Will Trust Funds Sustain the FSM and RMI?

Lessons from the Tuvalu Model

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Gerard A. Finin, PhD

Deputy Director, Pacific Islands Development Program, East-West Center

Thank you all for coming this afternoon. It is certainly an honor for me to be here.

When I think back to the beginning of my active research interest in Tuvalu, I recall an informal visit to the EWC several years ago by then Stanley Roth. Earlier in his career he had worked on the staff of Congressman Solarz, and during that period had visited most of the Pacific Island nations.

To get the discussion started on a lively note for those of us sitting in the conference room, he put forth this proposition:

> *The vast majority of Pacific Island nations are too small, too distant, and too diverse to be truly viable as nation states. The only thing that really keeps these islands going is large infusions of foreign aid. Within the next 25 years, these islands will have to be recolonized or put back under trusteeship by metropolitan powers.*

And so we subsequently had a lively discussion that highlighted the multitude of problems facing the Pacific Islands region.

But Roth's provocative thesis also stuck in my mind and kept reminding me of Tuvalu, primarily because it seemed to me that it provided a strong counterargument. Here was one of the most isolated and resource poor atoll nations without any compact of free association that seemed to be doing rather well. I had been to Tuvalu for a very brief visit in the early 1990s and supervised a number of Tuvalu students participating in the South Pacific Scholarship Program managed by the State Department's Bureau of Educational and Cultural Affairs. I had been gradually reading the literature about Tuvalu earlier this year, when the Chairman of the Pacific Islands Conference of Leaders, President Leo Fa1cam of the FSM, requested that the EWC undertake a study of the Tuvalu Trust Fund, said to be one of the most successful Pacific trust fund endeavors over the past 15 years.

After completing a review of the literature and speaking with some Tuvaluan friends in Honolulu and colleagues at the ADB in Manila, I went to Fiji for some more interviews, then onto Funafuti, Tuvalu for a month to see how things really worked on the ground.

Tuvalu prior to independence in 1978 was called the Ellice Islands, that was part of Britain's Gilbert and Ellice Islands Colony. Prior to independence, the UK warned Ellice Islanders that they were too small and too poor to go it alone, but 92% of voters favored separation in a UN supervised vote.

When independence came Tuvalu received one used inter-island boat and had less than $1 million in reserves. They soon found that revenues were insufficient to cover even basic services such as health and education. For a short time sale of Tuvalu stamps provided some additional revenue, including a best selling series featuring various kinds of locomotives, but management problems and market fluctuations soon resulted in losses.

Even more problematic was the first Prime Minister's decision to invest nearly all of the government's money with an American real estate salesman who promised 15 percent returns if they would purchase land in Texas. Predictably, this turned out to be a swindle.

Every year Tuvalu officials were forced to go to London with the hat in hand to reluctantly beg for budget support. This created frictions and animosity as Tuvalu's annual budget deficit grew to nearly $1 million.

Growing weary of this process, Tuvalu in the early 1980s approached UK, NZ and Australia and proposed a "once and for all" contribution to Tuvalu

that would establish a self sustaining Trust Fund similar to the one that was given to their neighbors and former colonial partner, the Gilbert Islands, when they became the independent nation of Kiribati.

All three countries said no-- Aid is not given in advance of need. However over several years that Trust Fund proposal was refined. Finally New Zealand, the smallest of the metropolitan powers, said yes and pledged $8 million. And in 1987 the Tuvalu Trust Fund was launched.

Of all the trust funds in the Pacific, it is the Tuvalu Trust Fund that appears to offer the most promise over the long term. I find myself in full agreement with Al and his colleagues that the Tuvalu model is the best one to learn from. Indeed, the general approach to the renegotiations that sets up a new structure, and not a detailed blueprint, for the next 20 years is the wisest course of action.

Some of the key elements:

- Strong working relationship among the partners. Appointment of good professional people to the Board and the Advisory Committee who have multiple year terms with staggered completion dates. There is an informal consultative process before people are appointed.

- Although there is strict oversight of the TTF, with multiple checks and balances, Tuvalu has a sense of ownership that makes them want to see the fund grow. (In fact, govt. criticized by some for putting off current consumption and reinvesting too much into the fund.) Tuvalu is always chair of the board-- important symbolically. Secretariat based in Funafuti with a Tuvaluan in charge of Secretariat responsibili ties.

- B account funds from the TTF returns belong to Tuvalu. But they know there will be years when because of weak market conditions that government will receive nothing. Hence the B account must maintain a sufficient balance to cover these years. So far they have done this. **The greatest weakness in the Tuvalu model is that there is no specific language in the international agreement specifying a minimum balance.** There is now considerable debate about how much should be maintained in the B account. How much of a buffer is sufficient?

Some possible differences between Tuvalu's Trust Fund and that proposed for FSM and RMI:

- TTF was a major step up that helped overcome annual budget deficit. For FSM and RMI this may be part of a painful reduction in public expenditures.

- It appears that the RMI and FSM trust funds will have to support a much larger percentage of each country's respective annual budget-perhaps 40-50 percent. Tuvalu has funded less than 25 percent of its recurrent budget from the trust fund.

- Tuvalu's board has always attempted to maximize returns based on sound financial criteria. There has never been much consideration of Socially Responsible Investment principles. This might in the future become an issue if

FSM, for example, is advocating environmental policies to reduce greenhouse gas emissions but the board wants to invest heavily in energy companies.

Returning then to the title of our session this afternoon, **"Will a Trust Fund Sustain the FSM and RMI?"**

I think the evidence from Tuvalu suggests that the TTF is not a panacea. And in the Working Paper I have discussed some of the ongoing challenges Tuvalu is facing in terms of environmental degradation, falling educational standards, etc. But what the Tuvalu Trust Fund experience has shown over the past 15 years is that with the right design, trust funds can go a long way toward promoting a more financially sustainable more self-reliant FSM and RMI. It also offers an opportunity to change the fundamental nature of our relationship toward a more equal partnership that has the potential to strengthen bilateral relations with both island nations.

Managing Financial Vulnerability in Small Island States

The Role of Trust Funds in Promoting Sustainable Development

Jerry Finin, PhD
Senior Fellow, PIDP

The Vision

"My vision is to use the Trust Fund to the best advantage of the Country. To use part of it for balancing the recurrent budget, some of it for development purposes to benefit Tuvaluans who are alive today and at the same time to build it for the future of the economy."

-- Prime Minister Koloa Talake, MBE

(Tenth Anniversary Profile on the TTF, 1997, p. 22)

Goals and Objectives

The Tuvalu Trust Fund was established in 1987 by an international agreement among Tuvalu, Australia, New Zealand and the United Kingdom to:

- provide bridge financing for budget deficits;
- support national economic development; and
- promote greater financial autonomy and sustainability.

Initial Capitalization

The initial value of the fund on 16 June 1987 was A$27.1 million. Contributors included:

Tuvalu	A$1.6 million
Australia	A$8.0 million
New Zealand	A$8.3 million
United Kingdom	A$8.5 million
Japan	A$0.7 million
South Korea	A$31,000

Management Structure

- Board of Directors
- Professional Fund Managers
- Fund Monitor
- Auditing
- Advisory Committee
- Secretariat

Board of Directors

"The fund shall have a Board of Directors, in which all powers of the Fund shall be vested in, and exercisable by, the Board." The Directors of the Fund are:

- **a Director appointed by the Government of Tuvalu, who is Chairman of the Board; and**
- **one Director appointed by each other original Party to the Agreement.**

Board meets twice each year.

Professional Fund Managers

Two firms based in Australia who manage the fund on a day-to-day basis in keeping with objectives and guidelines established by the Board of Directors. Performance of each firm is evaluated independently and comparatively.

Fund Monitor

Professional consultant actuaries evaluate the investment performance of the fund managers based on comparisons with other fund managers and provide quarterly reports to the Board of Directors.

Auditing

A professional firm provides an annual audit of the fund.

Advisory Committee

Consisting of one member each representing Australia, New Zealand and the United Kingdom, and two members representing Tuvalu. The Advisory Committee meets twice each year (one month prior to the Board meeting) to monitor and evaluate the impact of the fund on Tuvalu's economy and society more generally. Written reports are given to Board members prior to Board meetings.

Secretariat

Provides ongoing administrative support to the Board of Directors and is based in Funafuti.

Trust Fund Accounts

- **The "A Account"**
  - Repository for the capital of the Trust Fund.
- **The "B Account"**
  - Funds in the B Account come from the returns or "disbursements" of A account and belong exclusively to the Government of Tuvalu.

The "A Account"

Most of the A Account is invested in Australia with asset allocations reflecting the requirement to:

- **maintain the real purchasing power of the Fund; and**
- **provide a regular flow of income to the Government of Tuvalu.**

By agreement, the value of the A Account must be maintained in real terms (including calculations for inflation and administrative expenses). Only during years when the A Account's Market Value exceeds the Maintained Value does the Government of Tuvalu receive Trust Fund income.

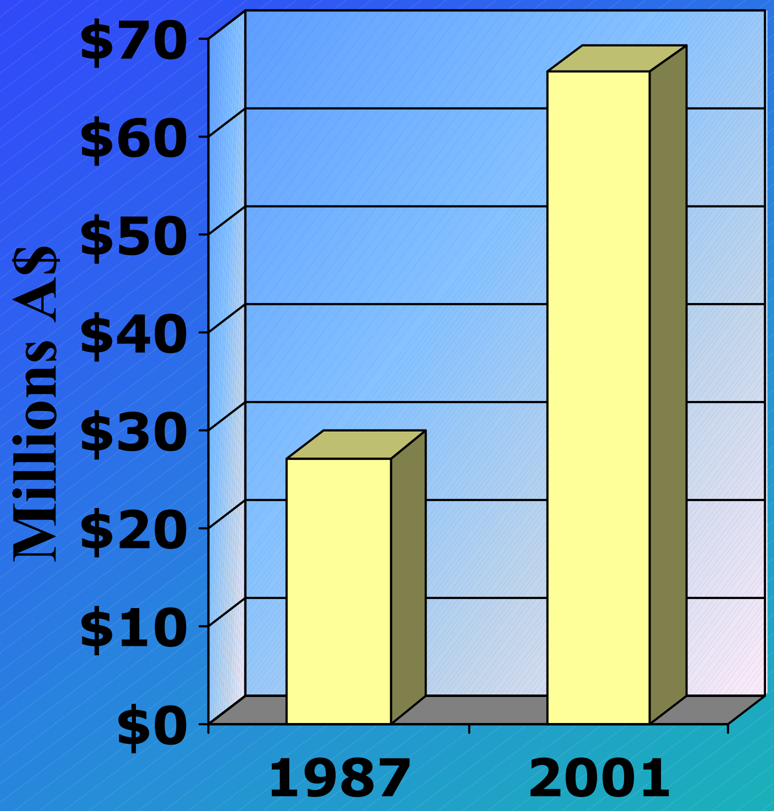
The "B Account"

The B Account was established after the fund was up and running to:

- **provide a place to hold income distributions from the A Account until funds are needed to be used for the national budget; and**
- **serve as a buffer against the volatility of the A Account returns, i.e., during years when there are no returns or low returns.**

The desired balance to be kept in the B Account is between two to four years projection of no income from the A Account. This buffer is designed to provide insurance against revenue shocks inherent in economic cycles.

Trust Fund Performance



- Only 4 out of 15 years was there no distribution to government.
- Through reinvestment and new infusions of ~A$13 million, Tuvalu is now the largest "shareholder" in the fund.
- In 1999, success resulted in the establishment of a new Falekaupule Trust Fund (~A$11.25) for local governments. This fund was established with funds from ADB, the national government, and local governments.

General Observations

- Strong fiscal discipline necessary
- Government transparency required
- Rigorous financial data collection required
- Government must be willing to hear frank and fearless advice from advisory committee
- Not a panacea

Other TTF Issues

- Maintaining "real" value in financial terms vs. per capita terms
- What should be the minimum balance of "B" account (buffer against volatility)?
- Should board composition reflect level of investment?
- Should government be consulted prior to board appointments?

Discussion Issues

- Political Question?
- Policy Question?
- Is it a replicable Public Finance model?