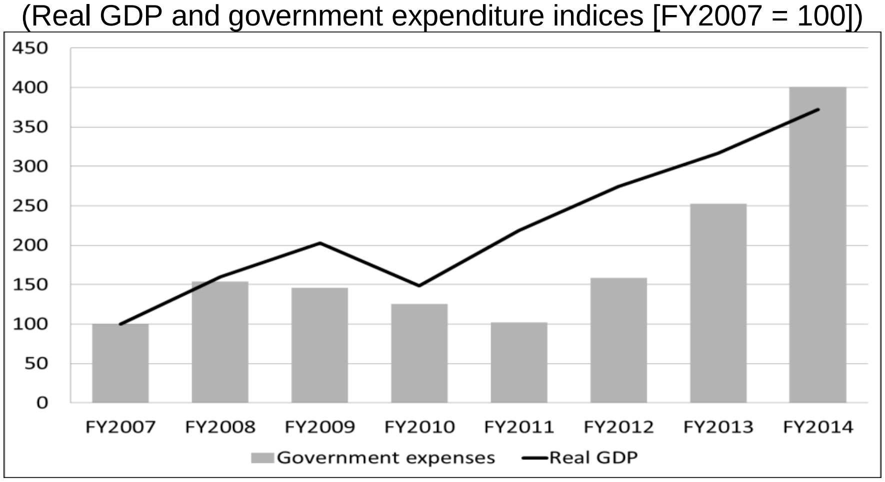
ECONOMIC AND FISCAL ANALYSIS

A. Economic Developments Since Independence

1. Nauru has a tumultuous economic history. From independence in 1968 up to the mid-1990s Nauru enjoyed a very high standard of living based on phosphate exports. A large share of these revenues was directed to the Nauru Phosphate Royalties Trust (NPRT) to save for future generations. However, the fund was poorly governed and its investments mismanaged. Funds not allocated to the NPRT were spent on free public services (including electricity, water, and housing) and heavily subsidized air travel. Little was invested in education and training. Public sector jobs were provided on demand at high rates of pay despite low skill levels.

2. As phosphate exports peaked in the 1980s, the government began a period of unsustainable borrowing from the Bank of Nauru (BON) using NPRT assets as collateral. By the mid-1990s, the country found itself in an economic crisis. Phosphate exports had fallen sharply as primary deposits were depleted and the BON went bankrupt in 1995. Meanwhile, government borrowing continued apace, including for meeting immediate debt service requirements. With phosphate exports virtually ceasing during 1999–2006, the government sought alternative rent-based revenues by establishing an offshore banking sector and tax haven. However, Nauru was forced to end this program after being blacklisted by the Financial Action Taskforce on Money Laundering, an intergovernmental body. From late 2001 to the end of 2007, Nauru's economy benefited from the establishment of the Regional Processing Centre (RPC) for asylum seekers under an agreement with the Government of Australia, which included substantial financial assistance.

Figure 1: Recent Economic Performance, FY2007–FY2014
(Real GDP and government expenditure indices [FY2007 = 100])



FY = fiscal year, GDP = gross domestic product.
Source: Asian Development Bank

3. Nauru has experienced an economic resurgence since 2007 (Figure 1). Phosphate mining resumed and provided a timely offset to the initial closure of the RPC that year. From mid-2012, the Government of Australia reopened the RPC and initiated an associated refugee resettlement program with Nauru, both including direct payments to the state budget. Combined with windfall fishing license revenue, this allowed the government to finance a significant fiscal expansion. Meanwhile the gradual liquidation of the NPRT since 2013 has delivered large payments to local landowners which have boosted consumer demand. Real gross domestic product (GDP) growth averaged 20.7% over fiscal year (FY)2008–FY2014. In FY2015 however

damage to Nauru's port mooring system, the country's main gateway for international cargo, caused real GDP to contract by an estimated 10.0% as phosphate exports collapsed by two-thirds. Nonetheless, national income remains high by historical standards and in per capita terms is comparable to levels last enjoyed in the mid-1990s.

B. Economic Structure

4. Nauru's economy remains dominated by the public sector (Table 1). The government budget is very high as a share of GDP while the presence of significant development assistance flows adds further to the role of public spending in the economy. Total official development assistance flows were $27.4 million in 2013, or about 21.5% of GDP.[1] Public administration directly accounts for 4.4% of output while state-owned enterprises dominate other sectors, including manufacturing, utilities, trade, and hospitality. As a result, the public sector accounts for about 92% of total local employment, excluding employment at the RPC. The phosphate industry has fallen in importance as the RPC and government spending have played a larger role, with manufacturing (largely phosphate processing) falling from a peak of 45.7% of GDP in FY2012 to 17.3% in FY2014.

5. The RPC plays a significant role in the local economy. It is the second-largest single employer after the government and the state budget presently receives A$31.5 million in direct RPC-related payments from the Government of Australia. The center also has a range of indirect economic benefits including local spending by expatriate workers, increased customs and other domestic revenue, and local spending by the Government of Australia on RPC-related activities. A significant number of Nauruans are also employed at the RPC and the labor market is generally thought to be at full employment.

Table 1: Nauru Economic Structure, FY2014
(Selected indicators, % of total)

Item	%
Real GDP by sector	
Primary	3.9
Secondary	21.5
Tertiary	63.5
Local employment	
Government of Nauru	47.0
Nauru Phosphate Corporation (RONPhos)*	10.9
Nauru Rehabilitation Corporation*	6.5
Eigigu Holdings*	8.7
Regional Processing Centre	20.2
Other (private sector and other SOEs)	6.7

GDP = gross domestic product, SOE = state-owned enterprise.
* State-owned enterprises.
Source: Nauru Statistics Office.

[1] OECD. Aid Statistics, http://www.oecd.org/countries/nauru/recipientcharts.htm.

C. Government Finances

6. The government's fiscal position has improved considerably in recent years (Table 2). Revenue has tripled in nominal terms since FY2012 and this has been matched by a similar expansion in government spending. Nauru does not publicly release government financial statements, however outcome figures reported in budget papers indicate that the budget has continued to be either in balance or have a small surplus. For FY2016 the government is targeting a balanced budget outcome. However, these figures mask a considerable improvement in the government's balance sheet. The budget is reported on a cash flow basis, recording several large financing transactions as expenses. Adjusting for this indicates that Nauru has recorded large overall surpluses.[2] These have been directed towards reducing public debt, the contingency reserve, and setting aside funds to be deposited in the Nauru Intergenerational Trust Fund (NTF).

Table 2: Fiscal Performance and Outlook, FY2013–FY2016
(% of GDP)

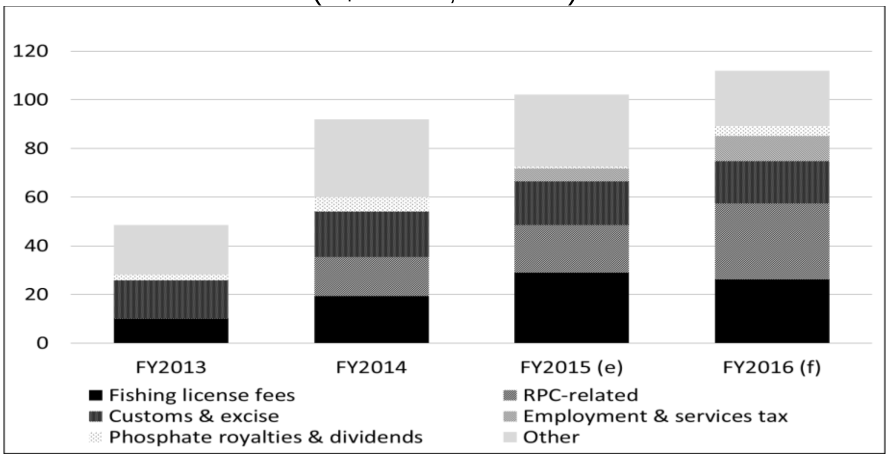
Item	**FY2013**	**FY2014**	**FY2015** (e)	**FY2016** (f)
Total revenue (including grants)	52.3	67.9	84.5	82.1
Total expenses	52.0	64.7	84.4	82.0
Budget balance	0.3	2.3	0.1	0.1
Adjusted balance*	12.6	20.3	11.0	14.1

(e) = estimate, (f) = forecast, FY = fiscal year, GDP = gross domestic product.
* budget balance excluding financing items.
Source: Government of Nauru budget documents (various years) and Asian Development Bank staff estimates.

7. Nauru's improving fiscal situation has been underpinned by large increases in domestic revenue (Figure 2). This has been driven by windfall revenue from fishing licenses and RPC-related payments. Revenue from fishing license fees rose from A$10.1 million in FY2013 to an estimated A$29.0 million in FY2015. Visa fees (mostly for refugees and asylum seekers) have emerged as an important source of revenue, rising from negligible levels in FY2013 to almost A$17.9 million estimated for FY2015. The recently introduced nonresident employment and services tax has also provided a new source of revenue, estimated at A$5.4 million in FY2015 and projected to rise to A$10.4 million in FY2016. Meanwhile, customs and excise revenue has risen in line with the surge in economic activity. Customs revenue increased particularly sharply during FY2013–FY2015 because of significant capital imports for the RPC in those years. Phosphate income by contrast has been volatile and disappointing in recent years, reflecting problems at Nauru's damaged port mooring facilities and delays to mining activities.

[2] For conceptual details see International Monetary Fund. 2014. *Government Finance Statistics Manual*. Washington, DC.

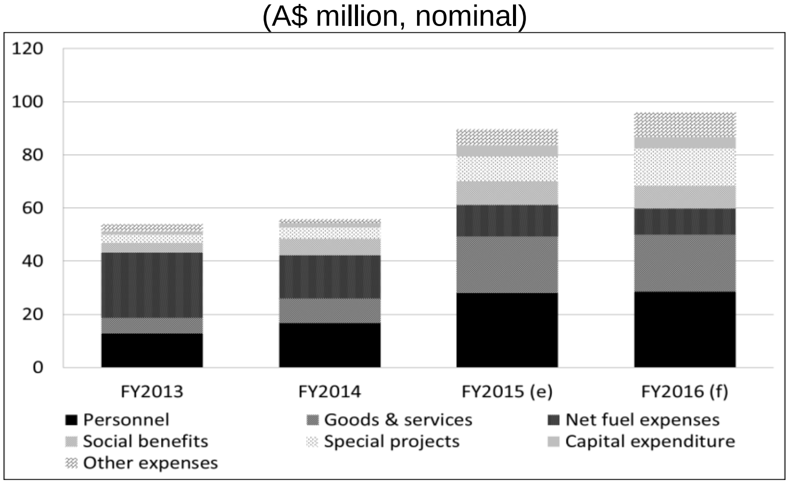
Figure 2: Sources of Domestic Revenue,[a] FY2013–FY2016
(A$ million, nominal)



(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 papers (various years), Asian Development Bank staff estimates.

8. Total government expenditures have risen in line with increased total revenues (Figure 3). The majority of the increase has been directed towards personnel costs and goods and services (excluding fuel), and so-called "special projects" which have each accounted for just under 30% of the increase in total expenditures from FY2013 to FY2016. The government payroll has expanded modestly while government salaries have been increased through a restructuring exercise (including back-dated pay increases). Special projects include a range of new government initiatives including a school feeding program, community works, operation of the Bendigo & Adelaide Bank banking agent, and a planned cash transfer program for school children. A new community housing scheme was also introduced in FY2016. Implicit fuel subsidies, measured as net fuel expenses, have been contained at about A$9.5 million, helped by the elimination of retail fuel subsidies in FY2015 and lower global oil prices. Meanwhile social benefits have accounted for 8.5% of the increase and capital expenditure 5.5%.

Figure 3: Government Expenditure,[a] FY2013–FY2016
(A$ million, nominal)



(e) = estimate, (f) = forecast, FY = fiscal year.
[a] Total expenditures less fuel sales.
Source: Government of Nauru budget papers (various years), Asian Development Bank staff estimates.

9. The composition of government expenditure has shifted over recent years (Table 3). Despite large increases in the absolute public service wage bill, the share of total spending going to personnel costs has fallen modestly over the past few years. Implicit fuel subsidies have fallen significantly as a share of total spending. Conversely, goods and services (excluding fuel) and special projects have received a much greater share of resources under the budget while the share going to social benefits has held steady. Capital expenditure has also attracted a higher share of funding, although its share remains low.

Table 3: Government Expenditure, FY2013–FY2016
(% of total expenditure[a])

Item	**FY2013**	**FY2014**	**FY2015** (e)	**FY2016** (f)
Personnel costs	32.8	35.0	31.6	29.9
Goods and services (excl. fuel)	15.4	19.7	24.1	22.5
Net fuel expenses[b]	24.5	16.2	12.0	9.9
Social benefits	9.5	13.2	10.1	8.9
Capital expenditure	2.9	3.7	4.9	4.4
Special projects[c]	7.9	8.8	10.4	20.6
Other expenses	7.1	3.4	6.9	9.6

(e) = estimate, (f) = forecast, FY = fiscal year.
[a] Total expenditures less fuel sales.
[b] Fuel purchases and fuel subsidy to power utility minus 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).

10. The government does not publish official debt statistics, however budget documents indicate that a significant portion of Nauru's increased fiscal resources have been directed towards paying off various forms of public debt. Total public debt is estimated to have been reduced by about 27.5% since FY2012. Most of this reflects reductions in domestic debt, in particular the near full payment of outstanding salary arrears. Payments have also been made to BON deposit holders based on the repayment of outstanding BON debts by RONPhos but also supplemented with direct payments from the state budget.

D. Macroeconomic Outlook

11. After contracting sharply in FY2015, the economy is expected to grow modestly in FY2016 by 3.0% before rebounding more strongly in FY2017 to grow by 15.0% when the port mooring system is expected to be fully restored. Phosphate exports are expected to remain depressed in FY2016 while the mooring system remains damaged before rebounding in FY2017. Government spending will increase in FY2016 but is expected to plateau from FY2017 onwards while activity at the RPC is expected to remain steady. The economy will however be boosted by the gradual integration of about 850 refugees recently processed at the RPC, mostly of working age and many of which are relatively skilled. This offers the prospect of a significant increase in Nauru's potential output, given its current workforce of only around 6,400 and problems with widespread skills shortages. Already many refugees are taking up local positions and opening new businesses. Consumer and government spending levels are expected to remain high, which should support the gradual integration of refugees into the local economy over the coming years.

12. Inflation rose sharply in FY2015 and the government reported inflation of 14.2% year-on-year in the March quarter. High inflation reflects congestion and damage at the port which has constrained inbound supplies while local aggregate demand remains elevated. The elimination of retail fuel subsidies and a falling Australian dollar (the local currency) have also added. Inflation is estimated to be 11.4% in FY2015 before easing to 6.6% in FY2016, partly reflecting the effects of low oil prices, and easing further to 1.7% in FY2017 once the mooring system is full restored.[3]

E. Key Policy Issues

13. Nauru remains highly dependent on a narrow set of uncertain income streams which, to varying extents, are likely to be both finite and subject to significant short-term volatility. This gives rise to important concerns around long-run sustainability, quality of public expenditure, and macroeconomic stability.

14. Income from the RPC is a large share of total revenue but faces significant uncertainty and is likely to be short-lived (the current bilateral agreement between the Nauruan and Australian governments covers a 5-year period, that is, 2015–2019 with the possible extension for another 5 years). Currently, revenue streams directly related to the RPC (largely visa fees for refugees and asylum seekers) account for around 20% of total domestic revenues.[4] In the absence of these Nauru would have recorded a large fiscal deficit in FY2015 (including after adjusting for financing transactions). However, the RPC also indirectly contributes towards other revenue streams. Collections from the nonresident employment and services tax are closely linked to the RPC, given the center employs about 72% of nonresident workers. Meanwhile, currently high customs and excise duties are also sensitive to the level of RPC activity through both direct RPC-related inbound shipments and its stimulatory effect on local demand.

15. Income from fisheries and phosphate exports are likely to be longer lasting, however both are subject to considerable short-run volatility. Phosphate exports are generally expected to average about 500,000 tons per year until expected exhaustion around 2030. However, actual phosphate-related revenues have proven highly volatile. Revenue from fishing license fees has risen consistently in recent years but is generally difficult to forecast, with accuracy and the long-run sustainability of this resource remaining unclear.

16. Intergenerational equity and fiscal sustainability concerns require that a significant portion of windfall revenues be saved for the future. This should principally be achieved through the accumulation of financial assets that can be drawn upon to provide a sustainable source of budget financing. The establishment of the NTF will provide a mechanism for this. Paying down of public debt has also contributed to fiscal sustainability. Some frontloading of spending can be relevant in terms of investing in productive assets (i.e., infrastructure and human capital) as well as delivering immediate benefits to the population. However, such frontloading should be balanced with the capacity of the public sector to scale-up spending effectively. Nauru has sought to frontload a large portion of spending and this has made strengthening the public financial management system an even more critical priority. Sustainability also suggests that a large share of increased spending should be directed towards capital spending, education and training, and health services. Presently only about 20% of the budget is directed towards these purposes. Frontloading spending must also be balanced with the absorptive capacity of the economy to avoid overheating. Recent high inflation suggests this is currently an issue.

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[3] ADB staff projections.
[4] This excludes payments for reimbursable operational costs.

17. Nauru is heavily exposed to potential negative shocks to its revenue base. Lack of access to debt financing means it is critical that Nauru maintain sufficient fiscal buffers to protect budget stability. The potential for unanticipated permanent shocks to its revenue base (notably an unexpected reduction in RPC-related activity) means maintaining fiscal discipline remains a critical priority so as to avoid a potential need for painful fiscal adjustment.

18. A strong fiscal framework is needed to guide policy making by setting targets and rules for key fiscal indicators that help the government to balance a range of objectives. This could be based around a fiscal anchor such as an adjusted fiscal balance that excludes highly uncertain income streams (i.e., RPC-related revenues) and makes cyclical adjustments for volatile revenue streams (i.e., fisheries and phosphate revenues) and expenditure items (i.e., fuel subsidies). It should allow for sufficient fiscal buffers to be built and maintained whilst ensuring a sizeable portion of windfall revenues is directed towards long-term savings through the NTF. Recurrent spending should be kept at sustainable levels while a greater portion of the budget could be directed towards productive uses, including infrastructure maintenance. The contribution framework of the NTF provides one key element of the fiscal framework and Nauru would benefit by integrating this into a more comprehensive medium-term framework.

19. Diversifying the economy and revenue base is also a priority. This should include efforts to improve the business enabling environment. One critical problem has recently been addressed with the opening of a banking agent on the island, whereas previously no formal banking services existed following the closure of the BON. However, the services offered are currently limited and financial literacy in the community remains low. To broaden the revenue base, the government introduced a nonresident employment and services tax and plans to introduce a business profits tax. A value-added tax is also planned for introduction over the coming years.