



Concept Paper

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October 2015

Proposed Policy-Based Grant Nauru: Fiscal Sustainability Reform Program

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Asian Development Bank

CURRENCY EQUIVALENTS

(as of 15 September 2015)

Currency unit	–	Australian dollar (A\$)
A\$1.00	=	0.7142
\$1.00	=	A\$1.400168

ABBREVIATIONS

ADB	–	Asian Development Bank
MOF	–	Ministry of Finance
NSDS	–	National Sustainable Development Strategy
NTF	–	Nauru Intergenerational Trust Fund
NUC	–	Nauru Utilities Corporation
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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PROGRAM AT A GLANCE

1. Basic Data		Project Number: 48478-001	
Project Name	Fiscal Sustainability Reform Program	Department /Division	PARD/PAUS
Country Borrower	Nauru Ministry of Finance, 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		1.80	
Counterpart		0.00	
None		0.00	
Total		3.80	
9. Effective Development Cooperation			
Use of country procurement systems		No	
Use of country public financial management systems		No	

I. THE PROGRAM

A. Rationale

1. The proposed Fiscal Sustainability Reform Program is the latest in a series of program grant and technical assistance (TA) operations of the Asian Development Bank (ADB) and other development partners designed to support the Government of Nauru's efforts to achieve fiscal sustainability.¹ The program's main feature is the establishment of the Nauru Intergenerational Trust Fund (NTF). This will be complemented by reforms to improve public financial management (PFM) and the efficient delivery of power and water services.

2. **Development context.** Nauru is very small and geographically remote. It has a total land area of 21 square kilometers and a population of approximately 10,000. Nauru's small size, remoteness, and limited resources significantly constrain the scope of private sector development. This limits the country's ability to finance basic government operations and service delivery while the public sector also faces diseconomies of scale and a small domestic pool of skilled labor.

3. **Overview of the economy.** The public sector dominates the economy. The civil service and state-owned enterprises (SOEs), particularly the Nauru Utilities Corporation (NUC), accounted for 82% of total employment in 2010. The state budget relies on a limited set of volatile revenue sources including fishing license fees, phosphate mining, customs duties, and, more recently, revenues associated with the reopened Australian Regional Processing Centre (RPC) for asylum seekers. Use of the Australian dollar as legal tender supports price stability but makes monetary policy unusable as an economic management tool.

4. **Recent economic and fiscal performance.** After the reopening of the RPC in 2012, Nauru experienced a resurgence in economic growth. This, together with windfall fishing license revenue and high levels of development assistance, led to average growth of about 8% during FY2012–FY2014, and a 288% increase in domestic revenues from FY2012 to FY2015. ADB estimates that, as the effects of these positive shocks taper off, growth will reach 6.8% in FY2015 and 5.4% in FY2016. As revenue stabilizes around current levels, the FY2016 national budget has targeted a surplus of 0.1% of gross domestic product predicated on expenditure restraint. Public debt, which has fallen significantly in recent years, accounts for around 31.8% of gross domestic product, together with arrears and liabilities. Nonetheless, Nauru faces large downside risks that could undo much of this progress, with significant uncertainty surrounding the future of the RPC and the sustainability of fisheries revenue.

5. **Government reform efforts.** A “stable, trustworthy, fiscally responsible government” is the central long-term goal of Nauru's National Sustainable Development Strategy (NSDS), 2005–2025.² Under this strategy, the government has delivered fiscal surpluses, reduced government debt, introduced finance sector reforms, begun restructuring poorly performing SOEs, and implemented vital PFM reforms. The government acknowledges the importance of continuing these reforms, particularly those related to improving PFM quality and delivery of utility services. It is critical to establish an NTF to accelerate these efforts.

¹ The program is included in ADB's country operations business plan (ADB. 2014. *Country Operations Business Plan: Nauru, 2015–2017*. Manila). It is aligned with ADB's Interim Pacific Approach (ADB. 2015. *Interim Pacific Approach, 2015*. Manila), which extends the validity of the Pacific Approach (ADB. 2009. *Pacific Approach, 2010–2014*. Manila).

² Government of Nauru. 2005. *National Sustainable Development Strategy, 2005–2025 (Revised 2009)*. Nauru.

6. **Public financial management reform.** In 2011, the government adopted a PFM action plan based on its 2010 public expenditure and financial accountability assessment³ to guide its reform efforts. Steady progress is being made, including (i) the installation of an automated financial management information system, Technology One; (ii) revision of the public procurement law and outsourcing of major procurement operations; and (iii) the introduction of annual operating plans linking expenditure more closely to the NSDS. However, many potential threats to Nauru's fiscal position remain to be addressed. For example, it is necessary to implement effective expenditure controls and improve the efficiency and fairness of the revenue system.

7. **Utilities reform.** The NUC supplies electricity and water. Poor asset management and outdated infrastructure has caused frequent power outages, a situation that has been exacerbated by the large increase in electricity demand since the reopening of the RPC. In addition, fuel subsidies provided to the NUC for power generation were a significant drain on the annual budget. These were replaced by a direct subsidy of up to \$5.5 million in FY2015. Planned power tariff reforms should reduce the fiscal burden of these subsidies.

8. **Ensuring future service delivery.** The government has been trying to set up the NTF since 2009 when a prospectus was forwarded to potential donors. In 2012, Parliament passed the Nauru Trust Fund Act to authorize its establishment. The NTF will help ensure that donor funds and windfall revenues are managed better and provide a future source of stable budget financing. The government has demonstrated its commitment by setting aside \$14.6 million during FY2015–FY2016 as its contribution to the NTF. ADB's experience with trust funds in the region demonstrates that they help sterilize a portion of these funds to avoid (i) the resource curse leading to nonproductive and non-wealth-producing spending and inflationary spirals; and (ii) constraints on areas such as capacity and infrastructure, some of which are now emerging in Nauru. Furthermore, trust funds should be established (i) in case of unanticipated excess resources for which there are no immediate or urgent uses, (ii) when a critical long-term resource shortage is forecast and no cheaper or more efficient means of financing is foreseeable, and (iii) as a hedge against economic volatility.⁴ The NTF meets these criteria.

9. **Program modality.** ADB proposes a stand-alone policy-based operation that requires all policy actions to be accomplished prior to grant effectiveness. The program fully supports the implementation of key policies agreed upon with the government, and is supported by all major development partners including the Government of Australia. The program is being developed in the context of a programmatic policy discussion with key partners and is based on the NSDS. Lessons from ADB's experience in Nauru and the Pacific include (i) limiting reform to a small number of major actions; (ii) using a single tranche within a programmatic, multiyear framework for policy dialogue and TA; and (iii) combining TA with policy-based operations to undertake complex, politically sensitive reforms.

B. Outcome and Outputs

10. The program outcome will be improved fiscal sustainability. This will be achieved by implementing three outputs that aim to (i) strengthen the PFM system, (ii) realize fiscal savings and efficiencies in the power sector, and (iii) establish a mechanism for the government to save windfall revenues for future generations. As of 21 August 2015, four of nine policy actions had been completed.

³ ADB. 2010. *Public Expenditure and Financial Accountability Assessment for Nauru*. Manila.

⁴ ADB. 2006. *Trust Funds in the Pacific: Their Role and Future*. Manila.

11. **Output 1: Improved public financial management.** The accounts receivable, accounts payable, fixed asset, and bank reconciliation functions of the financial management information system will be made fully operational. Aggregate revenue and expenditure projections for 2015–2020 will be prepared to inform budget ceilings as a first step towards medium-term budgeting. The Cabinet will approve the Employment and Services Tax Bill to help broaden the revenue base and generate sustainable revenue.

12. **Output 2: Efficient service delivery by the National Utility Corporation.** A power tariff reform study assessing economic cost and existing subsidies and proposing reform options will be completed to help the government continue tariff reform. A strategic plan and a strategic maintenance plan will be developed for the NUC and performance-based management arrangements adopted. This will improve efficiency and complement ADB investment in the NUC's generation capacity.

13. **Output 3: An improved funding mechanism for future service delivery.** Timely establishment of the NTF is crucial to save current windfall revenues. A governance and economic model for the NTF will be developed and agreed upon between the government and its key development partners at the official level, and the custodian bank and investment manager for the NTF will be selected. Further details on the NTF, including the investment strategy, are in Appendix 4.

C. Program Costs and Financing

14. The proposed program amount and direct partner cofinancing is in Table 1. Of the total amount of \$3.8 million, \$2.0 million is from ADB's special funds resources and \$1.8 million equivalent (or A\$2.5 million) is directly cofinanced by the Government of Australia.⁵ The program amount will provide seed financing for the NTF.

Table 1: Tentative Financing Plan

Source	Amount (\$ million)	Share of Total (%)
Asian Development Bank		
Special Funds resources (grant)	2.0	52.63
Government of Australia	1.8	47.36
Total	3.8	100.00

Note: Numbers may not sum precisely because of rounding.

Source: Asian Development Bank.

D. Indicative Implementation Arrangements

15. The Ministry of Finance (MOF) will be the executing agency. The MOF will (i) oversee policy, legal, and regulatory reforms; (ii) ensure that the policy actions, as agreed upon by the government and ADB, are duly carried out on time; and (iii) be responsible for the overall program implementation, including carrying out all policy actions, administering the program, and maintaining all program records. Monitoring program implementation and outcomes will maximize the use of existing processes, including regular reporting under the government's aid program. The program will be implemented over 18 months, from June 2014 to June 2016, with continuing post-program monitoring through December 2017.

⁵ The Government of Nauru will provide \$14.7 million equivalent and the Government of Taipei, China will provide \$2.5 million equivalent in parallel cofinancing.

II. DUE DILIGENCE REQUIRED

16. Due diligence for the program, to be prepared in cooperation with development partners, will include (i) a sector assessment focused specifically on public management, (ii) an assessment of the NTF's governance structure and resource flows, building on Appendix 4 and regional good practices; (iii) a macroeconomic assessment; (iv) an assessment of the utilities sector and the NUC's performance in particular; and (v) a risk assessment and risk management plan that includes the country's PFM system. The initial poverty and social analysis is in Appendix 3.

III. PROCESSING PLAN

A. Risk Categorization

17. The program is categorized as low risk because (i) its program grant does not exceed \$50 million (the program grant is \$3.8 million equivalent); (ii) it builds on ADB's previous experience in public sector management in Nauru as demonstrated by a sound track record in PFM and structural reforms; (iii) it has executing agency capacity in terms of externally financed project administration (the MOF has sufficient experience administering ADB policy-based grants and TA); and (iv) it is not classified as safeguard category A (it is classified as category C with no expected adverse impact on the environment and no involuntary resettlement and indigenous peoples impacts).

B. Resource Requirements

18. The program will require 6 person-months of international staff and 6 person-months of national staff. No project preparatory TA or project design advance will be required.

C. Processing Schedule

19. The proposed processing schedule is in Table 2.

Table 2: Proposed Processing Schedule

Milestones	Expected Completion Date
Staff review meeting	23 November 2015
Grant negotiations	14–15 January 2016
Board consideration	21 March 2016

Source: Asian Development Bank.

IV. KEY ISSUES

20. During processing and implementation, particular attention will be paid to (i) maintaining broad reform commitment and managing the political economy; and (ii) coordinating with other development partners providing TA during the program period to ensure, amongst other things, the timely availability of TA.

PRELIMINARY DESIGN AND MONITORING FRAMEWORK

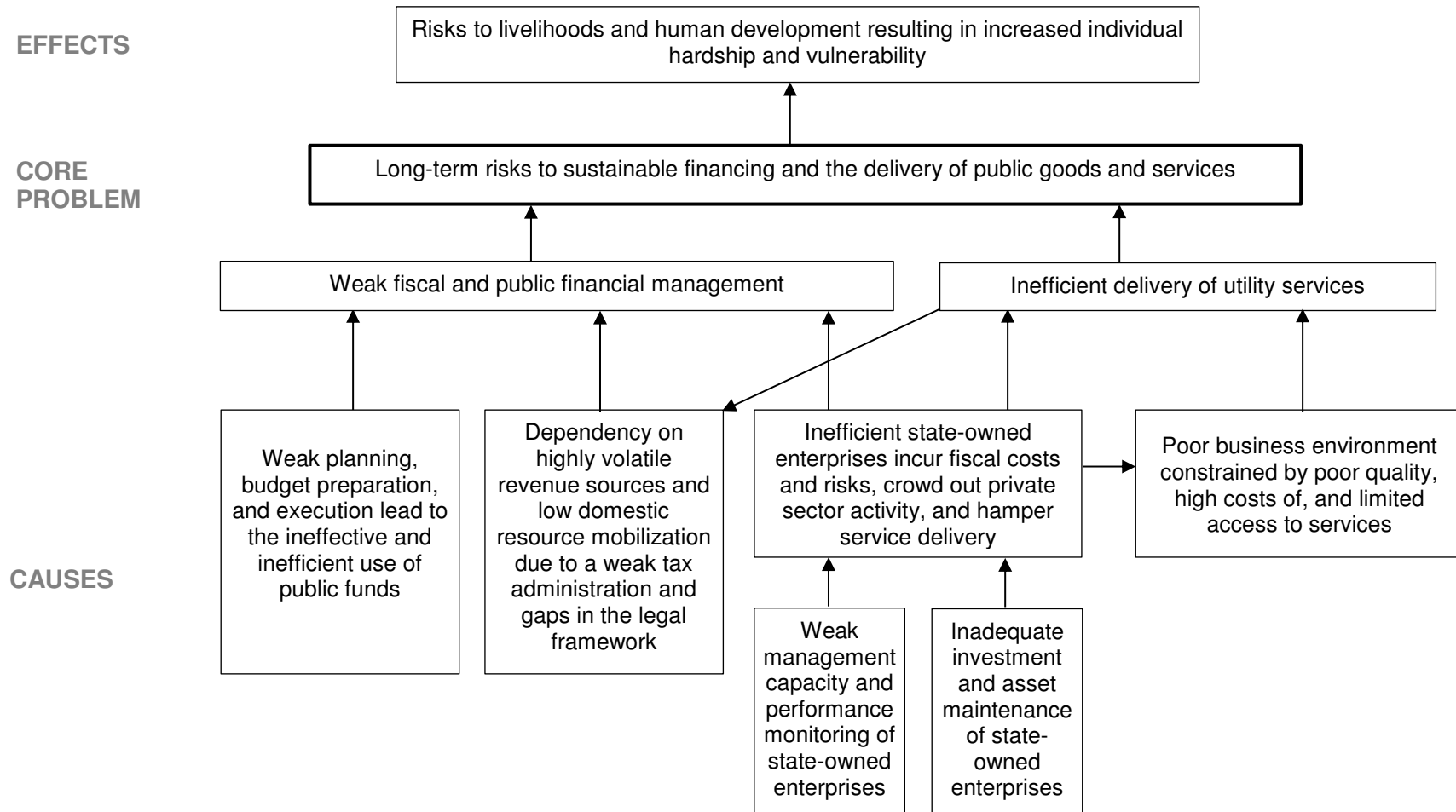
Impact the Program is Aligned with:			
The project is aligned with the objectives of Nauru's National Sustainable Development Strategy, 2005–2025:			
1. A stable, trustworthy, and fiscally responsible government.			
2. The provision of enhanced social, infrastructure, and utility services.			
3. The development of an economy based on multiple sources of revenue.			
Results Chain	Performance Targets and Indicators with Baselines	Data Sources and Reporting	Risks
Outcome The Government of Nauru improves its fiscal sustainability	a. Government contributions to the NTF exceed \$20 million by 2018 (2015 baseline: \$14.6 million) b. 50% of the NUC's operational costs funded through tariffs by December 2018 (2014 baseline: tariffs covered 20% of operational costs)	a. NTF annual report b. Government budget papers c. 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	1a. FMIS produces a government balance sheet by 2017 (2015 baseline: none)	1a. FMIS reports 1b. Government budget papers	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
2. Efficient service delivery by the NUC	2a. Strategic maintenance plan for NUC assets approved and allocations for operations and maintenance included in the annual budget by 2017 (baseline: not applicable)	2a. Certified NUC asset maintenance plan	Waning commitment to reform implementation and compliance at the administrative level
3. Improved funding mechanism for future service delivery	3a. 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)	3a. NTF annual reports	
Inputs			
ADB: \$2.0 million (grant)			
Government of Australia: \$1.8 million equivalent (grant)			

ADB = Asian Development Bank, FMIS = financial management information system, FY = fiscal year, NUC = Nauru Utilities Corporation, NTF = Nauru Intergenerational Trust Fund, SOE = state-owned enterprise.

^a The System Average Interruption Duration Index and System Average Interruption Frequency Index will be used to indicate performance.

Source: ADB.

PROBLEM TREE
NAURU: FISCAL SUSTAINABILITY REFORM PROGRAM



Source: Asian Development Bank.

INITIAL POVERTY AND SOCIAL ANALYSIS

Country:	Nauru	Project Title:	Fiscal Sustainability Reform Program
Lending/Financing Modality:	Policy-Based Program Grant	Department/Division:	Pacific Department/Pacific Liaison and Coordination Office

I. POVERTY IMPACT AND SOCIAL DIMENSIONS

A. Links to the National Poverty Reduction Strategy and Country Partnership Strategy

ADB's Interim Pacific Approach, 2015 focuses on private sector development and strengthening public sector management.^a ADB is also supporting the implementation of Nauru's NSDS, 2005–2025, which shares this dual focus.

The Interim Pacific Approach recognizes that, in a microeconomy such as Nauru's, poor public sector management coupled with a poor climate for doing business results in significant opportunity costs that impede development and growth. For this reason, the emphasis on improving public sector management, access to finance, and in particular the governance and performance of the SOEs that dominate Nauru's economy is highly appropriate. The proposed program grant is included in the Nauru country operations business plan, 2015–2017.^b

A new Nauru trust fund, improved utility services, the reintroduction of financial services, and improved public financial management are key deliverables under the NSDS, 2005–2025.

B. Poverty Targeting

General Intervention Individual or Household (TI-H) Geographic (TI-G) Non-Income MDGs (TI-M1, M2, etc.)

The program will contribute to poverty by supporting (i) sustainable, equitable, and inclusive long-term economic growth built on improved public financial management and an enabling business environment; (ii) improved service delivery from the NUC; (iii) reduced transfers to SOEs lessening the drain on the annual budget and freeing up resources for development expenditure; (iv) improved access to financial services through the introduction of a banking agent; (v) a strengthened tax administration and policy framework increasing revenue for development and poverty reduction; (vi) the saving of windfall revenues to fund essential services in the future; and (vii) enhanced job creation with private sector growth.

C. Poverty and Social Analysis

1. Key issues and potential beneficiaries. The potential beneficiaries are the general public and future generations of Nauruans. The proposed program will contribute to poverty reduction by helping improve access to and fund the delivery of services for vulnerable people in the future.

2. Impact channels and expected systemic changes. Due to its limited economic base, Nauru may have difficulty providing services to its citizens when its resources, such as phosphate, are exhausted. The program includes the establishment of a new Nauru trust fund to provide resources for future service delivery. Structural reforms and improvements to public financial management will also provide resources for pro-poor service delivery. Improved access to financial services will also facilitate greater income-earning opportunities and the development of financial services.

3. Focus of (and resources allocated in) the PPTA or due diligence. The due diligence focuses primarily on the design, governance, and sustainability of the new NTF. This will be achieved through existing TA resources.

4. Specific analysis for policy-based lending. The program will, among other policy reforms, support the establishment of a new Nauru trust fund to transform volatile revenues into a stable revenue stream to support future service delivery. The major short-term impacts will be improved access to financial services and improved service delivery by the NUC. The major long-term impact will be improved funding for future service delivery through the NTF.

II. GENDER AND DEVELOPMENT

1. What key gender issues in this sector/subsector are likely to be relevant to this project or program?

Women face particular challenges in Nauru, and the country is not on track to achieve MDG 3 to promote gender equality and empower women. Nauru acceded to the CEDAW in June 2011 and the government prepared a legal review for CEDAW compliance in February 2014, with a plan to implement the CEDAW over the next 5 years. A women's policy was approved in 2014, but there are no national mechanisms aimed at effective collaboration for gender equality and women's empowerment. In 2002, 68% of women were participants in the labor force, compared to 85% of men. Of these individuals, more women than men were actively looking for work, with unemployment rates

at 29.6% for women and 17.0% for men. Of those who were working, a slightly higher percentage of women (85.8%) were engaged in paid formal employment than men (82.5%). Although most Nauruans attend school, education attainment for both male and female students is poor, with only 11% of male students and 15% of female students completing secondary education. Efforts will be made during fact finding to incorporate gender-disaggregated data collection and reporting wherever feasible.

2. Does the proposed project or program have the potential to make a contribution to the promotion of gender equity and/or empowerment of women by providing women's access to and use of opportunities, services, resources, assets, and participation in decision making?
 Yes No Please explain. The program will empower women through better access to finance, which provides opportunities to run and expand businesses. Like many other patrilineal Pacific countries, men are still much more privileged than women with regard to workforce involvement. A woman's primary role is still thought to be preparing food for the family and other household activities, including gardening.
 Women will also benefit from increased resources for pro-poor service delivery in the future.

3. Could the proposed project have an adverse impact on women and/or girls or widen gender inequality?
 Yes No Please explain. The proposed program aims to improve (i) funding mechanisms for future service delivery, (ii) access to financial services, and (iii) public financial management.

4. Indicate the intended gender mainstreaming category: To be revisited during fact finding.
 GEN (gender equity) EGM (effective gender mainstreaming)
 SGE (some gender elements) NGE (no gender elements)

III. PARTICIPATION AND EMPOWERMENT

1. Who are the main stakeholders of the project, including beneficiaries and negatively affected people? Identify how they will participate in the project design.
 All residents of Nauru are potential stakeholders in this policy-based program. Specific interest groups among the stakeholders include private sector actors and women who are potential beneficiaries of proposed policy actions. Key implementing ministries—the Ministry of Finance; NUC; and Ministry of Commerce, Industry and Environment—are also key stakeholders.

2. How can the project contribute (in a systemic way) to engaging and empowering stakeholders and beneficiaries, particularly, the poor, vulnerable, and excluded groups? What issues in the project design require participation of the poor and excluded?
 Information on the establishment of a new trust fund should be shared and discussed with community groups, supplementing discussions carried out under previous ADB TA.

3. What are the key, active, and relevant civil society organizations in the project area? What is the level of civil society organization participation in the project design?
 (H) Information generation and sharing, (M) Consultation, (N) Collaboration, (N) Partnership

4. Are there issues during project design for which participation of the poor and excluded is important? What are they and how shall they be addressed? Yes No Information on the establishment of a new trust fund should be shared and discussed with community groups, supplementing discussions carried out under previous ADB TA.

IV. SOCIAL SAFEGUARDS

A. Involuntary Resettlement Category A B C FI

1. Does the project have the potential to involve involuntary land acquisition resulting in physical and economic displacement? Yes No The program will not involve involuntary resettlement.

2. What action plan is required to address involuntary resettlement as part of the PPTA or due diligence process?
 Resettlement plan Resettlement framework Social impact matrix
 Environmental and social management system arrangement None

B. Indigenous Peoples Category A B C FI

1. Does the proposed project have the potential to directly or indirectly affect the dignity, human rights, livelihood systems, or culture of indigenous peoples? Yes No

2. Does it affect the territories or natural and cultural resources indigenous peoples own, use, occupy, or claim, as their ancestral domain? Yes No The program will have no impact on indigenous peoples.

3. Will the project require broad community support of affected indigenous communities? Yes No The program will have no impact on indigenous peoples.

4. What action plan is required to address risks to indigenous peoples as part of the PPTA or due diligence process?
 Indigenous peoples plan Indigenous peoples planning framework Social Impact matrix

Environmental and social management system arrangement None

V. OTHER SOCIAL ISSUES AND RISKS

1. What other social issues and risks should be considered in the project design?

- Creating decent jobs and employment Adhering to core labor standards Labor retrenchment
 Spread of communicable diseases, including HIV/AIDS Increase in human trafficking Affordability
 Increase in unplanned migration Increase in vulnerability to natural disasters Creating political instability
 Creating internal social conflicts Others, please specify ___NA_____

2. How are these additional social issues and risks going to be addressed in the project design?

Further effort will be made to determine the impacts of NUC tariff reforms on the people of Nauru, particularly those living below the national poverty line (25.1% in 2006).

VI. PPTA OR DUE DILIGENCE RESOURCE REQUIREMENT

1. Do the terms of reference for the PPTA (or other due diligence) contain key information needed to be gathered during PPTA or due diligence process to better analyze (i) poverty and social impact, (ii) gender impact, (iii) participation dimensions, (iv) social safeguards, and (v) other social risks. Are the relevant specialists identified?

Yes No The program design draws on poverty, social, and gender analyses prepared for the expanded Nauru country operations business plan, 2015–2017 (approved in September 2014), Nauru Women's Policy, and country performance assessment.

2. What resources (e.g., consultants, survey budget, and workshop) are allocated for conducting poverty, social and/or gender analysis, and participation plan during the PPTA or due diligence?

None. The reforms are grounded in the NSDS, which was the product of an extensive consultation process across stakeholders in all districts. Additional consultations with civil society and the private sector will be carried out during fact finding.

ADB = Asian Development Bank, CEDAW = Convention on the Elimination of All Forms of Discrimination against Women, MDG = millennium development goal, NSDS = National Sustainable Development Strategy, NTF = Nauru Intergenerational Trust Fund, NUC = Nauru Utilities Corporation, PPTA = project preparatory technical assistance, SOE = state-owned enterprise, TA = technical assistance.

^a ADB. 2015. *Interim Pacific Approach, 2015*. Manila. The Interim Pacific Approach extends the validity of the Pacific Approach (ADB. 2009. *Pacific Approach, 2010–2014*. Manila).

^b ADB. 2014. *Country Operations Business Plan: Nauru, 2015–2017*. Manila.

Source: ADB.

SUMMARY OF THE NAURU INTERGENERATIONAL TRUST FUND

1. The Government of the Republic of Nauru has pursued establishing a trust fund since 2009 with the objective of providing a stream of revenue to replace or supplement various volatile and, possibly, terminating revenue sources.

2. The *Nauru National Sustainable Development Strategy 2005-25: Partnerships for Quality of Life (as revised in October 2009)* identifies the establishment of a trust fund as one of the seven strategies to stabilize the macroeconomic environment conducive to private investment. The aim was to have a trust fund provide supplementary funds to the budget as of 2030, mainly to replace dwindling phosphate royalty revenues. A trust fund prospectus was formulated in 2009 and forwarded to potential donors. Parliament passed the *Nauru Trust Fund Act 2012* to authorize the establishment of a trust fund.

3. Since that time, Nauru's economic structure and the government's revenue streams have improved. For the period between FY2010–11 (preliminary actual figures) and FY2014–15 (approved budget figures), domestic revenue is estimated to have increased by about 317 percent. Donor budget support and other donor-sponsored development expenditure have remained at sizeable amounts but are a reduced portion of the overall budget.

4. The change is catalyzed by: (i) continued phosphate royalty revenues but at lesser amounts than in past decades with continued fluctuation in this revenue source expected; (ii) fisheries revenue, resulting from fishing vessels using Nauru's Exclusive Economic Zone and a new fisheries agreement in effect, have increased and are expected to be at higher levels yet are volatile; and (iii) visa fees have dramatically increased based on the fees charged for the Australian Regional Processing Centre and may further increase because of a potential increased fee for business visas. At the same time, responding to these primary revenue increases, customs and tariff and other revenue streams have also increased. And, external aid assistance remains at high levels, making up about one-third of all revenue to include budget support and donor-supported development expenditure.

5. Establishing a trust fund at this time is more favorable given the healthier government budget picture and the need to steer some of these windfall revenues out of the economy and into a finance vehicle that will invest these funds in a productive manner so the funds are protected and produce future and stable budget support. The three revenue streams mentioned are not expected to continue over the long term and could be precarious over the medium term. As shown in past country economic history and by the establishment of trust funds for other countries including for Pacific island countries, a trust fund could (i) help "sterilize" a portion of these funds to avoid the so-called "Dutch disease" that could result in spending and inflationary spirals that are non-productive and non-wealth producing; and (ii) avoid capacity and other constraints, some of which are now surfacing in Nauru.

6. The proposed trust fund would be established as the intergenerational Trust Fund for the people of the Republic of Nauru (or NTF hereinafter referred to as the Fund). The Fund will aim to be a perpetual fund meaning its principal will be secured over the long term by eventual annual distributions that are less than the annual estimated long-term investment return rate. The Fund will be registered in Australia. The following are characteristics of the Fund:

- The Fund's purpose is to provide a source of budget revenue post-2033, or at a time sooner as determined by the Trust Fund Committee, for investments in education, health,

environment and infrastructure. The Fund will help to smooth out windfall income streams in the medium term and replace all or part or supplement questionable future revenue streams (phosphate mining, visa fees, fisheries, donor assistance).

- Based on estimates calculated at time of the Fund's design, the principal value to achieve is about \$400 million. The Committee from time to time based on the Fund's investment performance, contributions and the Government of the Republic of Nauru's fiscal situation may adjust this amount.
- The Fund will include contributions from the government, development partner countries and possibly others (international and regional entities, individuals, foundations).
- The Fund will be managed and administered by a Memorandum of Understanding between the Original Partners to the Fund. The Agreement describes the make-up and functions of the Trust Fund Committee and service providers such as Trustee/Custodian Bank, Investment Advisor(s), Fund Managers, Accountant, Executive Administrator, and Auditor.
- Each Original Partner will nominate a Committee member. Committee decisions will be by unanimous vote with the aim to achieve consensus on all decisions. Subsequent contributors (those who contribute but are not an Original Partner) may or may not be a Committee member depending on that Contributor and the Committee.
- The Fund cannot be encumbered or used as an asset to borrow against by any partner.
- The Fund build-up period is estimated at 20-years to allow for an accumulation of contributions and to generate investment returns so that phosphate-related revenue is replaced as well as part of other possibly dwindling revenue sources (visa fees, fisheries, other). The time period can be reduced, as determined by the Committee, if an agreed to principal value is achieved prior to the 20-year estimated build-up period.
- A set of fiscal rules is recommended to help determine the government's contribution. The fiscal rules are based on a review of budgetary revenue and expenditure dating back to FY2009–10 to the estimated budget outturns for fiscal year FY2013–14, the 2014–15 budget as well as a medium term budget framework for revenue (to FY2016–17). The fiscal rules are based on a review of three different budget scenarios- a high, medium and low growth scenario. A percentage of revenue will be contributed to the Fund with the amount contributed depending upon the amount of domestic revenue generated (not inclusive of development partner provided budget support or other development assistance). The aim is for the Fund to absorb any windfall that may be better used for future generations when such windfalls may not be present.
- The scenarios are presented to indicate a range of possibilities for the government's to make an affordable contribution that does not crowd out the following:
 - (i) Meeting recurrent and development expenditure based on historical trends,
 - (ii) Meeting scheduled debt service payments (possibly ending by FY2014–15);
 - (iii) Addressing, to the extent possible, infrastructure development and maintenance costs; and

- (iv) Establishing Cash Reserve Funds in the form of an: a) Cash Management Reserve Fund to meet temporary cash shortfalls during the fiscal year (and topped-up during high revenue months); b) Infrastructure Repair and Maintenance Fund; and c) Naturel Disaster and Emergency Reserve Fund.
- After reviewing low, medium and high domestic revenue generation scenarios, the government can make a range of contributions per fiscal year depending upon the amount of domestic revenue generated per Table 1.

Table 1: Revenue Generation Scenarios

Growth Range	Revenue Range	Contribution %
High Growth Year	\$90 million or greater	8% to 12%
Band 1	\$90-\$100 million	8%-10%
Band 2	Over 100 million	10.1%-12%
Medium Growth Year	\$50-\$89 million	4% to 7.9%
Band 1	\$50-\$69.9 million	4% to 6%
Band 2	\$70-\$89 million	6.1%- 7.9%
Low Growth Scenario	\$24-\$49 million	2%-3.9%
Band 1	\$24-\$36.5 million	2%-2.9%
Band 2	\$36.6-\$49 million	3%-3.9%
No Contribution Scenario	\$0-\$24 million	0

Source: Asian Development Bank.

- Development partner contributions would be per amounts stated in the MOU.
- The Committee will agree to an Investment Policy Statement based on the investment advisor’s advice. The Committee will monitor the investments with service provider support. The investment allocation could evolve during the life of the fund from a more managed (and lower administrative cost) portfolio during the initial start-up to a more aggressive approach in the mid-term and then to a more risk averse and value laden portfolio as the distribution years approach.
- The Fund will follow a set of investment and distribution principles to ensure the income from the Fund is exempt from tax under the Government of Australia’s common law doctrine of sovereign immunity and other principles to ensure the accountability and transparency of investments to the Fund and distributions from the Fund in accordance with international standards.
- The Fund will be made up of an A and B account:
 - The A account is the principal. It is the account where all contributions are made and all A account funds are invested for the life of the Fund.
 - The B account is established when the first distribution is made from the A account The B account shall hold the amount to be distributed to the government.
- Distributions will be based on a 3-year Moving Average Distribution approach. The approach will assure distributions annually even in low or no investment return years. The components of the calculation will need to be reviewed at least every 3-years by the

Committee to insure the sustainability of the Fund over the long-term for future generations. The Committee may use external technical advice to advise on the components of the calculation. The Committee may also distribute less than the amount calculated to help maintain the Fund's real value and strengthen sustainability.

- Distributions will be provided to the government based on a prepared programme and budget describing how the distributed funds will be used. The programme will have an agreed monitoring and evaluation framework.
- An independent audit of the Fund will occur annually. An Annual Report will be prepared annually based on audited financial statements and performance information. The reports will be provided to the contributing partners and to the public.
- An independent external evaluator will evaluate the Fund at least every 8 years. The evaluator will assess the governance of the Fund, fees and expenses paid by the Fund, and the appropriateness and performance of the Investment Policy's asset allocation. The report produced by the independent external evaluator will be made available to the participating government and to the public. A separate report may also be produced for the internal use of the Committee.
- Partners may withdraw from the Fund. Termination and Withdrawal procedures are provided for in the agreement.

7. The Fund's model includes the government being joined by 2 to 3 countries to initiate the Fund. Low, medium and high growth trust fund scenarios were assessed as well as a scenario with additional development partner contributions. The main difference between the scenarios is the amounts development partners and the government can reasonably afford to contribute per the above contribution ranges.

8. For the Medium Growth Scenario option, the government can afford contributions if revenue streams increase over the medium term but then settle down to more of an average high (current revenue period) and low (previous to Australia RPC period) domestic revenue generation scenario. The government would be able to slightly increase recurrent spending, make some infrastructure investments and meet some maintenance costs, and build-up cash reserves. These factors are more realistic if public debt is paid off in the next 1–2 years.

9. Medium Growth Scenario results are in the following table. For the Medium Growth Scenario with additional development partner contributions, the government contributions will remain the same, as below, and development partner contributions will increase to \$8 million annually for a total of \$152,000 in development partner contributions over 20-year period versus \$85,500 for the scenario below. The impact is that distributions will increase to \$12.5–\$14.5 million in the early years of the distribution period as opposed to the \$9.2–\$10.7 million per Table 2 (below).

Table 2: Medium Growth Revenue Scenario

Inputs per Year	Medium Growth Scenario			
	2013–14 2017–18	2018–19 2022–23	2023–24 2032–33	Total
Nauru	\$38,423,180	\$13,182,794	\$45,234,208	\$96,840,182
Country 1	\$10,000,000	\$12,500,000	\$25,000,000	\$47,500,000
Country 2	\$8,000,000	\$10,000,000	\$20,000,000	\$38,000,000
Country 3	\$0	\$0	\$0	<u>\$0</u>
Total Contributions				\$182,340,182
Estimated Annual Rate of Return		5%		
Build-Up Period (years)		20		
Estimated Distribution Rate		3-Year Moving NAV Avg x Distribution %		3.5%
Estimated Earnings to FY2032-33				\$129,164,994
Estimated Principal Value FY2032-33				\$311,505,176
	2033-34	2034-35	2035-36	2036-37
Annual Return Estimate	\$9,266,135	\$9,962,078	\$10,464,192	\$10,755,758

FY = fiscal year.

Source: Asian Development Bank.

10. The Fund will have a distribution policy, to be determined by the Trust Fund Committee, with a set of fiscal procedures. Distributions will be provided to the government based on a prepared programme and budget regarding how the distributed funds will be used. The programme will have an agreed monitoring and evaluation framework.

DRAFT – FOR POLICY DISCUSSION PURPOSES ONLY
GOVERNMENT OF NAURU: 2015 POLICY REFORM MATRIX

Expected Output	Policy Reform Action	Responsible Agency and TA
NSDS Goal: Stable, trustworthy, fiscally responsible government		
Output 1: Improved Public Financial Management	<ol style="list-style-type: none"> 1. The accounts receivable, accounts payable, fixed asset, and bank reconciliation functions of the financial management information system will be made fully operational. 2. Aggregate revenue and expenditure projections for 2015–2020 will be prepared to inform budget ceilings as a first step towards medium-term budgeting. 3. The Employment & Services Tax Bill will be drafted and approved by Cabinet. 	<ol style="list-style-type: none"> 1. Treasury Department (DFAT/PFTAC) 2. Treasury Department (DFAT/PFTAC) 3. Department of Revenue (DFAT/PFTAC)
NSDS Goal: Provision of enhanced social, infrastructure and utilities services		
Output 2: Efficient service delivery by the NUC	<ol style="list-style-type: none"> 4. Completion of power tariff reform study which assesses the economic cost, existing subsidies, and proposes reform measures. 5. Strategic Plan for NUC is developed 6. Performance-based management implemented. 7. A strategic maintenance plan for NUC assets will be developed and adopted. 	4–7. NUC (ADB)
NSDS Goal: Development of an economy based on multiple sources of revenue		
Output 3: Improved funding mechanism for future service delivery	<ol style="list-style-type: none"> 8. Agreement to a draft MOU that provides the management and administrative framework of the Nauru Trust Fund agreed to between the government and key development partners at the official's level. 9. The Custodian Bank and Investment Manager for the Nauru Intergenerational Trust Fund will be selected. 	<ol style="list-style-type: none"> 8. Planning and Aid Department (DFAT/ADB) 9. Planning and Aid Department (DFAT/ADB)

ADB = Asian Development Bank; DFAT = Department of Foreign Affairs and Trade (Government of Australia); MOU = Memorandum of Understanding; NSDS = National Sustainable Development Strategy; NUC = Nauru Utilities Corporation; PFTAC = Pacific Financial Technical Assistance Centre; TA = technical assistance.

Source: Asian Development Bank