

Keeping the Nauru economy afloat

Teuea Toatu

Fellow in Economics, Pacific Institute for Advanced Studies in Development and Governance
University of the South Pacific

The rapid deterioration of the Nauru economy in recent years has been a major concern to both the Nauru Government and its principal donors. Once the 'Brunei of the Pacific', Nauru is on the brink of insolvency. The Australian Government's development assistance of A\$41.5 million in late 2001, linked to Nauru's agreement to host asylum seekers, has been keeping the economy going. In February 2004 the governments of Australia and Nauru signed a new memorandum of understanding providing for A\$22.5 million in assistance for the period July 2003–June 2005. Included in this package was the provision for Australian personnel serving in line positions, including an Australian Secretary of Finance with a mandate to address key economic and financial reforms. The primary objective of Australia's aid is adoption of a sustainable development strategy and assistance with major economic and financial management reforms. A critical component of this assistance is the improvement of basic services including health, education, power and water.

Given these bleak circumstances, can Nauru recover and maintain macroeconomic stability and to what extent will it need external assistance?

Economic performance

A review of some of the factors precipitating the crisis may inform efforts to address these questions. It may also help to identify critical areas of intervention by the Nauru Government and the donor community to prevent further deterioration of the economy and to improve the prospects of getting the country onto a path of sustainable development and growth.

Fiscal management

Nauru's budget has been in deficit since the 1990s. In the fiscal year 1997–98, real government expenditure rose by 15 per cent and it has remained at this level. This increase in expenditure was not matched by increased revenue, resulting in chronic budget deficits. In the 2003 fiscal year, the budget deficit was estimated to be around A\$15.2 million, while for the fiscal year 2004 the deficit has been estimated to increase to A\$22 million (Asian Development Bank 2004).

Successive governments have financed these fiscal deficits by borrowing from the Nauru Phosphate Royalties Trust, the Nauru Phosphate Corporation and the Bank of

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Nauru—often in an unplanned and largely non-transparent manner (Asian Development Bank 2004). This deficit funding has had adverse implications for these organisations. The value of the NPRT has declined from A\$1.3 billion in 1990 to an estimated A\$300 million today—a drop in value of 77 per cent in nominal terms. Likewise, the Bank of Nauru's financing of the budget deficits has stressed its reserves, rendering it incapable of effecting international transactions and meeting depositors' withdrawal demands. By international standards, the Bank of Nauru is technically insolvent. As funds of these financial institutions have been depleted, the government is left with very few options for financing its operations.

It is important to underline the point that increased government expenditure is not necessarily a bad thing as long as it is used for productive activities that result in increased national income. However, if such expenditures have been going mostly to financing consumption expenditures such as high public sector wages, extravagant overseas travel allowances, or ministerial allowances—as has hitherto been the case with successive Nauru governments—the resulting budgetary deficits render the country vulnerable to fiscal crises.

Human resource development

Nauru's Human Development Index has slipped to a medium level in recent years as GDP per capita has fallen (Asian Development Bank 2004). With no minimum education requirements for employment in the government, education has remained a neglected sector. Nauruans are not particularly encouraged to go to school. Very few have attained college degrees or gone abroad for higher education. Years of high earnings from phosphate mining have led to a lifestyle of luxury and leisure. There has been no need to learn vocational skills. Most Nauruans do

not know how to fish, which is atypical of Pacific islanders.

The education and health services have deteriorated and suffer from chronic shortages of skilled staff. The lack of access to quality health services, safe water, and housing are the main areas that need to be urgently addressed. With the government and the Nauru Phosphate Corporation unable to absorb the increasing number of young new entrants into the job market every year, youth unemployment has risen to an estimated 35 per cent, impacting severely on the standard of living (Asian Development Bank 2004).

While there has not been any evidence of absolute poverty in Nauru, the inevitable downsizing of the government and Nauru Phosphate Corporation (which together account for 95 per cent of all employment) is likely to result in a significant fall in household incomes and even higher unemployment. With limited skills and educational attainments, Nauruans rendered jobless are likely to find difficulty in securing alternative employment. The situation is aggravated by the limited emigration opportunities available. Therefore, pending re-training, skill development, and generation of employment, Nauruans can be expected to suffer considerable hardship during the adjustment period.

Private sector development

The downsizing of the public sector as part of the ongoing public sector reform program is likely to cause a significant increase in unemployment. Can the private sector absorb the unemployed? Given the severe constraints arising from Nauru's remote location, shortages of skilled labour, and the lack of key infrastructure—in particular, water supply, electricity and telecommunications—the expansion of the private sector is a formidable task. The development of small-scale businesses in the service sector

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and small agro-industries such as poultry and backyard agriculture may be the only viable options.

What has gone wrong?

Nauru is an example of the 'Pacific Paradox'—a term used to describe the continued poor economic performance of Pacific island countries in spite of their being endowed with favourable levels of natural resources, high levels of public investment, and high per capita foreign aid. With all of its wealth from phosphate mining, low population, small size and high per capita incomes, few would have ever imagined that Nauru could be in the dire situation it is in now. So what has driven Nauru into this predicament? Is it the severe structural constraints facing this small island economy? Or is it policy failure as outlined above? Or is it something more fundamental than these two factors? One point that is unquestionable is that the problem cannot have been due to an acute shortage of savings/capital.

Let us examine the 'structural constraints' argument first. Nauru faces the structural constraints associated with smallness, such as geographical isolation, narrow production base, small domestic market, and dependency on a few commodities for export earnings. According to this argument, Nauru's growth and development will always be severely limited, and irrespective of the good efforts that the Nauru Government may undertake they are doomed to fail. But if this 'smallness' proposition is valid, then other small island countries in the region, notably Kiribati, Tuvalu, Cook Islands and Marshall Islands should all be in the same situation. None of these countries are in this dire economic situation (at least at the present time). Moreover, Nauru is much better off than most of these other countries in three respects. First, it has a much smaller

population, which, from a policymaking perspective, makes it easier to achieve social homogeneity and to forge the political consensus necessary for the resolution of major national issues. Second, Nauru has a better earning capacity, given its rich phosphate resources. Third, unlike most of the small island states in the region, which are dispersed over a wide area of ocean, Nauru is a one-island country and therefore does not suffer from the diseconomies of scale problems associated with the provision of public services in these other small islands. It should therefore be less costly to run.

Therefore, the structural constraints argument does not hold as a cause of the virtual collapse of the Nauru economy.

The 'policy failure' argument would appear to be the most likely cause of the deterioration of the Nauru economy. That is, the Nauru economy is where it is now because of the bad policies adopted by successive governments; the major policy deficiencies have already been highlighted. However, it would be presumptuous to attribute the dismal performance of the Nauru economy to bad policy without digging deeper and analysing why those bad policies have been, and continue to be, made. Public policies will only be as good as the incentive regime in which policymakers are working. The dictum that 'people respond to incentives' is as true in public policy-making as in any other human activity. This highlights the important role that state institutions—the constitution, laws, regulations, rules and decrees—and their implementation play in the creation of such incentives.

The fact that the successive governments have been allowed to misappropriate public resources with impunity clearly demonstrates the ineffectiveness of the existing institutions of the state. The passing of the Treasury Fund Bill in late May 2004 by the Nauru Parliament was testimony to the

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growing discontent with the apparent ineffectiveness of existing institutions (in particular, the Constitution and the Public Finance Act) in controlling the arbitrary behaviour of the government. The Treasury Fund Bill, moved by the Opposition, was aimed at taking the government to task for improper use of public finances. However, the Bill came too late. The damage to the Nauru Trust Fund and the economy at large, which now appears difficult to repair without substantial external assistance, could have been prevented or minimised if such institutional constraints had been put in place at an early stage.

All in all, it is not its smallness and the associated structural constraints or the lack of capital that have driven the Nauru economy into its present economic chaos. Neither is it policy failure *per se*. More fundamentally, it is the lack of effective institutions and incentives that would make those policies and deployment of the nation's resources effective.

Policy implications and strategies

Any reform program aimed at salvaging the Nauru economy must, first and foremost, target the strengthening of the institutions of the state if such reforms are to be sustainable. However, as with most of the Pacific island countries, there has been a tendency to neglect the institutional foundations of the reform process and to give undue emphasis to other components of the reform program, such as private sector development and public sector reform—the 'first-generation' reforms. Thus, any policy reform that the Nauru authorities and the donor community may attempt will be useless unless it is underpinned by complementary institutional reform.

The challenging questions, however, are which institutions to reform and in what order? The massive loss of trust funds over a

long period and the budgetary crises of recent years are central to all other problems in which the nation is embroiled and suggest that the strengthening of institutions governing the management of public finances is of first-order importance. A crucial constituent of these institutions is the Office of Auditor-General, given the important watchdog responsibilities that this office carries in the proper management of public funds.¹ However, in Nauru the powers of the Office of Auditor-General are vague. Moreover, its independence is not guaranteed by the Constitution. For instance, in the Constitution there is no mandatory requirement for the Auditor-General to audit public accounts and to table the audit reports in Parliament. Neither is there specific mention that the Office of Auditor-General will not be subject to the direction or control of any other person or body in the execution of its duties. Further, neither the Constitution nor the Finance Act provide for any disciplinary measures against improper use or misappropriation of public funds. The lack of these provisions explains in large part why the enforcement of accountability and transparency in the management of public funds has been very poor in Nauru.

The recent enactment of the Treasury Fund Protection Bill referred to above is a positive move. It is also necessary to put in place other oversight institutions, such as the Public Accounts Committee, to underpin the watchdog function of the Office of Auditor-General by ensuring that the reports of the Auditor-General are duly considered and actioned by accounting officers (Head of Departments). It is also important to provide mechanisms within the Finance Act and the Constitution that make possible the taking of disciplinary measures against those responsible for the abuse and misappropriation of public funds.

While the lost trust funds can never be regained, new arrangements must be put in

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place to ensure that the remaining funds are protected. The funds must be placed under the control of a body that will take its trusteeship role seriously and provide skilled, objective, and independent management. The management of the Tuvalu Trust Fund provides a good example to follow.

However, for the above reforms to be effective, a minimum level of human capital is necessary. There is little point in creating appropriate institutions when there no one with the necessary skills (for example, lawyers, judges and accountants) to run them. The inadequacy of human capital is perceived to be a major constraint to the successful implementation of reforms in Nauru.

Education is a neglected sector in Nauru, resulting in chronic shortages of qualified locals in the public service, and while there is no differentiation between qualified and unqualified individuals in the job market, Nauruans lack the incentive to pursue higher education and skills development. Unless serious efforts are made to upgrade the country's human capital base and to select on merit, Nauru could be trapped in a vicious circle, severely inhibiting the successful implementation of reform programs.

Concluding remarks

Nauru is in deep crisis. With the looming exhaustion of phosphate resources and the lack of alternative sources of income that the Nauru Government could resort to in the immediate future, the country faces a difficult future. Unless substantial external assistance is maintained for at least the next decade, the country is doomed to sink into economic ruin. The critical questions are how much aid is needed to support the Nauru economy, and for how long?

Rough estimates indicate that at least A\$250 million is required over the next

decade. Working on the premise that the current estimated budgetary deficit of A\$22 million represents the financing gap that the country will not be able to fill from domestic revenue sources for the next decade, and if it is further assumed that this deficit will grow at a rate equal to the rate of inflation of 3 per cent per annum, then it could reasonably be estimated (using the compounding method) that the amount of foreign aid that the country could need over the next decade is around A\$250 million.²

The question of how long aid donors will need to continue to support the Nauru economy is more problematic. The answer is a function of two critical factors. The first is the speed with which the Nauru government is able to identify alternative sources of income that it could tap to sustain its operations in the short to medium term. The sooner the Nauru government can secure these alternative sources the earlier will external assistance cease. Possible sources of income include the country's exclusive economic zone marine resources, in particular fisheries, airspace rights, and increased income from the Nauru Trust Fund that may arise through the more effective management of the Fund. Second, and more importantly, the period of aid dependency depends on how the current and future aid funds are deployed. For instance, if aid funds are to be used entirely for budgetary support without attempting to put in place the conditions necessary to promote broad-based, long-term economic growth, the sustainability of such aid funds will be severely limited, and would do little to help the country become less dependent on foreign aid.

The bottom line, therefore, is that foreign aid cannot help in getting the country back on a sustainable development path unless it is applied effectively. The severity of the current financial crisis underscores the lack of institutional restraints and hence the need to focus aid funds on reforming and

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strengthening state institutions—in particular the public finance institutions—in order to promote good governance and sound economic management. However, the success and sustainability of these reforms presuppose a strong human capital base, which Nauru seriously lacks. It is in this context that the development of the country's human capital should also be a primary focus of foreign aid.

Notes

- ¹ This is not to say that reforming the Office of Auditor-General will be a panacea to the country's entire financial problems. Indeed, this change needs to be underpinned by a host of mutually reinforcing reforms in other areas.
- ² Interestingly, this is equivalent to the maximum rate of periodic withdrawal from the Nauru Trust Fund that would completely liquidate the Fund over the same period.

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