFAT/PFTAC) 5. Department of Revenue (DFAT/PFTAC) 	<p>Letter from the Minister for Finance confirming completion of all actions.</p> <p>Certified copies of:</p> <ul style="list-style-type: none"> – Age Analysis Report; – MOF Treasury Bank reconciliation statement; – GON quarterly financial progress report; – GON weekly in-year budget report; – Copy of aggregate revenue and expenditure projections for FY2016–FY2018; – Employment and Services Tax Act 2014. 	Government to (i) make the general ledger, accounts receivable and purchasing modules fully functional, (ii) continue to prepare and submit quarterly financial progress reports and weekly in-year budget reports, (iii) take further steps toward medium term budgeting through establishing a medium-term fiscal framework and preparing of 3-year costed and rolling corporate plans; and (iv) adopt further revenue measures including the introduction of a business profits tax.
NSDS Goal: Provision of enhanced social, infrastructure and utilities services				
Output 2: Efficient service delivery by the NUC	<ol style="list-style-type: none"> 6. Strategic Plan for NUC is developed and the following strategies adopted, which shall cover: 	6–7. NUC (ADB)	Letter from the Minister for Finance confirming the adoption of the Strategic Plan and Strategic	Government to implement a comprehensive tariff reform to improve NUC cost recovery and financial sustainability.

Expected Output	Policy Reform Action	Responsible Agency and TA	Verification Measure	Post-Program Monitoring FY2016–FY2018
	<ul style="list-style-type: none"> – Performance-based management system for all employees; – “Mind-Your-Own-Business”, or MYOB, financial accounting software; and – Short-term program for asset rehabilitation. <p>7. A strategic maintenance plan for NUC assets will be developed and adopted.</p>		<p>Maintenance Plan.</p> <p>Letter from the CEO for NUC confirming adoption of the performance-based system, the MYOB software package, and the short-term program for asset rehabilitation.</p> <p>Certified copies of the Strategic Plan and Strategic Maintenance Plan.</p>	<p>Government to continue reforms to NUC including strengthening management autonomy through the establishment of an independent board of directors.</p>
NSDS Goal: Development of an economy based on multiple sources of revenue				
Output 3: Improved funding mechanism for future service delivery	<p>8. The MOU agreement between the government and Government of Australia on the establishment of the NTF will have been signed.</p> <p>9. An allocation of A\$20.4 million will be made as the government's initial contribution to the NTF, including A\$10.4 million to be paid from FY 2016 revenues and A\$10 million to be paid from cash set-asides from previous financial years.</p>	<p>8. Planning and Aid Department (DFAT/ADB)</p> <p>9. Treasury Department</p> <p>10. Planning and Aid Department (DFAT/ADB)</p>	<p>Copy of signed NTF MOU agreements with development partners.</p> <p>Copy of 2015-16 budget papers and budget appropriation bill.</p>	<p>The government will transfer the budgeted amount of A\$20.4 million to the NTF as its initial contribution to the fund. The government and other partners will make regular financial contributions to the NTF. Government contributions will follow the NTF contribution framework.</p> <p>The government will integrate the NTF into a broader medium-term fiscal framework.</p>

ADB = Asian Development Bank; DFAT = Department of Foreign Affairs and Trade (Government of Australia); FY = financial year; GON = Government of Nauru; MOF = Ministry of Finance; MOU = Memorandum of Understanding; NSDS = National Sustainable Development Strategy; NTF = Nauru Intergenerational Trust Fund; NUC = Nauru Utilities Corporation; PFTAC = Pacific Financial Technical Assistance Centre; TA = technical assistance.

Source: Asian Development Bank.