Trust Funds for improved governance and economic performance in developing countries

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A contributed paper delivered to the AARES 45th Annual Conference
23-25 January 2001, Adelaide, South Australia

The outstanding success of the Tuvalu Trust Fund (TTF) in providing a stream of revenue to overcome a chronic budget deficit and encourage economic self reliance has led the Government of Tuvalu to extend the trust concept to outer island development. This paper looks at the role of trust funds in economic development in Pacific Island Countries including a brief review of relevant country experience. The success factors of the TTF are outlined along with how the trust fund concept is being adapted to bottom up community based development in Tuvalu. Lastly, possible future directions are explored.

Key words: trust funds, governance, development and economics.

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Introduction

Tuvalu is one of the world's smallest and most isolated independent nations with nine coral atolls covering only 25 square km of land spread over a distance of 676 km (Moon, 2000). Funafuti, the capital is around 1,000 km north of Fiji. Current population is around 10,000. The United Nations classifies Tuvalu as a least developed nation, with GDP per capita in 1996 of $1,329 (GoT, 2000). Most people live in a subsistence culture with the major domestic employer the government. Remittances from locally trained merchant seamen along with foreign assistance remain important sources of foreign exchange. Given this picture, how can such a small, poor and isolated country expect to survive and develop in the modern global economy? With innovative thinking and support from donor partners remarkable things can happen. This paper is about that story and what it tells us about economic development.

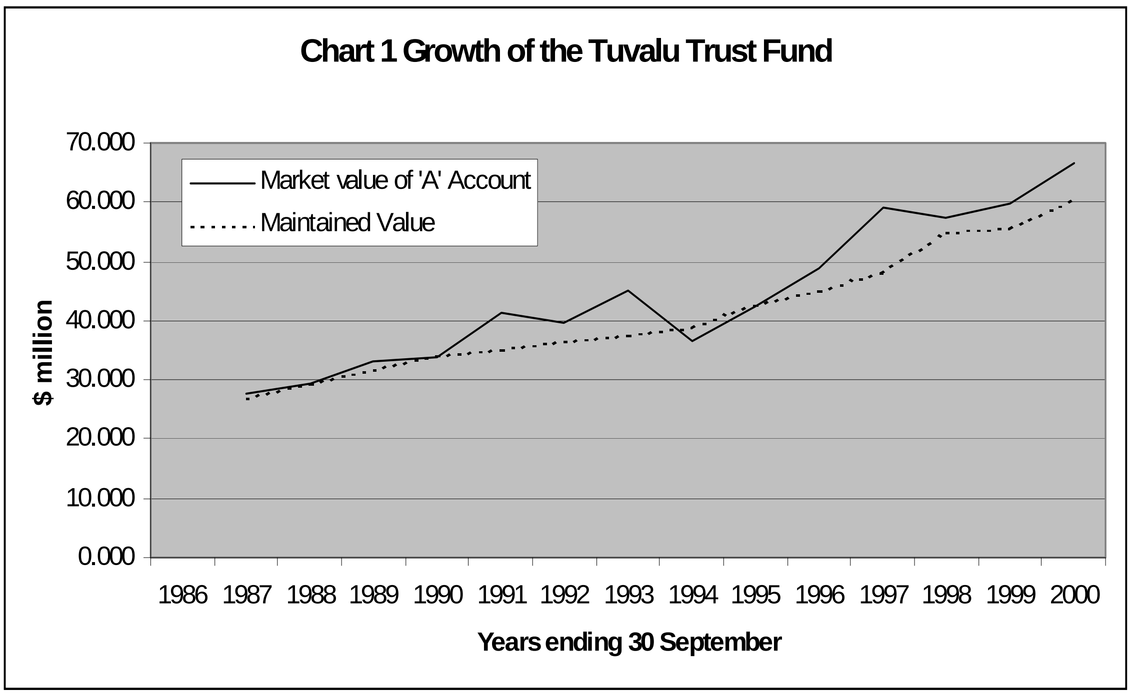
The Tuvalu Trust Fund, formed in 1987, is upheld as one of the outstanding successes of a partnership between a developing country and its donor partners. While the track record of direct bilateral assistance to developing countries in the Pacific has generally been poor, the Tuvalu Trust Fund has shown that it is possible to have a successful long-term development programme. There is one key difference between the Tuvalu Trust Fund and most other development assistance. In the case of the trust fund, an asset is being built up over time generating revenue under the control of the recipient. Under direct bilateral assistance expenditure is supported under the control of the donors. This difference in approach has major implications for developing countries in that in the case of the trust fund, there is an increasing degree of economic self-reliance while in the latter case, countries continue to be dependent on the assistance from the donor countries.

A brief history of the TTF

When Tuvalu became independent from the British in 1978, it faced very bleak financial prospects with a low capacity to earn foreign exchange and no financial reserves from the split up of the Gilbert and Ellis Islands colony. Through the persistence of Tuvalu's political leaders and a dedicated small band of officials including Tuvaluan and expatriate advisers, the case was made by Tuvalu for a trust fund that would be set up predominantly through donor contributions but also including a small contribution from Tuvalu.

The earliest attempt to seek an alternative to continuing direct budget support was in 1982. This was followed by a number of approaches that eventually resulted in the formation of the Tuvalu Trust Fund through the signing of an international trust fund agreement on 16 June 1987 (NZ Ministry of Foreign Affairs, 1987). The parties included the Government of Tuvalu (GoT), and the governments of Australia, New Zealand and the United Kingdom. Subsequently, Japan and South Korea also contributed but in a much smaller way. Each of the three main donors contributed around $8 million[2] with Tuvalu contributing $1.6 million. In total the initial funding amounted to $27.1 million.

As at 30 September 2000, the market value of the fund A Account stood at $66.6 million, around two and a half times the original contributions (see Chart 1). Over the 13 years of the fund's existence, Tuvalu has had automatic distributions amounting to $46.4 million or an average of $3.6 million per year. The distribution to the government for the 2001 fiscal year amounts to $6.1 million which represents 38 percent of core expenditure. Thus the fund is now having a very significant impact on the Tuvalu economy.



Tuvalu's share of the fund capital now amounts to 30.1 percent compared with the starting capital where the share was 5.9 percent. Tuvalu has reinvested $14.2 million back into the fund so that its share of the maintained value of $60.5 million is now $18.2 million.

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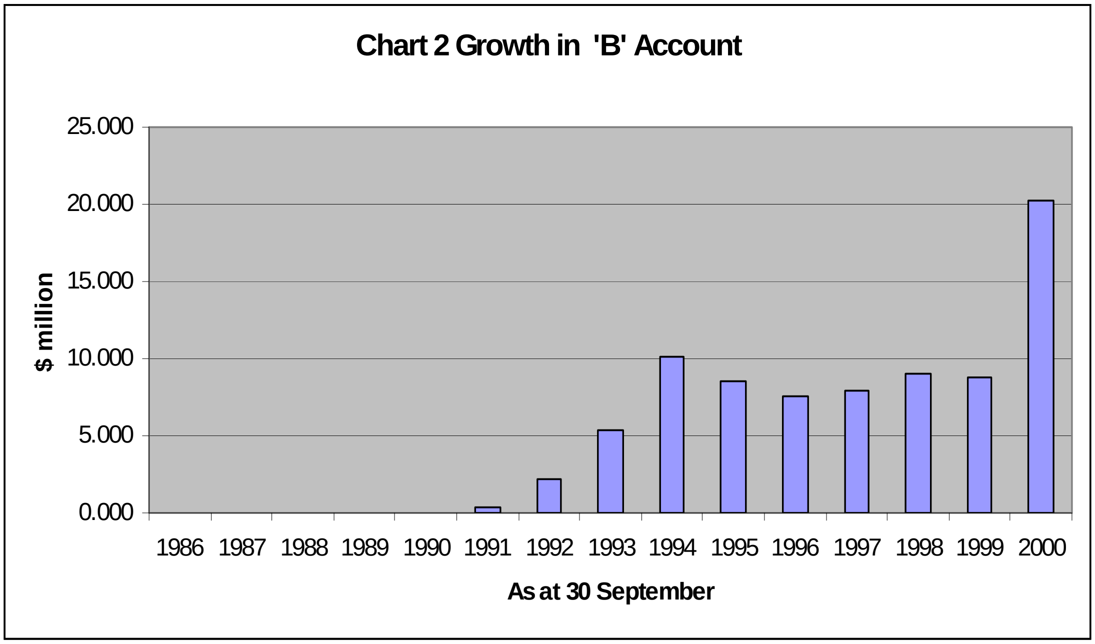
[2] All dollar amounts are in Australian currency.

In addition to the A Account capital, the Tuvalu Government has built up a buffer fund (the B Account) which, at 30 September 2000, stood at $20.2 million (see Chart 2). Thus over the 13-year period of the fund, Tuvalu's reserves have grown from $27.1 million to $86.8 million which is a compound increase of 9.4 percent per annum nominal growth in reserves.



While in theory the original contributions of donors may be returned on the break up of the fund this is unlikely and the fund's life is seen as indefinite.

Impact of the TTF on the economy

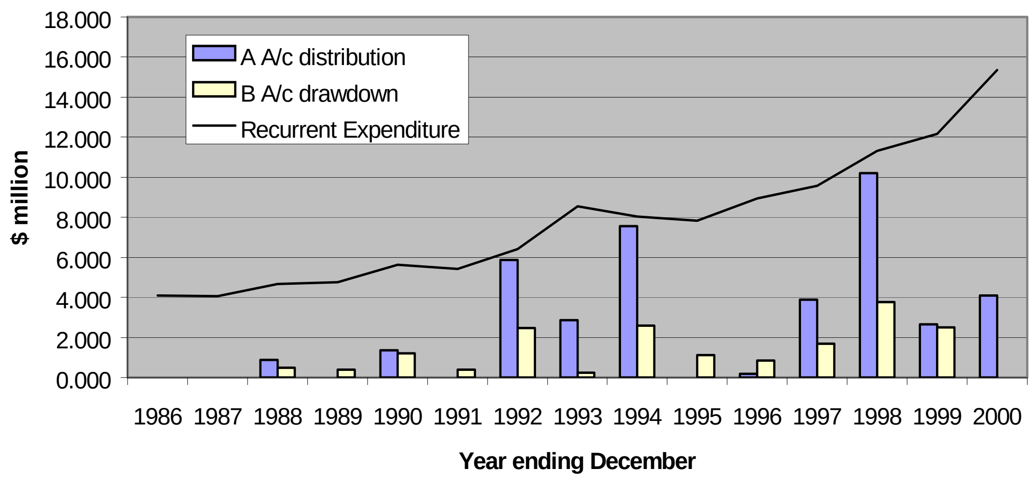
There are three key ways the fund has impacted on Tuvalu:

- Additions to recurrent revenue and support for the recurrent and development budgets
- Change in thinking about opportunities for revenue generation
- Funding of outer island development.

Budget support

The Tuvalu Trust Fund was aimed at providing a source of revenue to overcome a chronic budget deficit situation. The revenue is distributed to the Government from the A Account to the B Account. The amount needed is then drawn down into the consolidated revenue account as an additional source of revenue for expenditure on government services through the recurrent budget (see Chart 3). As the amount available from the fund has increased in recent years, it has enabled the government to begin funding its own development projects. This was unthinkable at the time the fund was established but it shows how quickly Tuvalu has moved in terms of its financial strength. This highlights a key benefit of the fund that it is changing attitudes away from an aid mentality towards that of economic self sufficiency. Tuvalu still has a long way to go, but it has also come a long way and much further than most people would have dared hope.

Chart 3 TTF distributions & drawdowns v Recurrent Expenditure



The foreword to the 1998 budget (GoT, 1997) stated that the centrepiece of the strategy is the establishment of a special development fund (SDF) which enables Tuvalu to become a major contributor to the national development programme. For the first time Tuvalu became a significant funder of its own development programme and in 1998 the SDF included 45 expenditure items ranging in size from $2,000 to $1.25 million and totalling $6.4 million. The government was able to meet those expenditures from the consolidated fund which was fed by general revenues, grants and transfers from the Tuvalu Trust Fund. The range of items was very wide, from weightlifting equipment and motorcycles to community fishing centres and primary schools.

In the 1999 budget estimates (GoT, 1998), $9.3 million was allocated to special development expenditure and in the 2000 budget (GoT, 1999), $10.1 million. This represents a little over 40 percent of total expenditure and shows the huge strides the government has made in meeting its own financial requirements.

The ability to increase government expenditure through the national budget is based on the foundation provided by the TTF. It is a remarkable achievement that the Government of Tuvalu now has reserves of over $80 million starting from a base of $1.6 million in 1987.

Changes in financial and economic thinking

The existence of the fund has had a profound influence over the way Tuvalu now addresses the world. It has introduced a new way of thinking and broadened the horizons of Tuvalu officials and politicians. By exposure to financial markets and the potential for utilising funds for development, a number of new initiatives have taken place. The most significant of these is the formation of Dot TV Corporation which Tuvalu has sold rights to use its high level domain name Dot TV for a sum of US $50 million over 13 years. Tuvalu now receives US $1 million per quarter from Dot TV Corporation.

Another opportunity Tuvalu has capitalised on is the excess capacity under its telecommunications country code of 688. As there is unused capacity under the country code, this has value to companies that provide telephone services. Tuvalu has received more than $2 million per annum in recent years from an international telecommunications company for the lease of this unused capacity[3].

It is unlikely that these opportunities would have been identified and developed without the environment created by the trust fund. The fund has exposed politicians and officials to a whole new world of finance and investment.

Outer island development

A key obstacle that has stood in the way of island development has been the small amount of money under the direct control of island governments (Government of Tuvalu, 1998). Through the success of the TTF the Government has been able to allocate considerable resources to the setting up of a fund specifically for island development.

The government, after consulting widely with island leaders, implemented a devolution programme with the longer-term financial and technical support to come from the Falekaupule Trust Fund (FTF). While similar to the TTF in some ways a big difference is that the island communities will control the FTF. This fund is for the exclusive benefit of the island communities and for the exclusive purpose of island development (GoT, 1998a). Another important difference is that the TTF was set up

[3] This is the so-called sex lines business. There has been much moral debate in Tuvalu over the continuation of this contract. So far pragmatism has over come the moral objections. It is understood the latest contract specifically excludes sex calls.

to fund the recurrent budget while the FTF is designed to fund development in a broad sense including maintenance and local training. In the FTF recurrent expenditure is excluded except for these two areas. The success of the TTF has allowed it to fund development, although this was never expected by the designers.

The FTF is discussed further below, but first the features of the TTF are outlined.

Features of the Tuvalu Trust Fund

Governance

The International Agreement for the Tuvalu Trust Fund has provided a system of governance that has served Tuvalu extremely well. There are a number of key aspects that have contributed to the excellent performance of the fund including:

- Accountability through a Board of four directors with Tuvalu in the chair and the other original parties providing members
- Professional funds management
- Monitoring of the fund performance by actuarial consultants (the Fund Monitor)
- Auditing of the fund by international auditors
- An advisory committee to monitor Tuvalu's economic performance and provide advice to the Government and the Board.

The primary responsibility of the Board is to manage the Fund. It does this by appointing a Fund Monitor who recommends an investment policy and money managers. The investment policy sets out the objectives of the fund and from this is determined the risk profile including benchmarks and allowable ranges for the balanced portfolio of growth and defensive assets. The monitor drafts the contracts with the money managers who invest the money on behalf of the Board.

The Advisory Committee prepares an annual report on the performance of the fund and the impact of the fund on the economy that is tabled in Parliament. The committee which has representatives from the original donor country plus Tuvalu meets bi-annually in Tuvalu for about 10 days. It reviews the government's budget and provides advice on macro and micro economic issues in a similar way to an IMF Article 4 mission.

Central to the operation of the fund is the requirement that the capital of the fund be maintained in real terms for inflation. Only in very exceptional circumstances would the capital of the fund be considered to be drawn down by the Government of

Tuvalu. This has never happened. At the end of each financial year on 30 September, the Advisory Committee calculates the maintained value of the fund based on the Australian consumer price index. If the market value of the fund is greater than the maintained value, then the difference is automatically distributed to the Tuvalu Government and placed in a buffer fund (the B Account) referred to in the Budget as the Consolidated Investment Fund (CIF). The purpose of the B Account is to ensure that there is a steady flow of revenue available to the Government from year to year.

The structure of the TTF International Agreement offers a unique partnership between a recipient and donor governments with the recipient government benefiting in many ways. Purely because of the lack of scale, small island states suffer huge difficulties in implementing good governance in public policy. Most importantly the trust fund offers a way to augment their scarce human resources in a non-threatening way. The country gains access to very experienced and highly qualified people at almost zero opportunity cost on a regular basis. These include fund managers, board directors and financial and economic advisors. Their advice may not be welcome by some politicians and officials all the time as sometimes the medicine they dispense is hard to swallow.

Performance

Since the fund's inception the TTF has achieved an average rate of return of 11.6% per annum during a period of average inflation of 3.4% per annum (Mercer, 2000). This equates to a real return of 8.2%. The prime objective of maintaining the real capital value of the fund has been comfortably achieved and significant distributions have been made to the GoT.

While the average distribution over 12 years has been $3.6 million, in the three years 1988, 1990 and 1994, there was no distribution as the market value was less than the maintained value. On the other hand, the largest distribution was in 1997 at $10.2 million. These large fluctuations highlight the need for a mechanism to even out distributions.

Providing a buffer

The B Account was established in 1991 after the first major distribution from the A Account which amounted to $5.9 million. It should be noted that the 1994/95 period provided almost nothing from the fund with $0.2 million being provided in 1995. Even though the fund is invested in a balanced portfolio, there are still very significant fluctuations in revenue.

The size of the B Account balance has been the subject of considerable debate because of the conflicting objectives of maximising the drawdowns into the Budget and maintaining a smooth flow of revenue for the Budget over time. The Advisory Committee and Board on the Advice of the Fund Monitor has set a target for the B Account balance of the sum of the last four years of drawdowns into the Budget in real terms. The Government has a preference for a formula based on two years of drawdowns.

Strictly speaking the decision on the B Account balance is one for the Government to make. However, the Board has an interest because it determines whether capital can be drawn down from the fund. In setting the target for the B Account the Government balances the need to have enough in the account to buffer itself against years of few or no returns on the A Account against the opportunity cost of returns foregone, since the B Account is invested in cash. In the event that the fund did not provide a distribution over a number of successive years the Board may decide that some capital could be drawn down. The Board's view on this would be coloured by the prudence displayed by the Government in managing its financial affairs. The current balance lies between the two targets.

The fund is now invested with 70 percent of assets in growth areas and 30 percent in defensive areas. The Board has indicated that if the B Account balance falls below its target then it will consider adopting a more conservative investment structure that is less volatile, but lower yielding.

A trust fund for island development

The success of the Tuvalu Trust Fund also enabled the Tuvalu Government to convince the Asian Development Bank that a trust fund for outer island development would be a good use of loan funds from the bank (ADB, 1998). This concept was new for the Bank and required considerable effort by Tuvalu to convince the ADB Board that it was the best investment the Bank could make in the Tuvalu economy. The FTF concept fitted well with the ADB's overarching goal of reducing poverty given that the island communities have been neglected since independence and are considered the less prosperous areas of Tuvalu.

The concept was that the ADB would provide $6 million in two tranches matched by the Tuvalu Government with contributions from each of the eight island communities of Tuvalu, with the island contributions also matched by the Government. This GoT generous matching was made possible because of the performance of the TTF in the late 1990s.

The fund was established by Deed in July 1999 and invested in February 2000, with the first substantial distribution expected in March 2001. The purpose of this fund, called the Falekaupule Trust Fund (FTF), is to provide a source of revenue for small scale grassroots development projects on the outer islands. Prior to the establishment of the FTF, these island communities relied on donor countries and in recent years project financing from the Tuvalu Government. They had virtually no funds of their own and the process led to a heavy dependence on outside assistance to do anything on the islands. By establishing the fund and the islands each making a contribution to it, there is now a mechanism whereby the island communities can take a stake in their own development.

The fund currently stands at around $15 million of which $1.2 million has been contributed by the island communities. The distribution formula for the fund is based on the proportion each community has made to the fund in relation to the other communities. Initially the distribution formula was based on three criteria: a flat rate amount to account for overheads faced by each island; a proportion based on the population of each island; and the size of each island's contribution to the fund. At the eleventh hour the Government changed the distribution formula. To this day the formula remains the most controversial feature of the fund.

Another area of debate has been the need to establish a buffer account for the FTF. The Board initially approached the Government to assist in setting up a buffer account, but has since agreed to establish this buffer by setting aside a proportion of returns, as distributions from the FTF become available.

The FTF follows the general governance structure of the Tuvalu Trust Fund, but instead of donor countries being represented on the board, each island community has a representative and the government provides a non-voting chair. The strong island affiliations mean that peer pressure in the island communities is the critical factor in maintaining the integrity of the Fund. The FTF enjoys the same level of professional fund management as the TTF. There is a trust deed and legislation to ensure the capital of the fund is protected and to ensure the revenue made available from the fund is used for the purposes that the fund was set up for.

ADB has provided technical assistance with a community development specialist to ensure proper procedures are set up for the allocation of funds based on simplified strategic plans for island development and basic project documentation. It is early days yet to see how successful this fund will be, but there are encouraging signs that it will form just as much an important role on the islands as the TTF has for central government.

While it is too early to judge the performance of the FTF the chief criteria, in my view, should be how the money from the fund is used. If the islands follow the purpose as set down in the deed then it is likely that further contributions will be made to the fund, not only from the Government, but also from donors who are looking on with great interest. If the money is frittered away and no sustainable gains can be observed, or if the money is misappropriated, or used for inappropriate purposes then it is unlikely the fund will grow. The Board is grappling with these allocation issues. For example, there have been requests for money to provide houses for the island pastor and island council members and the Board has approved these.

Other Trust Funds in the Pacific

There are several other trust funds that are well established in the Pacific including those in Kiribati, Fiji (for the Banaban people on Rabi Island), Palau and the trust funds set up for the islands affected by nuclear testing in the Marshall Islands. The first two of these funds were established with the proceeds from phosphate settlements and the Palau and Marshall Islands funds from money provided by the United States Government. Both the Kiribati and Palau funds have performed well and criticism from donors appears to centre on the fact that each of these countries has emphasised building the capital base of the funds rather than spending the revenue generated. The Banaban fund suffered from misappropriation and is now in a process of rebuilding under a new governance structure (ESCAP, 1998).

The New Zealand Government has funded investigations into trust funds for Niue (MFAT, 1998) and Tokelau (MFAT, 1998a), but both have not progressed mainly due to the requirement that the recipient country provide half the initial start up capital. This requirement has proved to be too great a sacrifice of current income, even when generated from windfall gains, and highlights the high implied discount rates these countries operate under. Another factor is that both these countries have arrangements with New Zealand that provide a high degree of comfort over future financial support.

As part of ADBs public policy reform programmes in the Republic of Marshall Islands (RMI) and Federated States of Micronesia (FSM) trusts funds have been set up in both countries. Both are modelled on the TTF. To date both funds have seeding capital only and in the case of FSM further capital contributions are dependent on Compact negotiations with the United States.

The above funds are all aimed at providing an additional sustainable source of revenue for the national budgets of these countries. There are also moves to develop trust funds for specific purposes and in particular conservation. There is a proposal for a Pacific Islands Trust Fund for Nature Conservation under investigation by SPREP with the United Nations Global Environmental Fund (GEF). In addition, the New Zealand Government (MFAT, 2000) has funded a project to investigate the feasibility of a trust fund to protect the Sovi Basin. This is a large area of indigenous rain forest in Fiji that has potential global heritage status.

Risks and risk management

There are a number of risks that trust funds face that are different to traditional forms of aid to ensure that the funds actually provide a net benefit to developing countries.

A major risk is that the returns from a fund will be diluted through government policy (NZIER, 2000). The most obvious way this can happen is when the funds become a slush fund to finance pet policies and projects with Fund managers instructed to invest in particular sectors or business activities, rather than aiming for the highest possible return (within appropriate risk parameters). This can be protected by ensuring that the fund is managed at arm's length by competing fund managers of international reputation.

Explicitly excluding investments within the country is an additional step that can be taken to protect the capital. In developing countries capital is very short and it may seem odd that all the money in the fund should be invested off-shore. There are three reasons why this should be done. Firstly, it removes the possibility of the fund being used as a slush fund. Secondly, it generates claims on resources outside the country i.e. increases foreign reserves. Thirdly, there may be no bankable projects inside the country with the highest returns for acceptable risk being off-shore.

At the very least the fund should be prohibited from holding public debt. This is a key sustainability factor as the aim is to maximise the net claims. If the fund holds public debt as an asset there will be a liability elsewhere on the country's balance sheet that will offset it. Hence, the net claim will be zero.

Using the fund as collateral to increase borrowing for capital investment also has the potential to debase the fund. This will not show up as expenditure and so will not affect the budget surplus (apart from debt servicing costs). But the likely result will be investments in low yielding or negative returns for projects including political projects thus reducing future incomes.

It is important to have a strong budgetary framework to ensure that funds are used sustainably. Recent budget decisions in Tuvalu are showing signs of erosion of public financial management. It is essential that strong, transparent budgeting and financial management complements Trust Funds and, probably most importantly, prompt professional auditing. Trust funds are not a panacea, but can be an important part of sustainable public finance in small island states. It all gets back to good governance.

Future directions

Prior to the setting up of the trust fund the Tuvalu Government was subjected to a line by line examination of its Budget by British aid officials to ensure there was no "wastage". If savings were made these were clawed back. This process ensured there would be no development or a move to economic self reliance with an almost total dependence on the colonial powers.

The TTF has demonstrated that the trust fund concept for support of a national budget can have very positive benefits for small states that lack the resources and capacity to develop their economies by them selves. A number of countries in the Pacific have adopted the TTF model, but it is early days and time will determine whether the concept is exportable. An important success factor with the TTF has been the prudent approach shown by the GoT in its financial affairs. This is demonstrated by a discipline to produce surplus budgets year on year. They have limited growth in the recurrent budget to inflation plus population growth using the surplus to fund development projects and reinvest in the fund.

Tuvalu has moved from a position of chronic budget deficits to the position of having significant budget surpluses. It is now grappling with the difficult allocation problems involving capital investment in its own economy. The decisions made are in some cases different to what donors have been prepared to fund in the past, but this is what increased self reliance is all about – being able to make these difficult decisions themselves.

The TTF has been adapted to provide a sustainable source of revenue for small-scale development projects under the control of isolated island communities in the new FTF. This project is in the start up phase and the first round of approvals have just been made. A key part of the structure of the FTF is the maintenance of the capital and ownership of a part of the fund by the island communities. These communities now have the task of making difficult allocation decisions themselves which is a completely new experience. By protecting the capital and only using the revenue for projects there is a huge safety margin built in.

The trust fund concept as developed in Tuvalu has proved to be sound and there are many applications across countries and sectors that could adopt the principles that have served Tuvalu so well.

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