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Report No. 77446-TV

INTERNATIONAL DEVELOPMENT ASSOCIATION

PROGRAM DOCUMENT

FOR A PROPOSED

GRANT

IN THE AMOUNT OF SDR 2 MILLION
(US$ 3.0 MILLION EQUIVALENT)

TO

TUVALU

FOR A

FIRST DEVELOPMENT POLICY OPERATION

OCTOBER 21, 2013

Poverty Reduction and Economic Management Department
Timor-Leste, Papua New Guinea and Pacific Islands Department
East Asia and Pacific Region

GOVERNMENT FISCAL YEAR
January, 1 – December, 31

CURRENCY EQUIVALENTS
(Exchange Rate Effective as of October 21, 2013)

Currency Unit =	Australian Dollar (AU$)
US$1.00 =	AU$ 0.96655

WEIGHTS AND MEASURES
Metric System

ABBREVIATION AND ACRONYMS

ADB	Asian Development Bank
AU$	Australian Dollar
AUSAID	Australian Agency for International Development
CAS	Country Assistance Strategy
CIF	Consolidated Investment Fund
CSOs	Community Service Obligations
DHS	Demographic and Health Survey
DPO	Development Policy Operation
DSA	Debt Sustainability Analysis
FTF	Falekaupule Trust Fund
GDP	Gross Domestic Product
GFC	Global Financial Crisis
GNI	Gross National Income
GOT	Government of Tuvalu
HIES	Household Income and Expenditure Survey
IBRD	International Bank for Reconstruction and Development
IDA	International Development Association
IMF	International Monetary Fund
IRD	Inland Revenue Department
JSAN	Joint Staff Advisory Note
LDP	Letter of Development Policy
MDGs	Millennium Development Goals
MOE	Ministry of Education
MFED	Ministry of Finance and Economic Development
MOH	Ministry of Health
MTEF	Medium-Term Expenditure Framework
NGO	Non-Governmental Organization
NZ	New Zealand
PEs	Public Enterprises
PEFA	Public Expenditure and Financial Accountability
PEMRU	Public Enterprise Management and Reform Unit
PFM	Public Financial Management
PFTAC	Pacific Financial Technical Assistance Centre
PPG	Public and publicly guaranteed
PRM	Policy Reform Matrix
RMS	Revenue Management System
SDR	Special Drawing Rights
TKII	Te Kakeega II - National Strategy for Sustainable Development 2005-2015
TMTI	Tuvalu Maritime Training Institute
TMTS	Tuvalu Medical Treatment Scheme
TTF	Tuvalu Trust Fund
TVET	Tertiary Vocational Education and Training
UNICEF	United Nations Children's Fund
US$/ USD	United States Dollar
VLH	Vaiaku Lagi Hotel

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TUVALU

FIRST DEVELOPMENT POLICY GRANT

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GRANT AND PROGRAM SUMMARY

TUVALU

FISRT DEVELOPMENT POLICY GRANT

Recipient	Tuvalu
Implementing Agency	Ministry of Finance and Economic Development
Financing Data	IDA Grant (Standard IDA Grant terms) SDR 2 million (US$ 3.0 million equivalent)
Operation Type	The proposed operation is the first in a programmatic series of two development policy operations.
Main Policy Areas	Strengthened public financial management and improved social service delivery.
Key Outcome Indicators	- Reduced variance in actual versus budgeted expenditure - Improved management of revenue records - Higher share of outer island projects implemented in-line with outer island plans for community development - Increased expenditure allocation to primary and secondary health care - Increased expenditure allocations to primary, secondary, and vocational education
Program Development Objective(s) and Contribution to CAS	The objective of the proposed operation is to support reforms that strengthen public financial management and improve the delivery of social services, while providing critical financing to enable the rebuilding of fiscal buffers. Given the importance of the public sector to Tuvalu's economy, an effective system for public financial management is critical to public service delivery and overall economic management. The reforms in this area are focused on improving budget execution, transparency and revenue administration. They also address the management of outer island spending where most of the poor reside. The social service delivery reforms focus on improving the management and efficiency of Tuvalu's essential, but costly, overseas medical treatment and scholarship programs. These reforms will also help rebalance public expenditure towards primary and secondary education, as well as towards basic and preventative healthcare. Primary social services are heavily relied on by the majority of Tuvaluans, especially poorer households. Through strengthening public financial management and supporting the rebuilding of fiscal buffers, the proposed operation is aligned to the CAS theme of increasing resilience against external shocks
Risks and Risk Mitigation	<u>Thin capacity</u> in the public sector could impede the implementation of the proposed reforms. This has been mitigated by selectivity in the design of the program, clear communication on requirements of each policy action, and where gaps arise, by mapping technical assistance from development partners. <u>External shocks</u> such as financial market volatility and commodity price spikes could place a strain on Tuvalu's fiscal situation. The proposed program seeks to mitigate this risk by supporting measures that will contribute to improved revenues and prudent expenditure management in the medium term. The Bank will also continue to work with IMF staff to monitor macroeconomic risks and provide policy advice as needed. <u>Policy continuity.</u> The reforms supported under this operation have been endorsed by both the government and the opposition. It is therefore unlikely that the general election scheduled for late-2014 would lead to significant policy reversals.
Operation ID	P145488

IDA PROGRAM DOCUMENT FOR A PROPOSED DEVELOPMENT POLICY GRANT TO TUVALU

I. INTRODUCTION

1. **Tuvalu, comprised of nine Polynesian islands and atolls, is one of the smallest states in the world with a population of around 11,000 and a land area of only 26km^2.** Tuvalu is the smallest and one of the newest members of the World Bank Group. Tuvalu joined the World Bank in 2010, making the Tuvalu Country Assistance Strategy (CAS) and this Development Policy Operation (DPO) amongst the first steps for the World Bank in engaging with this new member state. Hence, in addition to supporting important policy reforms, this operation will provide an important opportunity to develop mutual understanding of Tuvalu's special context, and the potential role that the Bank can play in Tuvalu's development.

2. **Tuvalu's economy is highly vulnerable to challenges stemming from its very small size and geographic isolation, and relies heavily on grants to meet its development financing needs.** The size of Tuvalu's economy is around AU$38.5 million[1], and it is over 3,500 kilometers away from the nearest major market (New Zealand), making it one of the smallest and most remote Pacific islands. As is the case in many other small, open and import-dependent economies, Tuvalu is highly vulnerable to global economic shocks and price spikes. With no monetary independence[2], a high level of import dependence and a minimal financial infrastructure, fiscal policy is the main tool available to the Government of Tuvalu (GoT) to manage the economy. Yet, Tuvalu's fiscal position is extremely tight with regular fiscal deficits providing limited space for government investments or operations, particularly in times of crisis[3] and with a heavy reliance on grants (averaging more than 20 percent of Gross Domestic Product (GDP) in recent years)[4]. Tuvalu has a long tradition in seafaring on merchant ships, which has been a major source of employment and foreign exchange for Tuvalu. However, employment opportunities have been disappearing as demand for seafarers has declined in the aftermath of the global economic crisis and competition for jobs increased. In addition, natural disasters such as cyclones, king-tides, and droughts are relatively frequent and devastating occurrences in Tuvalu, as in other Pacific Islands.

3. **The Global Financial Crisis (GFC) contributed to the depletion of Tuvalu's main fiscal buffer, impeding the GoT's ability to meet its financing requirements.** The Tuvalu Trust Fund (TTF) is a capital preserving fund established post-independence to contribute to Tuvalu's fiscal sustainability[5]. Surplus returns on the investment of the TTF had been generally sufficient to provide a regular source of funding for the budget[6] and saved surplus

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[1] GDP in 2012.
[2] Tuvalu does not have a central bank, and uses the Australian dollar as its currency.
[3] Tuvalu has been in primary deficit since 2005 and relies on grants to finance some of its basic government operations.
[4] Grants financed 80 percent of deficits over the past five years.
[5] See Box 1 for more detail on the TTF.
[6] Since inception, distribution from the trust fund provided on average budget support equivalent to15 percent of total revenues.

returns have provided a fiscal buffer at times when fund earnings have been low or when unexpected financing gaps arise. However, Tuvalu's trust fund suffered large losses in 2008 with the GFC. The fund's capital value has been recovering gradually since then. In the meantime, Tuvalu's savings have been substantially drained since 2009 to finance budget deficits. This trend is not expected to be reversed before 2014.

4. **At the same time, poverty in Tuvalu's outer islands deepened as a series of shocks including water shortages, deteriorating soil quality and increasing prices contributed to rising poverty.** Severe hardship, as measured by food poverty is low in Tuvalu. Basic needs poverty is more widespread. The most recent poverty estimates indicate that poverty is concentrated in the outer islands and that the gap with the capital Funafuti has increased significantly in recent years. The lack of access to services, scarce employment opportunities, falling remittances and vulnerability to price shocks are some of the underlying factors affecting this trend.

5. **The GoT has shown commitment to reforms to strengthen its fiscal position and to improve public services but the fiscal outlook is fragile.** The GoT has taken steps to consolidate expenditures and to address fiscal imbalances in the medium term. It also set out an agenda for policy reform in its National Strategy for Sustained Development, 2005-2015 or *Te Kakeega II* (TKII). A Policy Reform Matrix (PRM) was developed by the GoT, in consultation with the World Bank and other development partners to pursue measures that would ease fiscal constraints, improve public financial management and enhance the efficiency of key government programs in health, education and outer islands. This process has enabled the Bank to work with other development partners in a coordinated policy dialogue for the achievement of the priority goals identified in the TKII. Through the process of developing the matrix, the strategic focus was enhanced among key stakeholders around the areas that government and development partners identified as priorities for reform. Nevertheless, the fiscal outlook remains fragile and reliant on both grant support and TTF recovery. The GoT will also need to maintain its focus on fiscal prudence and to enhance revenues where possible in order to commence the rebuilding of fiscal buffers.

6. **This program document proposes a Development Policy Grant for SDR 2 million (USD 3 million equivalent)[7] as the first in a programmatic series of two operations in support of Tuvalu's ongoing reform efforts.** The operation will provide critical financing to support the GoT's budget and the rebuilding of Tuvalu's fiscal buffers. It will also support complementary reforms to: (i) strengthen public financial management, and (ii) improve social service delivery. Given the importance of the public sector to Tuvalu's economy, an effective system for public financial management is critical. The reforms in this area are focused on improving budget execution, transparency and revenue administration. They also address the management of outer island development spending, which accounts for around 40 percent of Tuvalu's capital budget. The social service delivery reforms focus on improving the management and efficiency of Tuvalu's essential, but costly, overseas medical treatment and scholarship programs. The lack of economies of scale prevents Tuvalu from providing tertiary healthcare or education in-country. Yet these services are essential to building and

[7] USD 3.0 million equivalent based on SDR/ USD rate on August 30th, 2013.

maintaining human capital, a key asset for an undiversified small economy. Together, the supported reforms are designed to help Tuvalu improve its fiscal position both in terms of revenue and expenditure, while maintaining the quality of public services.

7. **The operation is expected to contribute to the improved wellbeing of Tuvaluans in both Funafuti and the outer islands.** Better management of both the overseas scholarship and medical treatment programs will improve the quality of these services while reducing the cost of their provision. These savings will free up scarce resources and allow the GoT to rebalance health and education expenditure towards primary services (such as primary healthcare, secondary and vocational training) which are heavily relied on particularly by poorer households. Together, the reforms are expected to contribute to the government's TKII objective to "provide quality health and education services that are equitable, balanced, cost effective, and meet the needs of Tuvaluans". Similarly, the outer island project management reforms are expected to improve access to services for some of Tuvalu's poorest and most remote households. The outer island policy is expected to reverse poor project implementation that has been hampering investments in the provision of basic services and infrastructure such as water tanks and improved school and medical facilities. The other reforms supported by this operation for strengthening public financial management are also expected to contribute to improving poverty and social outcomes in Tuvalu indirectly by making the budget a more effective tool for responding to national poverty and social needs.

8. **The proposed operation carries risks stemming from thin institutional capacity in the GoT, and an uncertain external environment.** Firstly, thin capacity in the public sector presents a risk that could impede the implementation of the proposed reforms. This is being mitigated by selectivity in the design of the program, clear communication on requirements of each policy action, and where gaps arise by mapping technical assistance from development partners. Secondly, external shocks such as financial market volatility and commodity price spikes could place a strain on Tuvalu's fiscal situation. The Bank will continue to work with International Monetary Fund (IMF) staff to monitor macroeconomic risks and provide policy advice as needed. Finally, policy continuity may pose a risk to the proposed program. This risk has, however, been mitigated through the endorsement of the reforms by both the government and opposition. Therefore it is unlikely that the general election scheduled for late-2014 would lead to policy reversals. Furthermore senior officials remain in position even when political mandates change, providing continuity. A two-year programmatic operation is proposed to sustain the progress made in policy dialogue over the last 18 months and to maintain the momentum of reform in the medium term.

II. COUNTRY CONTEXT

A. ECONOMIC CONTEXT

9. **Tuvalu is on the margins of the global economy, with a very narrow economic base, and faces both scale and distance-related constraints to goods or services export.** Tuvalu has experienced uneven and generally low economic growth in the past five years[8],

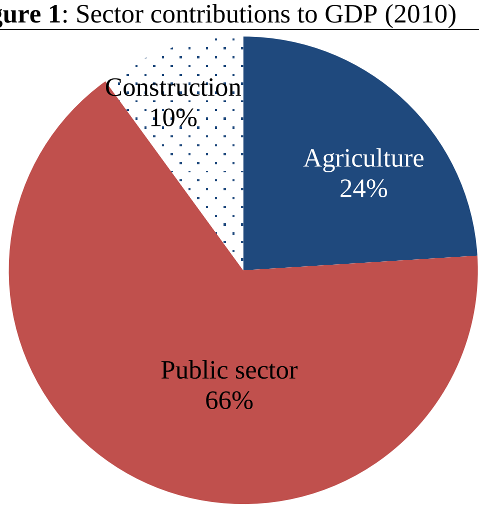
[8] GDP growth averaged 1.9 percent over the past five years.

with real GDP growth ranging from -4.4 percent to +8.5 percent. The public sector dominates the economy, accounting for approximately two-thirds of GDP between 2008 and 2012, as well as the majority of formal sector employment[9]. The size of the public sector reflects the inability of a very small country to exploit economies of scale in public administration and the provision of services. Agriculture contributed 23.5 percent of GDP. Subsistence farming and fishing, the main economic activities in this sector, have suffered more recently from poor soil quality, limited access to fresh water and the high cost of imported fuel. Droughts (the most recent being in September 2011) have also had a further negative effect on crop yields and the contribution of this sector to the economy. The construction sector, largely driven by donor financed projects, has contributed around 10 percent of GDP over the period (see Figure 1).

10. **Fiscal policy is the only macroeconomic policy lever against external shocks.** Tuvalu uses the Australian dollar as currency and with no monetary policy independence, and minimal financial diversification, fiscal policy is the only instrument for dealing with external shocks. The volatile nature of Tuvalu's revenues frequently results in large deviations on fiscal outcomes. Unlike other countries, Tuvalu has limited channels to finance fiscal deficits and relies heavily on grants.

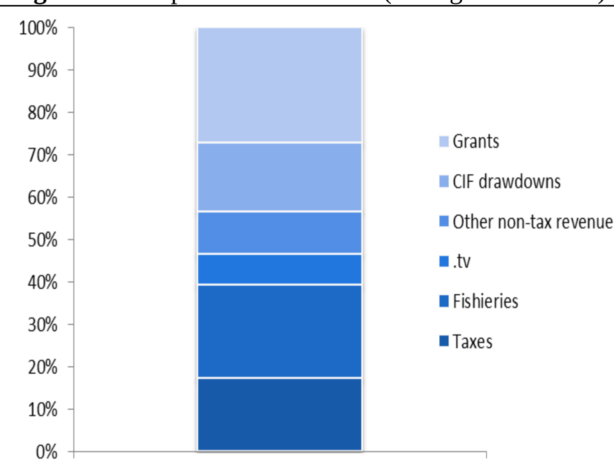
11. **Taxes fund a relatively small proportion of Tuvalu's budget compared to income from fisheries, the trust fund and grants.** Tuvalu's taxes receipts accounted for 30 percent of recurrent revenue between 2008 and 2012. Non- tax revenues account for the remaining 70 percent, with fisheries income and royalties from the .tv internet domain having been significant contributors at 51 percent over the last five years (see Figure 2). Even though revenues have been growing in recent years, they have been annually exceeded by total expenditures. Donor grants and funding from the TTF have been the main sources for financing the resulting deficit.

Figure 1: Sector contributions to GDP (2010)



Souce: World Bank estimates

Figure 2: Composition of revenue (average 2008-2012)



Souce: World Bank estimates

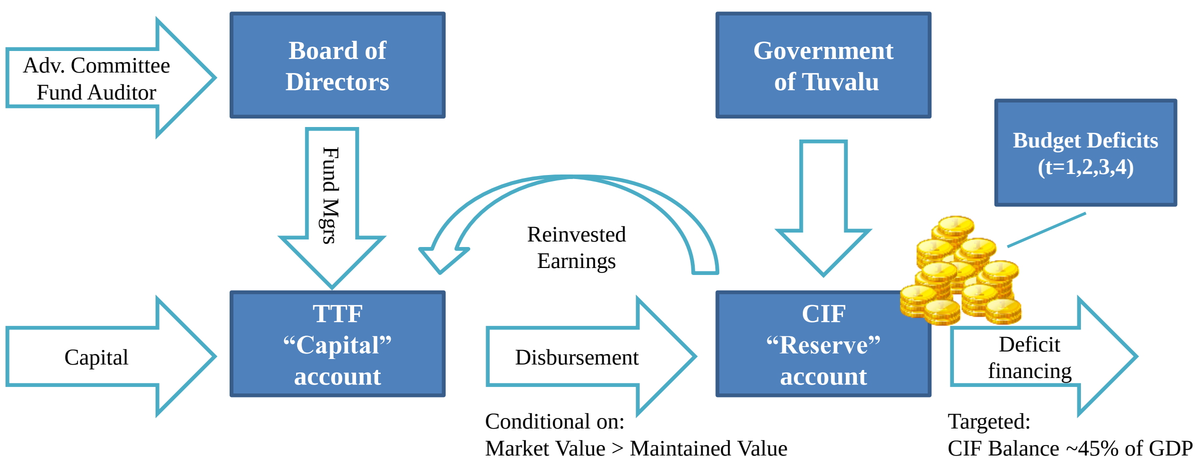
[9] Government expenditure represented 83 percent of GDP and wages contributed to 42 percent of total expenditures.

Box 1. THE TUVALU TRUST FUND

The TTF was established in 1987 to provide an additional source of revenue for recurrent expenditures and to set the country on a path towards greater financial autonomy. The TTF initially comprised of a single capital account commonly referred to as the TTF. The TTF was capitalized by donors (Australia, New Zealand, Japan, the Republic of Korea and the United Kingdom), and the GoT in 1988. The TTF's capital has grown over the years through reinvestment of its own earnings and contributions by the GoT during surplus periods. The TTF is not fully sovereign with development partners represented on its Board. The TTF's capital account aims to generate a real rate of return of 4.5 percent in excess of the Australian Consumer Price Index.

The TTF Board of Directors endorsed the initiative of the GoT to create a buffer account, the Consolidated Investment Fund (CIF) in 1991. An ancillary trust fund was established under full government control to facilitate predictability and regularity of transfers to the budget. In years when the market value of the TTF exceeds it's real maintained value (indexed to the Australian CPI), the surplus is transferred to CIF. Transfers accumulate in the CIF until the GoT withdraws for budget financing. The CIF targets a minimum balance equivalent to 16 percent of the TTF's real maintained value (or around 45 percent of GDP). This is based on the assumption that a "dry-spell" up to four years could occur where no distribution would be made from the TTF. Should a four year "dry-spell" happen, the CIF could finance budget deficits up to 11 percent of GDP per annum. CIF receives transfers from the TTF, donors, fishing license fees, and at times, reinvests back in the TTF.

Tuvalu Trust Fund Structure



12. **The TTF and CIF were established to contribute to Tuvalu's fiscal sustainability however, their ability to achieve this is contingent on global financial market conditions.** Distributions from the TTF provided budget support equivalent to 15 percent of total revenues on average since its inception, and partly financed the majority of past budget deficits. However, since the capital of the TTF is invested in international financial markets (approximately 60 percent in defensive and 40 percent in growth assets), annual investment returns have typically shown high levels of volatility[10]. Negative shocks usually mean that no new distributions will be made to the CIF. In 10 out of the past 25 years, the TTF did not make distributions to the CIF (post 1987, 2000 and 2008 crises). Such external shocks have also tended to simultaneously affect other key incomes such as license fees and remittances,

[10] Return in the past decade averaged 6 percent and standard deviation on return was 7¼ percent.

further straining fiscal resources. At these times, the government continued to draw down on savings in the CIF, highlighting the importance of maintaining a sufficient balance in the CIF to provide fiscal buffers against future shocks.

13. **Tuvalu faces a structural trade deficit and is vulnerable to international price fluctuations.** Merchandise exports are typically less than 2 percent of GDP, and prospects for increasing these are limited. Given very limited domestic production, Tuvalu is heavily dependent on imports. All petroleum products and a very high proportion of food are imported, leaving the country extremely vulnerable to international commodity price shocks. Tourist arrivals, unlike some other Pacific island countries, are very low (just over 300 visitors per year) due to poor infrastructure and low passenger capacity. The trade deficit is largely financed by remittances, investment income from the TTF (discussed above), fishing license fees, as well as official grants. The current account deficit in the past five years averaged 1.8 percent of GDP whilst reserves remained steady at approximately 7 months of imports.

B. POVERTY AND GENDER CONTEXT

14. **Severe hardship, as measured by the food poverty line, is low in Tuvalu and has declined between 2005 and 2010.** In Funafuti, where almost half of Tuvalu's population resides, food poverty (the ability of the household to meet its basic food needs) fell to just 0.6 percent in 2010. In contrast, food poverty increased amongst the outer island populations from 3.7 percent in 2005 to 6.6 percent in 2010 (see Figure 5). A series of shocks including water shortages, deteriorating soil quality and increasing prices contributed to these trends particularly in the outer islands. The decline in remittance flows would also have negatively impacted households.

15. **Basic needs poverty is more widespread and is estimated to affect over a fifth of the population in both Funafuti and the outer islands in 2010**. Tuvalu's basic needs poverty line is based on a relative measure that makes it difficult to compare basic needs poverty rates between periods[11]. Figure 3 presents the incidence of poverty based on this measure, whereby similar levels of poverty were recorded in both 2005 and 2010 for Funafuti, and a higher basic needs poverty rate was reported for the outer islands. Figure 4 presents an adjusted set of poverty estimates for 2010. These adjusted estimates differ from relative measure presented in the HIES report in that the 2005 non-food poverty line (adjusted for prices) is used as the point of reference. This adjustment is made in order to enhance comparability between the survey periods[12]. In addition, the adjusted estimates use one national poverty line for both Funafuti and the outer islands[13]. The adjusted estimates indicate that the basic needs poverty rate in the outer islands is almost twice as high as that of the rate

[11] In contrast, the food poverty measure is based on individual calorific intake requirements and is therefore broadly comparable.

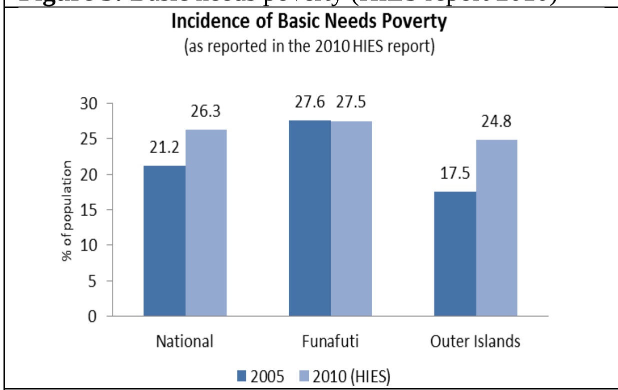
[12] The adjusted basic needs poverty line is composed of the food poverty line as reported in the HIES 2010 report and the non-food poverty line for 2005 which was adjusted upwards (using the non-food CPI) to bring it to 2010 prices.

[13] World Bank estimates.

in Funafuti. Overall, these poverty estimates indicate that poverty is concentrated in the outer islands and that the gap with Funafuti has increased significantly in recent years[14].

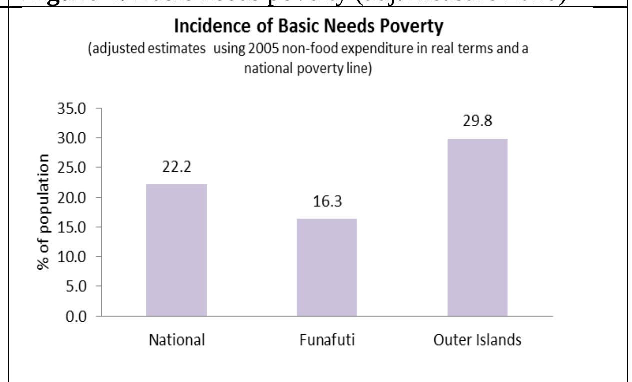
16. **Lack of access to services, employment opportunities and vulnerability to shocks are some of the factors underlying these trends.** Poverty in the Tuvalu context more frequently refers to lack of access to basic services such as potable water as well as lack of income earning and higher education opportunities, particularly in the outer islands. Poverty dynamics also demonstrate vulnerability to price changes, particularly for imported goods such as food and fuel[15] that constitute a large share of the consumption basket. Customs of mutual support within communities and extended families and remittances have been a traditional safety net that still protects many of Tuvalu's households from extreme poverty. Investments in public services have also been sufficient to bring Tuvalu's health and education indicators on track to meeting the Millennium Development Goals (MDGs) (see Annex 5).

Figure 3: Basic needs poverty (HIES report 2010)



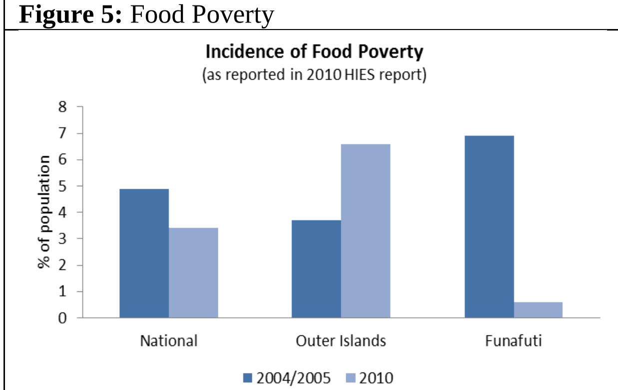
Source: GoT

Figure 4: Basic needs poverty (adj. measure 2010)



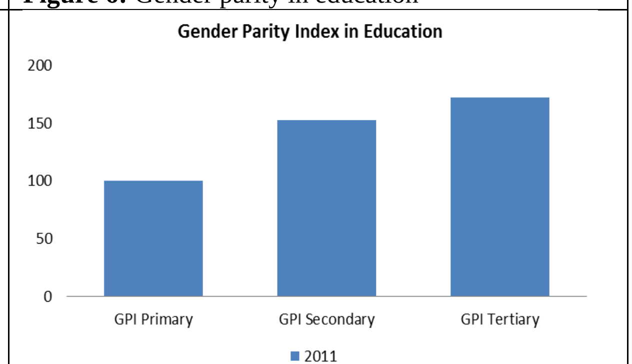
Source: GoT and World Bank estimates

Figure 5: Food Poverty



Source: GoT

Figure 6: Gender parity in education



Source: Secretariat of the Pacific Community

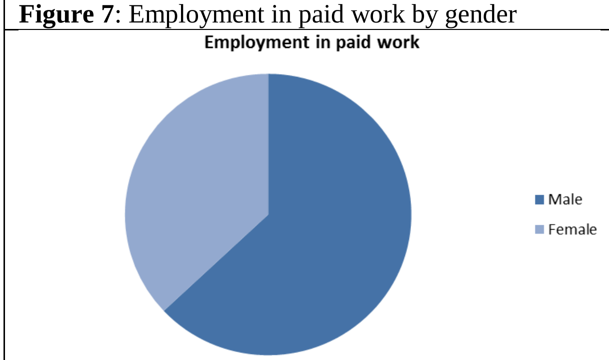
17. **Tuvalu has made significant progress towards the achievements of gender equality in education and in improving health outcomes for mothers**. Almost all Tuvaluan girls and boys are enrolled in primary schools, and there are more girls than boys enrolled in

[14] Like several other Pacific Island countries, Tuvalu has not been part of the surveys conducted by the International Comparison Project (which computes Purchasing Power Parities). Hence, a reliable estimate of the Purchasing Power Parity conversion factor is not available for Tuvalu.
[15] Growing fuel prices inflate electricity costs as power is generated through diesel generators.

secondary and tertiary education (see Figure 6). Tuvalu is also one of the few Pacific island countries on track to achieve the MDGs for maternal mortality by 2015. Despite these achievements, there is much progress to be made in gender based violence and in terms of female participation in employment and leadership. The Demographic and Health Survey (DHS) 2007 reported that 4 in 10 women have been subjected to some type of physical violence, and a large proportion of these incidents remain unreported. As part of its response to this issue, the GoT has prepared a domestic violence bill that is currently under consultation in the outer islands. In terms of political power, Tuvalu's Constitution and electoral laws provide equal opportunities for women and men to contest in elections. Nevertheless, it is rare for women to compete in the political arena and there have been only two females in Parliament since 1986. At the local level, the *Falekaupule* (local government) Act provides for the appointment of a 'Women's Community Worker' as a permanent office in the local council, and women constituted 8.3 percent of elected members at the council level[16].

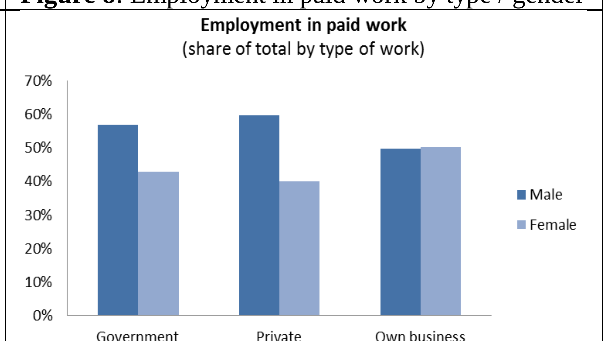
18. **Although girls have a relatively high level of access to education, women's share of paid employment is lower than men.** Figure 7 presents women's share of employment in the non-agricultural sector, which is relatively low and is estimated to be 36 percent in 2010[17]. This reflects the general scarcity of paid employment opportunities outside of the public sector and the male dominated nature of the traditional occupations such as seafaring, fishing and construction. This trend differs however in terms of own business employment, where women are equally active as men (see Figure 8). This suggests that small scale entrepreneurial activities may be an area with fewer traditional barriers to entry for women. It also highlights the potential for stimulating women's employment through vocational training in targeted business related skills.

Figure 7: Employment in paid work by gender



Source: Pacific MDGs tracking report, 2013.

Figure 8: Employment in paid work by type / gender



Source: HIES, 2010.

C. RECENT ECONOMIC DEVELOPMENTS IN TUVALU

19. **Tuvalu was hit hard by the GFC through its financial asset holdings.** The government's foreign asset holdings, exceeding 400 percent of GDP, exposed Tuvalu to the crisis in the financial markets. The TTF, the Tuvalu National Provident Fund, and the

[16] Beijing + 15: Review of progress in implementing the Beijing Platform for Action in Pacific Island countries and territories. Secretariat of the Pacific Community, 2010.
[17] Pacific regional MDGs tracking report, 2013. Additional gender disaggregated data is not available.

Falekaupule Trust Fund (FTF)[18] are largely invested in international equity and fixed income markets. Losses in these funds exposed not only the central government but also local governments and the retirement holdings of individuals to global financial market fluctuations. The financial crisis resulted in a 20 percent loss in the TTF, the largest fund. As a result of the losses, the TTF has not made any distributions to the CIF since 2009. This would have resulted in the near exhaustion of CIF buffer assets without donor support.

20. **The impact of the GFC on Tuvalu's economic situation has been protracted and the country remains vulnerable.** Growth has remained low following the GFC. After two consecutive years of decline, the economy revived briefly in 2011, growing by 8.5 percent due to a pick-up in construction of infrastructure projects and small service sector business activities before slowing down to 0.2 percent growth in 2012 (see Figure 9). Tuvalu's asset holdings are gradually recovering, however, disbursements from the TTF to rebuild buffer assets in the CIF are not expected until 2014 at the earliest.

21. **Sharp increases in inflation resulting from commodity price shocks, together with decreasing remittances, contributed to rising poverty in recent years, particularly on outer islands.** Households experienced a shock to their real incomes as rising international prices for fuel and imported food caused inflation to spike in 2008, reaching 10.4 percent from 2.3 percent the previous year (see Figure 11). An additional shock to household incomes came from a decline in remittances, which fell from around 17 percent of GDP in 2008 to 7 percent in 2012. This resulted from a decline in work opportunities on merchant ships, traditionally one of the largest sources of foreign exchange. Seafarer remittances had also been affected by the depreciation of the US dollar against the Australian currency (see Figure 10 and 14). Tuvaluans depend on the support of extended families, and the loss of cash income from a single person may have a widespread impact on the community. Given limited cash earning opportunities domestically, particularly outside of the capital city Funafuti, the fall in remittance flows and the rise in prices, the population's access to basic goods and services deteriorated.

22. **GoT responded to this period of economic hardship with increased public spending, enabled by grants and reserves in the CIF.** Public expenditure expanded from 76.5 percent of GDP in 2008 to a peak of 96.6 percent of GDP in 2010. The largest increases in expenditure were due to infrastructure projects, capital spending in the outer islands and higher fuel costs for electricity generation. The GoT medical treatment scheme and tertiary education scholarships also expanded during this period. As this fiscal expansion was taking place, revenue remained relatively flat around 57 percent of GDP. The resulting spending gap was partly covered by CIF drawdowns and grants, with a notable increase in grants in 2009 as donors responded to the crisis.

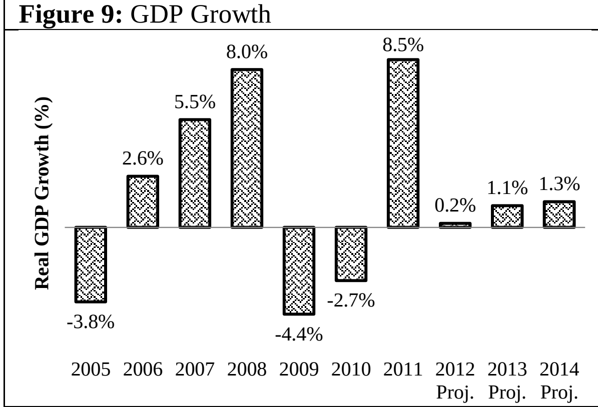
23. **Although the recent fiscal expansion has been largely wound down, near-term risks are significant and fiscal buffers remain weak.** By 2012, expenditure was consolidated to 76.1 percent of GDP (around the pre-crisis average) from 96.6 percent of GDP in 2010 owing to the winding-down of some capital projects and restraints on recurrent

[18] The FTF was established in 1999 with a similar structure to the TTF.

expenditures. In 2012, revenues from fishing licenses, the .tv internet domain and a continued high level of grant funding helped bring Tuvalu's budget to a 9.9 percent surplus after grants for the first time since 2009 (see Figure 12). Improvements in tax administration that led to a modest increase in tax revenue also supported Tuvalu's fiscal position. The 2013 budget marks a modest departure from this trend as it projects a 13 percent increase on the previous year, bringing expenditure up to 83 percent of GDP in the medium term. Much of the budgeted increase reflects the expected costs arising from the discontinuation of the Japan fuel subsidy program, resulting in the increase of fuel costs incurred by government. Although the government remains committed to fiscal prudence, rising fuel prices are inflating the costs of service delivery. In addition, the assets in the CIF remain significantly below pre-crisis levels and are well below the minimum balance (16 percent of the TTF's real maintained value, equivalent to approximately 45 percent of GDP), posing a risk, particularly given Tuvalu's vulnerability to external shocks.

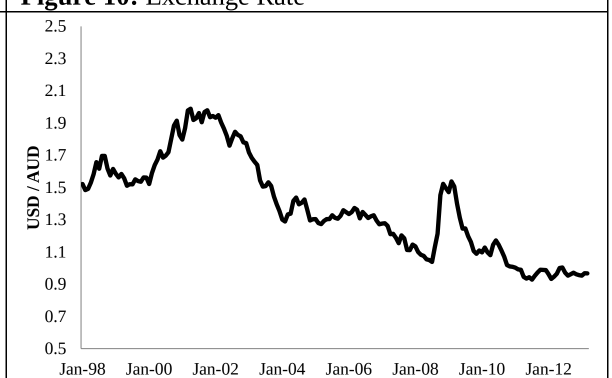
24. **The GoT has laid out an agenda to address economic challenges and improve macroeconomic sustainability.** Having achieved considerable fiscal consolidation between 2010 and 2012, the GoT will now focus on ensuring continued provision of adequate services to Tuvaluans, and will pursue efficiencies in both revenue and expenditure (as reflected in the policy areas supported by this operation). In line with national development priorities, the GoT has also initiated a series of reforms spanning public enterprise management, public financial management, outer island development, public service delivery, and infrastructure development. These efforts will help bring Tuvalu back on a sustainable fiscal path in the medium-term. Nevertheless, fiscal sustainability will depend on Tuvalu having continued access to sizable grant financing in the long-term, continued recovery of the TTF and continued prudence in fiscal policy.

Figure 9: GDP Growth



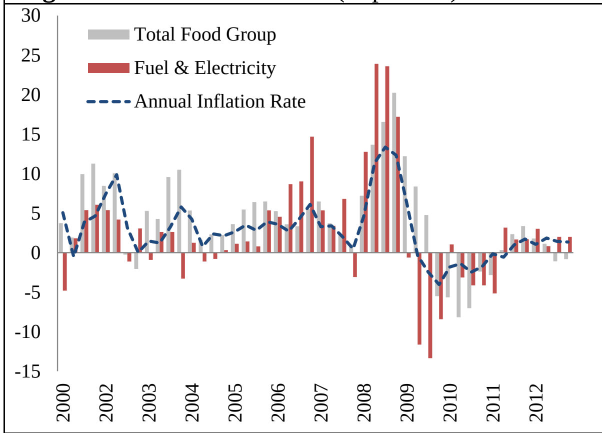
Source: MFED

Figure 10: Exchange Rate



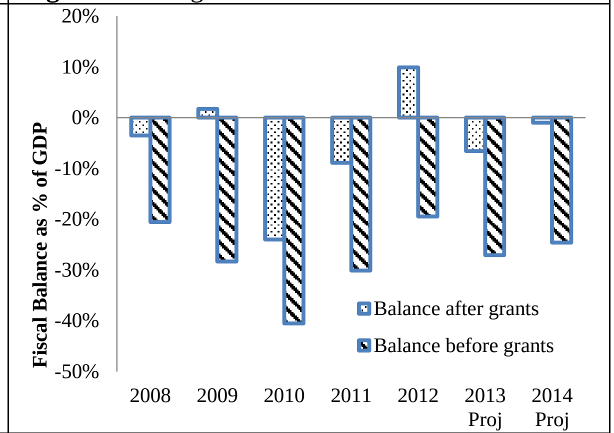
Source: MFED

Figure 11: Funafuti Inflation (in percent)



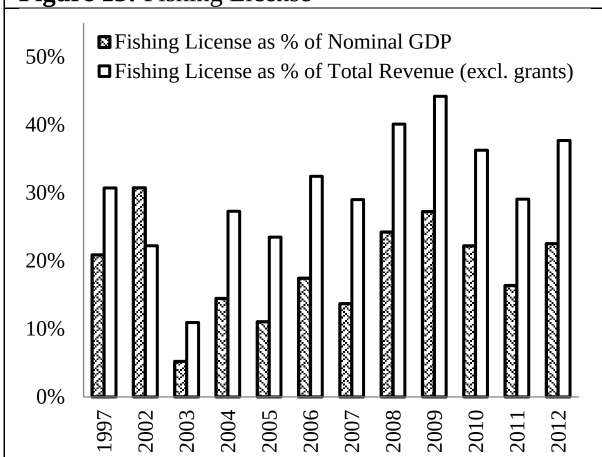
Source: MFED

Figure 12: Budget Balance



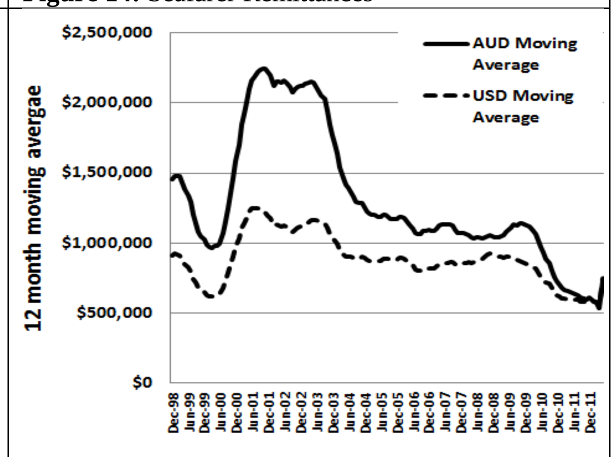
Source: MFED and IMF

Figure 13: Fishing License



Source: MFED and IMF

Figure 14: Seafarer Remittances



Source: ALPHA Pacific Navigation

D. MACROECONOMIC OUTLOOK, FISCAL AND DEBT SUSTAINABILITY

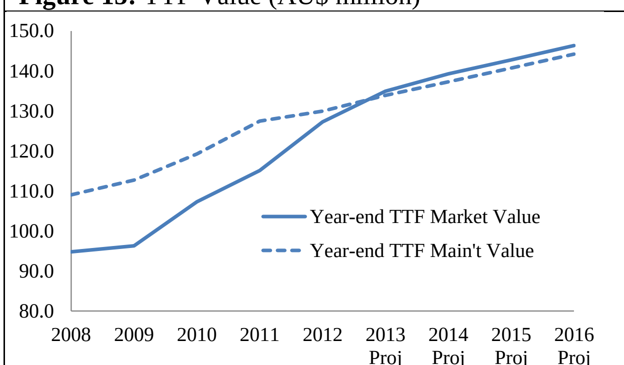
25. **Tuvalu has a structural fiscal deficit; its macroeconomic outlook relies largely on its fiscal position and its capacity to meet its financing needs in the medium term.** Tuvalu's macroeconomic indicators, including the current account balance, debt ratios and reserves, are substantially driven by fiscal variables such as revenue from fisheries, return on the TTF and the government's commitment to constraint in expenditure management. However, even in years when revenues and the TTF show robust performance, Tuvalu will likely continue to depend on grants to finance the budget.

26. **The GoT is committed to continued fiscal prudence in the medium term, but the fiscal outlook remains fragile and reliant on grant support.** Tuvalu's recent budget plans brought the fiscal balance to a surplus of 9.9 percent of GDP (after grants) in 2012. However, despite expected steady revenues from license fees as well as GoT's continued commitment to fiscal prudence, a deficit averaging 1.1 percent of GDP is projected in the medium term, based

on moderate grant estimates[19]. At the same time, the TTF is expected to continue to recover from the GFC but may not begin disbursing surplus returns to the CIF before 2014. Taken together, these factors indicate a delicate fiscal setting for Tuvalu in the medium term, with sustainability being fragile and subject to a series of risks including weak TTF performance, unpredictable grant flows and higher costs emerging from external prices and conditions[20].

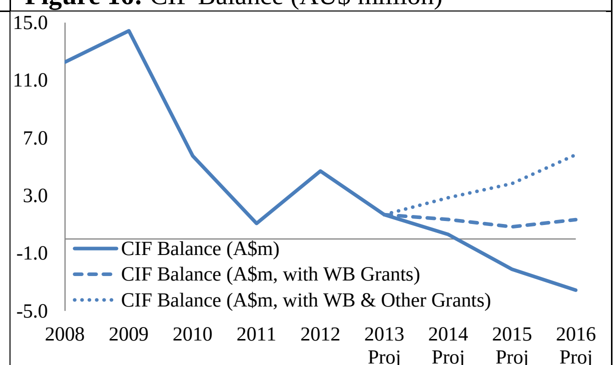
27. **Revenues are expected to stabilize at the higher 2012 levels in the medium term, after contract re-negotiations provided a boost to fishing license and the .tv domain earnings.** Tuvalu is a member of the Parties to the Nauru Agreement which has initiated a more strategic management of tuna resources with higher economic returns for member countries through the Vessel Day Scheme. The scheme allocates member countries with a set number of days to allocate to the highest bidding commercial fishing vessels. It is designed to increase the rate of return from fishing activities by limiting catches of target tuna species and stimulates competition between Distant Water Fishing Nations to purchase units of fishing effort in days. Tuvalu, along with 15 other countries in the Pacific, including Australia and New Zealand, has also recently renewed a Multilateral Treaty on Fisheries (commonly called ‘US Treaty’) for US purse seiners to fish in the waters of the Pacific Island countries on an interim basis[21]. The GoT anticipates that with the Vessel Day Scheme and renewal of the US Treaty Agreement in 2013, revenue from fisheries will at least stabilize at the higher 2012 levels, and possibly increase in the medium term.

Figure 15: TTF Value (AU$ million)



Source: TTF Advisory Committee Annual Reports

Figure 16: CIF Balance (AU$ million)



Source: TTF Advisory Committee Annual Reports

28. **Given the uncertain outlook for TTF performance, an increase in grants will be needed to support the rebuilding of fiscal buffers in the medium term.** Accelerating the buildup of Tuvalu’s only fiscal buffer (the CIF) requires strong TTF performance and a higher level of grant flows in the medium term. Although the TTF’s performance has been healthy in recent years (around 10 percent returns on average from 2010 to 2012), the outlook in the coming years is subject to a high level of uncertainty and vulnerable to downside risk. As a

[19] The GoT receives a recurrent budget support grant of approximately AU$ 5 million (13 percent of GDP) per annum from Taiwan, China. Grants from other donors are variable.

[20] Tuvalu’s economy is particularly exposed to economic conditions and prices in Australia as the TTF is invested in Australian securities and since Tuvalu uses the Australian dollar as its currency. Income from remittances is also affected by economic conditions in Australia and New Zealand.

[21] An interim agreement was concluded in June 2013 which saw the value of the regional US treaty triple from USD 21 million to USD 63 million per annum.

result, under a baseline scenario, the CIF will be exhausted in the absence of additional grants (see Figure 15 and 16). In the longer term, expenditure restraint together with continued grant flows would be needed to support the buildup of the CIF towards its target level of 45 percent of GDP.

29. **Growth is expected to be low to moderate in the medium term and to remain dependent on the public sector and donor-funded expenditures.** Tuvalu's GDP growth was 0.2 percent in 2012 and 1.1 percent growth is projected for 2013, with public services and construction being the most important contributors. The economy faces challenges in achieving more robust growth over the medium term. Further progress with the structural reforms agenda, including stronger risk management in the banking sector and better support to private lending, may stimulate growth. However, growth opportunities are limited given its geographical isolation, small size, high-cost structures and the economy's dependence on the public sector.

30. **Inflation is expected to remain moderate in the medium term.** Inflation remained low, averaging 1.4 percent in 2012 and is expected to remain moderate in the medium term as increased retail competition and more competitively priced imports from Asian countries help to counter upward commodity price pressures. The appreciation of the Australian dollar in recent years had helped to keep a downward pressure on inflation. Nevertheless, Tuvalu remains highly exposed to external price and exchange rate shocks. In particular, the depreciation of the Australian dollar in the past few months and rising oil prices could result in higher prices in 2013-2014.

31. **Tuvalu's current account is expected to remain in deficit in the medium term.** With little scope for import substitution or export diversification, the trade balance is expected to remain in deficit. There is a likelihood that the trade account will deteriorate slightly in the medium term as capital intensive projects in transport and energy infrastructure scheduled for implementation boost imports. Tuvalu's income account showed a marked improvement in 2012 as trust fund earnings were relatively high. Returns on the trust fund are expected to stabilize henceforth as reflected in the income account balance. In the medium term Tuvalu's current account deficit is expected to widen mildly as current transfers to government (mostly budget support grants) are estimated to drop from a peak level in 2012. Similarly, reserves are expected to remain at above 6 months of import cover in 2013 - 2014, but may decline if grant levels fall.

32. **Employment opportunities have tentatively picked-up.** Employment prospects outside of the public sector rely largely on employment opportunities abroad, especially seafarers and seasonal laborers. These are constrained by Tuvalu's distance from major markets as well as demand from labor receiving countries. Seasonal laborers going to New Zealand declined from around 100 prior to the GFC to around 50, before recovering to around 90 in 2012. Given the government's focus on employment orientated education, and depending on global market conditions, these may pick-up further in the medium to long term.

33. **From a debt perspective, the first joint IMF -World Bank Debt Sustainability Analysis (2012 DSA) concluded that Tuvalu is at high risk of debt distress.** Although Tuvalu's public and publicly guaranteed (PPG) debt stock has declined in the past three years,

external debt and debt service ratios breached indicative thresholds under the baseline assumptions of the DSA. Stress tests confirmed that Tuvalu's debt burden was highly vulnerable to deteriorating macroeconomic conditions or a weaker financing outlook. Concessional loans provided by the Asian Development Bank (ADB) constitute the majority of external debt. Loans contracted in 2008 and 2010 by joint ventures in the fisheries sector constitute a substantial contingent liability. The PPG debt stock currently stands around 24 percent of GDP[22]. Ensuring debt risks remain contained while the country's development needs are addressed will require that donors continue to provide assistance in the form of grants.

34. **The GoT is committed to returning its debt to sustainable levels, through prudent fiscal policy and effective debt management.** The GoT effectively consolidated government expenditures in 2011 and 2012, helping to strengthen government finances. With official borrowing halted since 2008, external debt stock has fallen since 2009. The 2012 DSA analyzed the debt dynamics under the reform scenario supported by the proposed operation, and concluded that the implementation of the reform agenda would support debt sustainability. In terms of improved debt management, the Debt Risk Management and Mitigation Policy was introduced and approved by the Cabinet in 2009, providing clear guidelines on the contracting of debt. Furthermore, in 2012, the GoT has completed and published (as part of the 2011 government financial accounts) a stock-take of bank accounts and government debt and guarantees, obtaining a comprehensive position of its net liabilities. In 2013, it is planned that the GoT will assign institutional responsibility for debt policy, ensuring that all loans adhere to the restrictions of the debt management policy.

35. **Overall, the macroeconomic policy framework in place is adequate for the purposes of this operation but is subject to uncertainty.** The GoT will need to continue its focus on controlling expenditure and enhancing revenues to withstand budgetary constraints and to begin rebuilding fiscal buffers. In terms of the broader economic outlook, the incipient economic recovery in Tuvalu could be threatened by a sharper than expected rise in global commodity prices. A renewed shock to global growth would further dent overseas employment opportunities, hurting growth, while financial market turmoil would depress Tuvalu's asset holdings. A depreciation of the Australian dollar could also cause inflation to spike and the trade deficit to widen[23]. The macroeconomic policy framework also depends on the continued availability of grants from development partners over the long term. This is especially important at present given Tuvalu's high risk of debt distress and limited scope to borrow to cover fiscal deficits. In addition, any large negative movements in fisheries licensing fees or USD exchange rates could cause the fiscal deficit to widen. Tuvalu like other Pacific islands remains vulnerable to adverse natural events that may also place considerable stress on the macroeconomic policy framework. Finally, with national elections planned for 2014 there is a possibility that recent fiscal restraint may weaken in the coming year.

[22] This is lower than the 36 percent estimated in the DSA as GDP estimates have been upwardly revised since the preparation of the DSA.

[23] The trade deficit would be expected to widen since Tuvalu's imports (of which food and fuel for electricity generation are large share) are likely to be relatively inelastic. A depreciation of the Australian dollar could however strengthen the income account as US dollar denominated government income would increase in local currency value.

Table 1. Tuvalu: Selected Social and Economic Indicators, 2008–2016

I. Social and Demographic Indicators

GDP (2012):		Poverty rate (2010)	24.8
U.S. dollars (millions)	39.9	Life expectancy at birth (years, 2008)	64.0
Per capita	3,677	Total fertility rate (births per woman, 2008)	3.2
		Infant mortality rate (per 1,000 live births, 2011)	25
Population:		Births attended by skilled personnel (percent, 2007)	98
Total (thousands, 2012)	10.8	Adult literacy rate (2002)	99.0
Urban population (percent of total, 2008)	51.0	Unemployment rate (2004)	16.3

II. Economic Indicators 1/

	2008	2009	2010	2011	2012 Est.	2013 Proj.	2014 Proj.	2015 Proj.	2016 Proj.
	(Percent change, unless otherwise indicated)								
Real sector									
Real GDP growth	8.0	-4.4	-2.7	8.5	0.2	1.1	1.3	1.2	1.2
Consumer prices (end of period)	10.4	-4.0	-1.8	1.7	1.3	2.7	2.7	2.7	2.7
	(In millions of Australian dollars, unless otherwise indicated)								
Balance of payments									
Current account balance	3.5	7.8	-2.3	-13.7	0.5	-1.2	0.6	-0.5	-0.9
(In percent of GDP)	9.7	22.6	-6.6	-35.9	1.4	-3.0	1.5	-1.2	-2.0
Trade balance	-10.8	-15.7	-16.8	-16.9	-17.4	-17.9	-18.4	-18.9	-19.5
Exports	0.6	0.6	0.5	0.8	0.4	0.5	0.5	0.5	0.5
Imports	11.5	16.3	17.3	17.6	17.8	18.3	18.9	19.4	20.0
Services balance	-27.4	-24.0	-25.5	-31.6	-24.4	-23.1	-23.7	-24.3	-25.0
Income balance	26.3	27.8	21.3	16.6	22.1	22.9	23.3	25.8	26.3
Current transfers (net)	15.5	19.8	18.7	18.2	20.2	16.9	19.4	17.0	17.4
o/w Remittances	6.2	5.2	3.3	3.3	2.7	2.7	2.8	2.8	2.8
Gross official reserves 2/	26.0	29.9	25.8	24.3	25.8	23.0	24.5	25.5	27.5
(In months of imports of goods and services)	7.4	8.3	6.7	5.5	6.8	6.1	6.3	6.4	6.7
Debt indicators									
Gross external public debt	17.4	13.6	11.7	9.8	9.3	8.9	8.5	8.0	7.7
(In percent of GDP)	48.1	39.3	34.1	25.6	24.1	22.4	20.7	19.1	17.8
Debt Service	0.9	0.3	0.6	0.5	0.2	0.6	0.6	0.6	0.5
(In percent of GDP)	2.4	0.8	1.7	1.3	0.5	1.6	1.6	1.5	1.2
Exchange rates									
Australian dollars per U.S. dollar (period average)	1.2	1.3	1.1	1.0	1.0	…	…	…	…
Real effective exchange rate (2005=100)	103.2	100.2	114.8	123.0	126.1	…	…	…	…
Nominal GDP (In millions of Australian dollars)	36.1	34.7	34.4	38.1	38.5	39.5	40.7	41.9	43.2
Nominal GNI (In millions of Australian dollars)	61.0	62.5	55.7	66.9	67.6	69.4	71.5	73.6	75.9

Sources: Tuvalu authorities, PFTAC, and IMF & WB staff estimates.

1/ Tuvalu uses the Australian dollar as its currency. It has no central bank operations.
2/ Defined as sum of foreign assets of the National Bank of Tuvalu, the Consolidated Investment Fund, and SDR holdings. Excludes the Tuvalu Trust Fund.

Table 2. Tuvalu: Government Budget, 2008-16

	2008	2009	2010	2011	2012	2013 Proj.	2014 Proj.	2015 Proj.	2016 Proj.
	(In percent of GDP)								
Revenue	55.9	59.1	56.0	47.9	56.6	56.6	58.8	61.3	64.1
Taxes	17.6	14.7	16.6	16.9	15.0	15.8	15.8	15.8	15.8
Nontax revenue	38.3	44.4	39.4	30.9	41.6	40.8	43.0	45.5	48.3
o/w fishing license fees	23.3	26.3	20.8	14.9	21.8	21.8	24.3	27.1	30.3
o/w .tv	6.2	6.7	5.9	4.9	9.6	10.3	10.0	9.7	9.4
Total expenditure	76.5	87.4	96.6	78.0	76.1	83.7	83.4	83.2	83.1
Current expenditure	67.7	81.1	76.2	66.0	71.1	75.7	75.6	75.6	75.6
Wages and salaries	27.5	32.6	34.1	31.4	31.9	31.7	31.7	31.7	31.7
Purchase of goods and services	15.8	22.0	23.4	19.8	22.4	24.3	24.3	24.3	24.3
Subsidies and transfers 1/	18.7	23.6	15.2	11.7	15.2	17.2	17.2	17.2	17.2
Interest payments	0.6	0.7	0.8	0.8	0.3	0.6	0.5	0.5	0.5
Other expense	5.0	2.3	2.7	2.3	1.2	1.9	1.9	1.9	1.9
Net acquisition of nonfinancial assets (capital) 2/	8.8	6.3	20.4	12.0	5.0	8.0	7.8	7.6	7.6
Balance before grants	-20.6	-28.3	-40.5	-30.1	-19.5	-27.1	-24.6	-21.9	-19.0
Grants	19.1	30.0	16.5	21.2	29.4	20.5	23.6	19.3	18.8
TTF distributions	0.0	0.0	0.0	0.0	0.0	0.0	4.9	4.9	4.9
Overall balance (net lending / borrowing)	-1.4	1.7	-24.0	-8.9	9.9	-6.6	3.9	2.4	4.6
Net Acquisition of Financial Assets	-19.4	-0.6	26.7	9.4	-9.8	7.7	-2.9	-1.4	-3.7
Net Acquisition of Liabilities	-23.7	-1.0	-2.7	-0.5	-0.2	-1.1	-1.0	-1.0	-1.0
Memorandum Items									
TTF balance	94.6	95.5	107.5	115.1	130.0	133.9	137.3	140.7	144.2
(In percent of GDP)	261.9	275.5	312.7	302.5	337.9	338.7	337.1	335.6	334.0
Consolidated Investment Fund (CIF) balance 3/	12.3	14.4	5.8	1.1	4.7	1.7	2.8	3.8	5.8
(In percent of GDP)	34.0	41.7	16.8	2.8	12.2	4.3	6.9	9.1	13.4

Sources: Tuvalu authorities and IMF and WB staff estimates.

1/ Includes medical treatment scheme and scholarships, as well as Community Service Obligations (CSO).

2/ Includes capital expenditure as well as in-kind and technical assistance.

3/ CIF balance after deficit financing based on a 4 percent rate of return for TTF in FY14-16.

III. THE GOVERNMENT'S PROGRAM

A. THE NATIONAL DEVELOPMENT STRATEGY

36. **The GoT's vision for achieving sustainable development and "a healthy, educated, peaceful and prosperous Tuvalu" is outlined in TKII.** The strategy was endorsed by the Parliament after a nationwide consultation with the public in 2005 and is rooted in a commitment to attaining the MDGs. It is underpinned by eight strategic areas: (i) good governance; (ii) economic growth and stability; (iii) social development; (iv) Falekaupule and outer islands development; (v) employment and private sector development; (vi) education and human development resources; (vii) natural resources; and, (viii) infrastructure and support services.

37. **A review of the implementation progress of TKII, with wide ranging consultation, was completed in 2011, and the GoT identified governance, human development, and economic growth as forward looking priority areas.** The TKII Mid-Term Review Action Plan 2015 was completed in 2011, and takes into consideration the problems and challenges that were faced in the implementation of the TKII. The review

resulted in a more strategic focus. It accordingly identifies and proposes new and revised strategies to ensure that TKII targets for 2015 will be met. TKII Term Review Action Plan 2015 will guide the government's development policies as well as Tuvalu's development partners' assistance to Tuvalu for the remaining life of the TKII. The areas of focus identified by the review are:

Box 2: TKII Areas of Focus
I - Good governance in both the capital and the outer islands.
II - Creating an attractive public sector to generate economic growth.
III - Maintenance of macroeconomic stability, through economic growth and stability, as well as private sector and employment.
IV - Providing quality health and education services that are equitable, balanced, cost effective, and that meet the needs of Tuvaluans.
V - Sustainable development of Tuvalu, focusing on natural resources and infrastructure.

B. THE POLICY REFORM MATRIX

38. **The GoT developed the PRM in 2012, in consultation with development partners, to map out a clear path for the achievement of priority goals identified in the review of TKII.** The PRM (see Annex 3) presents a consolidated set of reform measures for fiscal years 2012 and 2013. Through the process of developing the PRM, the strategic focus was enhanced among key stakeholders around the areas that government and development partners identified as priorities for reform. The process also helped establish the first step in building a coordinated basis for strong policy dialogue amongst the key stakeholders.

39. **The PRM reform actions focus on improving management of public finances and state enterprises, and on increasing efficiency in public service delivery.** The PRM has four main areas of focus: (1) sound macroeconomic management and fiscal discipline; (2) strengthening public enterprise management and public administration; (3) providing Tuvaluans with the highest attainable standard of health; and (4) improving management of the education system. To achieve results in these areas of focus, the PRM aims to strengthen the building blocks for public financial and fiscal management through improved cash and debt management, leading to enhanced macroeconomic stability. The reforms for increasing the efficiency and effectiveness of social spending focus on improving the management of tertiary health and education services, ultimately leading to better human development outcomes. On Public Enterprises (PEs), the PRM supports reforms to improve the accountability and financial sustainability of government corporations, and to attract private participation. These PRM areas of reform will in turn support strategic areas I – IV of the national development strategy.

40. **The GoT is taking steps to extend the PRM to beyond 2013.** Development partners held further discussions with the GoT soon after a new government was appointed in Tuvalu in July 2013[24]. The GoT expressed its commitment to the existing reform program, provided

[24] Tuvalu is a non-partisan democratic monarchy under the British Commonwealth. Its fifteen members of parliament are directly elected, without reference to political parties to form a unicameral parliament. Elections take place every four years. However, changes in government are not infrequent as the fine balance of power

an update on progress against the PRM and set out its plans to develop the next phase of the reform agenda. During these discussions, the new government indicated that it plans to deepen reforms to strengthen public financial management and accountability, service delivery and reforms in other key sectors. It also re-confirmed its commitment to prudent macroeconomic and fiscal management in recognition of the economic risks faced by Tuvalu. The PRM is expected to be updated on an annual cycle to reflect policy dialogue within government and with development partners.

41. **The proposed operation will help to support and sustain the momentum of key reforms mobilized by the PRM.** The policy focus for this operation was developed through the process of dialogue and policy analysis that accompanied the PRM. Dialogue between the Bank and the GoT included consultations with all relevant authorities, both within the central government and PEs as well as civil society organizations. A common vision and a concrete set of policy actions/ processes were established in 2012. Since then, the GoT has demonstrated good progress in pursuing the objectives of the PRM and this is also reflected in the progression of development partner support. The ADB, AusAID and New Zealand have provided policy-based grants to the GoT reflecting their achievements against the PRM.

IV. BANK SUPPORT TO THE GOVERNMENT'S PROGRAM

A. LINKS TO THE COUNTRY ASSISTANCE STRATEGY

42. **The proposed DPO contributes to the second CAS theme by supporting Tuvalu's capacity to increase fiscal resilience against external shocks**. The first World Bank CAS for Tuvalu FY2012 - 2015 is focused around the two themes of: (i) mitigating economic isolation by encouraging regional and global integration; and (ii) building resilience against exogenous shocks. The CAS noted that budget support grants from the World Bank and other development partners will help Tuvalu rebuild its fiscal buffers in the medium term, especially in the CIF, in turn building resilience against exogenous shocks. In addition, the reforms proposed in this operation are expected to strengthen Tuvalu's capacity to manage its budget and public financial system, thereby also improving the ability to respond to shocks from a fiscal perspective.

B. COLLABORATION WITH IMF AND OTHER PARTNERS[25]

43. **The World Bank and the IMF maintain a close working relationship in Tuvalu, and engage in an on-going dialogue on a range of macroeconomic and structural issues.** The Bank has participated in all Article IV missions and most staff visits since Tuvalu became a member, facilitating the discussions on structural reforms. In addition, the Bank and the IMF

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between government and the opposition group and by-elections may result in votes of no confidence in Parliament. The most recent vote of no confidence took place in July 2013, resulting in a change of government.

[25] Tuvalu's principal budget support development partners are AusAID, New Zealand and the ADB. Taiwan, China also provides regular budget support. Other non-budget support partners include the European Union, Japan International Cooperation Agency, and several agencies of the United Nations.

jointly prepared the 2012 DSA for Tuvalu. Based on this cooperation, the Bank and the IMF teams share a common view about Tuvalu's macroeconomic and structural reform priorities.

44. **The Bank is working in coordination with other development partners to provide budget support to Tuvalu.** The authorities have requested development partners for coordinated budget support in light of the country's capacity limitations. In 2011, the Bank began a dialogue with the GoT and development partners on the policy actions (proposed by GoT in the PRM) that might be associated with budget support going forward, culminating in agreement on a multi-year policy matrix. The ADB, AusAID, and New Zealand are all supporting the implementation of the matrix - through varying combinations of budget support and technical assistance – and have arranged for joint missions when possible.

C. RELATIONSHIP TO OTHER BANK OPERATIONS

45. **The World Bank has been scaling-up analytical and financial support throughout the Pacific and has recently begun to provide IDA support to Tuvalu.** Structured around the CAS themes, the Bank's engagement spans investments in aviation and infrastructure, budget support and technical assistance for labor migration. The Bank is also exploring options for its treasury department to provide advisory support to Pacific island countries, including Tuvalu, to improve asset management.

46. **The proposed operation will complement the Bank's regional Pacific aviation and fisheries engagements, and together contribute to a more sustainable macroeconomic environment.** The Bank has approved an investment project to rehabilitate the country's aviation and road infrastructure, bring the facilities into compliance with international safety regulations and safeguard this important connection to the outside world. This improvement in aviation infrastructure could help promote regional integration, including greater international employment and tourism opportunities, to boost growth prospects. The Bank is also preparing a project to support regional and national fisheries frameworks. Although at an early stage, the fisheries sector engagement is envisaged to contribute to the enhancement and sustainability of this important source of income for Tuvalu. These projects will complement this DPO, and will together contribute to a more sustainable macroeconomic environment.

47. **The policy reforms supported by the current series of operations could potentially broaden to complement the Electricity Sector Enhancement Project being developed by the Bank.** Energy is a priority sector for the GoT. In recognition of this, the World Bank is proposing an investment project to support Tuvalu in reducing fossil fuel dependency and to enhance its energy security, which in turn is conducive to a more sustainable macroeconomic environment. Although the proposed DPO does not currently include a policy action or trigger related to the energy sector, the GoT has expressed an interest to pursue reforms that could form part of the second operation of the series. These policy reforms would support improving the efficiency of Tuvalu's electricity system and increase renewable energy in the generation mix, which are consistent with the objectives of the Electricity Sector Enhancement Project.

D. LESSONS LEARNED

48. **The proposed operation also reflects key lessons learned from the DPOs that the Bank has recently undertaken in the Pacific Islands.** Budget support is a relatively new modality for Bank operations in the Pacific, but has proven successful thus far. The proposed operation draws lessons from the Samoa Economic Crisis Recovery Support Credit in mid-2010, the Tonga Energy Sector DPO in late 2010, and the Tonga Economic Recovery Operations in 2011-2012, the Solomon Islands Development Policy Grant as well as other operations with relevant contexts. Some of the main lessons learnt so far are:

49. **A strong reform momentum can be mobilized in Pacific island countries and can be driven forward by programmatic DPOs.** Under recent DPOs in the Pacific islands (such as the Tonga and Solomon Islands) the Bank's programmatic engagement helped maintain momentum at times when the reform agendas could have gone off-track due to multiple challenges facing the governments. For the proposed operation, the GoT has a strong commitment to a broad medium-term reform agenda. Development partner engagement has assisted the GoT to clarify and sequence its reforms, and will provide momentum to implement them through continued engagement.

50. **Selectivity in the choice of prior actions - that are supported by a broad medium-term reform program - will strategically anchor the DPO whilst being cognizant of capacity constraints.** The approach taken by this operation, as in the other Pacific island DPOs, was to engage with government on a broad reform program and then to identify a few critical actions (in consultation with the authorities) as conditions for disbursement. This made it possible to identify actions with the significant potential impact on achieving the program's development objectives without overloading the government's implementation capacity.

51. **Close coordination and engagement with other development partners in the identification of policy priorities is important to supplement our work in sectors where the Bank has limited engagement.** Similar DPOs in the Pacific reflected the value of drawing selectively on inputs from other development partners to make judgments regarding policy priorities across a broad range of sectors. Since Tuvalu is a new member of the World Bank, the process of building-up a knowledge base benefited greatly from working closely with development partners that have had a longer engagement, and also by working closely with the IMF. The Bank team also conducted regular missions over the past two years to deepen our direct engagement with Tuvalu.

52. **Coordinated management of aid, in the context of prudent fiscal policy, can provide vital support in mitigating the impacts of external shocks in the Pacific Islands.** Without the aid flows provided to Samoa and Tonga to help them respond to the shocks they were facing, the impacts of these shocks would have been more extensive and prolonged. Development assistance played a vital role in financing essential government services, while supporting macroeconomic stability. These operations demonstrated the importance of coordination between macroeconomic policy and international aid flows in managing economic shocks, a lesson that is equally applicable to this operation, given the continuing

effects of the shocks Tuvalu has experienced in recent years, and its particular vulnerability to exogenous shocks.

E. ANALYTICAL UNDERPINNINGS

53. **The design of the proposed operation has been informed by a number of analytical studies.** The World Bank has collaborated with the GoT and other development partners on many of these analytical exercises, and expects this collaboration to continue going forward. The fiscal and macroeconomic frameworks are informed by Tuvalu's Article IV report, the joint Bank-Fund DSA, TTF reports and by analysis of the Tuvalu's expenditure data. Besides the macro framework, other pieces of analytical work underpinning the proposed program include:

Public Financial Management Reforms

54. **The Public Expenditure and Financial Accountability Report (2011).** Tuvalu's PEFA report highlighted several weaknesses in public financial management, some of which will be tackled over the course of the proposed series of operations. The 2011 PEFA identified Tuvalu as having relatively weak treasury functions, including delays in completing bank reconciliations and annual accounts. The 2011 PEFA also found that tax administration (applying in particular to the new consumption tax) requires considerable strengthening in order to realize revenue potential. Finally, the 2011 PEFA raised concerns about the recording and management of cash balances, debt and guarantees, especially given the relatively high levels of existing debt. It was also noted that a more pro-active stance by the GoT concerning the release of information to the public would make the PFM system more transparent, assist in making public officers more accountable. A PFM roadmap (2012 – 2015) was developed in response to the weaknesses identified in the 2011 PEFA.

55. **Assessment of Tuvalu's National PFM and Fiduciary Systems (2012).** AusAID conducted an assessment of Tuvalu's national systems, which reviewed the historical, governance and institutional context of Tuvalu and evaluated the performance of the PFM system (including procurement) largely based on the 2011 PEFA report. The report then identified key fiduciary risks and considered areas to be further improved. The report identified procurement, tax administration, and transparency as key areas of fiduciary risks not being mitigated adequately by existing reforms.

56. **Reports of the Auditor General (2009 - 2012).** The Auditor General's annual audit reports present detailed analyses of fiduciary, accountability and financial management issues. These audit findings confirm several of the issues identified in the PEFA assessment and identified some other financial challenges. The Auditor General also prepared a performance audit on managing sustainable fisheries that highlighted some of the key gaps in the management of fishing revenues.

Service Delivery Reforms

57. **The Tuvalu Medium Term Expenditure Framework Report for Education and Health (2010).** This study analyzed a series of topics including expenditure and performance of the overseas medical treatment scheme and the tertiary scholarship programs. It also analyzed overall expenditure patterns in clinics and schools. The analysis found that: (i) donor funded scholarships have a higher completion rate than those funded by the GoT; (ii) the rise in costs associated with TMTS is largely attributable to a rise in the number of non-dialysis patients; and (iii) equity of school financing is a concern, and may be overcome by introducing a capitation grant to schools. In order to control costs and improve the outcomes of these programs, the study recommended that the TMTS entitlement framework and policy be revised. It also recommended that extension/termination criteria for scholarships be tightened. The report concludes with an assessment of net fiscal impacts (savings and incremental expenditure) on the base case recurrent budget arising from different policy scenarios.

58. **Achieving Education for All in Tuvalu (2010).** The report produced by United Nations Children's Fund (UNICEF) provided a brief review of early childhood, primary and secondary education in Tuvalu. The review identified a range of issues including the need for evidence based strategic plans, capacity limitations in planning and policy development, imbalance in education expenditure and concerns regarding quality of education.

Poverty

59. **The Household Income Expenditure Survey (HIES) Poverty Analysis Report (2010).** The HIES report presents poverty estimates and related analysis. It highlighted that households headed by the elderly are amongst the most vulnerable to falling below the poverty line. Given limited job opportunities, people in outer islands are facing greater hardship than in the capital city, including as a result of the declining opportunities for seafarers. This points to the importance of improving outer island development as well as quality of education and vocational training to increase employment and cash earning opportunities for Tuvaluans both at home and overseas.

V. THE PROPOSED OPERATION

A. RATIONALE AND OBJECTIVES

60. **The overall objective of this DPO series is to support reforms to strengthen public financial management and improve social service delivery**. The operation will provide critical financing to support the GoT's budget and to accelerate the build-up of savings in the CIF. The DPO will also support reforms that are expected to enhance efficiency in some of the government's largest spending programs. The public financial management reforms are focused on improving budget execution, transparency, and basic reporting and revenue administration. They also address the management and development impact of outer island capital spending. The social service delivery reforms focus on improving the management and efficiency of Tuvalu's overseas medical treatment and scholarship programs.

The end of the series would broadly coincide with conclusion of the period covered by the national development strategy. A two-year programmatic approach is proposed to help to sustain the reform momentum in Tuvalu as the policy agenda progresses.

61. **Budget support serves several strategic purposes as a form of assistance in Tuvalu.** This is apparent from the experience of other development partners, who have engaged through this modality in Tuvalu, as well as World Bank's dialogue with the GoT so far. It has proven to be an effective tool for clarifying and sequencing a practical reform agenda through the coordinated PRM and has mobilized government initiative in tackling difficult areas of reform. It has also promoted coordination amongst development partners, reducing fragmentation and increasing the quality of the dialogue.

62. **The policy actions are carefully selected to support the government's key development objectives.** The policy actions for this operation are described both in terms of content and rationale below. In selecting these reforms, priority is given to areas where the World Bank can add value in coordination with development partners. These reform areas are consistent with CAS objectives and have been selected because of their importance for the government's core reform priorities as expressed in the TKII and the PRM. They also reflect demonstrated government commitment whilst being cognizant of the limits placed on the pace of reforms by available capacity. The indicative triggers for this operation reflect the natural next steps in pursuit of the reforms supported by the policy actions, as well as the priorities of the GoT. They are indicative and will be firmed up as dialogue continues with the GoT regarding the next phase of reforms through the annual PRM dialogue process.

Table 3

Prior Actions for 1st Operation	**Indicative Triggers for 2nd Operation**
Strengthening Public Financial Management	
The Recipient has strengthened its budget execution and transparency through the preparation and publication of quarterly fiscal reports. The Recipient has resolved to offset the tax related cross liabilities that have hindered the operations of the Tuvalu Maritime Training Institute and the Vaiaku Lagi Hotel.	The Recipient introduces centralized commitment control procedures to strengthen treasury commitment and expenditure control. The Recipient updates all financial records in the fisheries management system, and concludes a full reconciliation of fishing revenues for 2013 with Treasury records to strengthen oversight of fishing revenues.
The Recipient has approved the outer islands project management policy aimed at strengthening project selection, implementation and monitoring in its outer islands.	The Recipient pilots a streamlined Outer Island financial reporting framework to reduce administrative burden on the Kaupules and enable better tracking of funds.
Improving Social Service Delivery	
The Recipient has: (a) on a pilot basis, implemented measures, designed to reduce health care costs and improve the quality of care provided through the Tuvalu Medical Treatment Scheme; and (b) submitted to its Parliament the report and recommendations from the TMTS pilot.	The Recipient revises the TMTS Policy to strengthen the patient referral process and institute efficiency measures piloted in 2013.
The Recipient has approved the revised pre-service and in-service training and scholarship policies in order to tighten the criteria for extension of scholarships.	The Recipient broadens vocational training programs, to increase post-primary education opportunities, particularly for Tuvaluan women.

B. POLICY AREAS

Prior Action 1: The Recipient has strengthened its budget execution and transparency through the preparation and publication of quarterly fiscal reports.

63. **Weaknesses in core accounting procedures made it difficult for the Ministry of Finance and Economic Development (MFED) to monitor and evaluate the government's financial position on a timely basis.** Significant delays in treasury reconciliations made it difficult for the GoT to monitor budget execution and to take stock of in-year budget performance. In-year budget reports were not produced. The backlog of reconciliations also caused delays in the production of the government's annual accounts[26]. Besides these issues, the limited budget reporting environment narrowed government's opportunity to pursue its transparency agenda by providing the public with regular updates on key fiscal trends. These issues were identified in the PFM roadmap as priorities, particularly the need for Tuvalu to have access to timely and accurate information and to control in-year expenditure allocations given the tight fiscal context.

64. **The GoT has made a clear commitment to strengthen the building blocks of its PFM system as prioritized in the PFM roadmap.** The PFM reform roadmap that lays out priority measures in the areas of revenue administration, accounting procedures, reporting, procurement policy, audit, budget formulation and planning[27]. The GoT also recognized capacity constraints as a major impediment to the proper functioning of its treasury operations. To address these constraints the GoT has contracted long-term technical advisers in the budget and treasury departments who will also provide capacity building services. Specific steps were taken by the GoT to strengthen in-year accounting and reporting. The treasury now reconciles all accounts on timely basis and provides a monthly statement of operations to the budget department and to senior management. The financial management information system has also been made more comprehensive through the integration of budget allocation and actual expenditure records.

65. **As a result of the above described steps, the MFED has begun producing quarterly fiscal reports aimed at improving budget execution and transparency.** The GoT has instituted quarterly fiscal reporting and the publication of the reports[28] through cabinet approval of the PFM reform plan **(prior action)**. These quarterly fiscal updates assess key financial aspects of budget execution and provide explanations of the identified divergences, and consider the implications on government reserves. The updates subsequently feed into the GoT's Medium Term Fiscal Framework and key fiscal ratios are computed to track any emerging risks. GoT has also started to make a summary of the quarterly fiscal reports public via radio announcements and through newsletters to increase access to fiscal information. Timely reconciliations and the improved accounting processes have also helped

[26] Delays in bank reconciliation together with a change in financial accounting standards resulted in the 2009 annual financial statements of the GoT having only been tabled to Parliament in May 2012, a 23 months delay. Subsequently, neither the 2010 nor the 2011 accounts were tabled until September 2012.
[27] Some of these reforms are supported by this program (such as improved accounting and reporting, outer island financial management, arrears management and fisheries revenue management).
[28] The quarterly reports are due for publication within two months of the end of the quarter.

the GoT to submit all pending annual financial statements (for fiscal years 2009, 2010, and 2011) to the Auditor-General and to Parliament[29]. The focus on the approval of a policy to publish quarterly reports helps to lock-in the underlying accounting reforms and to ensure that they are not one-off actions.

66. **The key next step identified in the PFM reform plan is to strengthen treasury commitment and expenditure control by introducing centralized commitment control procedures (trigger)**. Tuvalu has a relatively realistic budget which is an important condition for the effectiveness of commitment controls. The MFED has also started to strengthen cash planning but has not effectively used cash ceilings to affect commitment controls on spending units. Introducing a basic centralized commitment control process using existing systems, as appropriate for Tuvalu's context (where limited skills and capacity would make it more difficult to implement a de-centralized process) will help government to match its financial obligations to its resources and control arrears. The GoT is also continuing to pursue other PFM reforms, including the development of a Procurement Act and strengthened audit capacity which are directly supported by other development partners.

67. **The series of reforms supported by the DPO are expected to strengthen budget execution, transparency, and in the medium term improve efficiency and effectiveness of the use of public resources.** In conjunction with the wider PFM reforms being undertaken by the GoT (including areas supported by other development partners), improving accounting procedures, fiscal reporting and financial control procedures are expected, over the medium term, to improve cash management, strengthen budget execution and facilitate prioritization and decision making in a tight fiscal context. Quarterly reporting is expected to help strengthen monitoring of budget implementation (for both Finance and line ministries) by comparing actual expenditures with budgeted amounts and in-year allocations and may lead to fewer re-allocations stemming from weak monitoring and controls. Similarly, the introduction of commitment controls will help to control overspending by line ministries and hence, the need for re-allocations. Taken together, these reforms are expected to lead to improvements in budget execution and are likely to improve effectiveness in the use of public resources.

Prior Action 2: The Recipient has resolved to offset the tax related cross liabilities that have hindered the operations of the Tuvalu Maritime Training Institute and the Vaiaku Lagi Hotel.

68. **Weaknesses in tax administration have resulted in unresolved cross-liabilities between the GoT and the PEs.** In recent years, Tuvalu's effectiveness in the collection of payments and tax compliance in general had been poor. Weak record keeping by both government and PEs has meant that tax liabilities are not adequately quantified. Tax audits have not been performed on high risk entities to ensure that businesses are paying the correct amount of tax. PEs are major tax payers in Tuvalu, and have contributed to the problem by not remitting the correct amount of taxes in a timely manner. Government ministries which are often the main clients of PEs have not always paid their bills in full or on time. Recent

[29] Government documents automatically become public once they are tabled in Parliament.

reforms to the tax system[30] together with the introduction of a new Public Enterprise Act have also led to some misunderstanding and resulted in cross-liabilities. The situation is further complicated by capacity constraints. So far, the ongoing PE tax audits have identified approximately AU$ 1 million (16 percent of tax revenue) in tax arrears.

69. **Unresolved cross-liabilities between the GoT and PEs, including the Tuvalu Maritime Training Institute (TMTI) and the Vaiaku Lagi Hotel (VLH) have hindered public service delivery and tax collection efforts.** The TMTI is Tuvalu's only training institution for seafarers. Seafaring is a major source of employment for Tuvaluans. Income from seafaring supports consumption, particularly for the outer islands, where cash earning opportunities are low and poverty rates are higher compared to the capital. Cross-liabilities had accumulated between the TMTI and the GoT, stemming from unpaid scholarships by GoT and unpaid taxes by TMTI. These liabilities resulted in a temporary disruption to student intake at the TMTI. In the case of VLH, the cross-liabilities stem from unpaid bills by GoT and unpaid taxes by VLH. This situation restricted VLH's ability to operate on a more commercial footing. Apart from impacting the operations of these public bodies, a continuation of the current situation makes it more difficult to predict tax revenues and undermines the integrity of the tax system. The TMTI and the VLH were selected by GoT as pilot cases, given capacity constraints and the expected volume of cross-liabilities, with a view to clearing cross-liabilities with other PEs in the future.

70. **Unresolved cross-liabilities could also hinder the achievement of a broader set of reforms underway to strengthen the PE sector.** Under the broader PE reform agenda, the GoT is taking a series of steps to strengthen the financial management and sustainability of the eight PEs in Tuvalu. Reforms that are underway include: the merger and rationalization of the Tuvalu Philatelic Bureau, post office and travel office; reforms to the business environment for the telecoms sector; strengthening the financial sustainability of the Tuvalu Electricity Corporation; and exploring professional management[31] options for the VLH. Resolving the cross liabilities and tax arrears of these PEs is an important first step towards planned reforms, and is in line with the Public Enterprises Act (2010), which requires operation of PEs on a commercial basis and aims to regularize government financial relations with PEs.

71. **To address these issues, the GoT is strengthening the process to enforce tax compliance.** The Internal Revenue Department (IRD) has taken steps to better grasp the potential tax base and clear any roadblocks to compliance. A long-term tax adviser was appointed to assist in this process. The adviser will also work towards improving the capacity

[30] Legislation supporting tax reforms was introduced in 2008, providing among other things for the introduction of a consumption tax on taxable supplies and taxable imports, to be phased in over 5 years and amendment of the Income Tax Act to allow for presumptive tax to be levied on businesses with a turnover of less than $100,000. Since introducing these reforms, the GoT has accordingly commenced a process to refine tax administration. Initial efforts focused on facilitating tax compliance, through tax payer education and introducing new taxpayer registration process - involving a centralized registration process which allocates a unique tax identification number used by the Inland Revenue Department (IRD), the Customs Department and the Tuvalu National Provident Fund.

[31] The GoT is preparing plans to either privatize the Vaiaku Lagi hotel or to place it under a professional management contract.

of the local tax officers and the overall tax administration system. More specifically, the GoT has adopted a computerized Revenue Management System (RMS), cleared the backlog of tax return postings and concluded a full reconciliation of tax records up to 2012. These measures have provided the basis for launching a series of compliance initiatives, starting with a tax payer profiling exercise. They also allowed the GoT to finalize the tax audits of the TMTI and VLH, facilitating an agreement on the respective net arrears positions.

72. **The steps taken by the GoT have provided clarity on tax obligations of the TMTI and VLH, while ensuring viable service provision by these PEs going forward.** The GoT has completed the assessment of the net arrears for the TMTI and the VLH, and the Cabinet has resolved to offset these cross liabilities (**prior action**). Since then, TMTI and VLH have been compliant with their tax obligations to the GoT, and the GoT had paid scholarships to TMTI without delay. Clearing the net arrears for the TMTI enables it to operate on a more financially viable basis and will prevent further disruptions to the training programs for marine cadets. Ensuring that marine cadets are trained adequately and in a timely manner will support income vital to the community, especially for the poorer outer islands. Resolving the net arrears between GoT and the VLH helps to place the hotel on a commercial footing, and is an important step in the ongoing process of commercializing the hotel. Going forward, regular reconciliation of tax records between IRD and treasury will ensure the integrity of the tax system, and improve revenue management. To prevent the reoccurrence of cross arrears, the IRD has initiated tailored awareness and training programs to major entities on applicable taxes and laws. Furthermore, the IRD is planning to continue conducting regular audits of selected entities and reconciliation of tax records with treasury.

73. **The GoT is pursuing other reforms to further strengthen revenue administration and address issues raised in recent audits findings.** A priority amongst these reforms is strengthening the administration of fishing revenues. The GoT plans to update financial records in the fisheries management system and conclude a full reconciliation of fishing revenues for 2013 between the fisheries department and treasury (**trigger**). All vessels granted permission to fish in Tuvalu's exclusive economic zone must pay access fees and vessel day fees or license fees. These fees often arrive in large lump-sums. The fisheries management system, which records these revenues, had reportedly not been updated with all financial data, including information on payments and receivables. Treasury records and fisheries records are also not reconciled. As a result the GoT is unable to tell which fishing vessels have paid their licensing fees. The completeness of revenues collected from this key resource is therefore at risk. Given the significance of fisheries receipts, updating all financial records in the fisheries management system and concluding a full reconciliation of fishing revenues for 2013 with Treasury records are expected to improve Tuvalu's oversight over fees received from fisheries. These measures will also improve in-year cash management through more accurate revenue estimation.

Prior Action 3: The Recipient has approved the outer islands project management policy aimed at strengthening project selection, implementation and monitoring in its outer islands.

74. **Kaupules play a key role in providing basic services to the outer islands' citizens, although their capacity is very thin.** Around half of Tuvalu's population lives on the outer

islands, where incidence of poverty is higher. Each island has a *Kaupule* (local government council) which governs local affairs and manages the implementation of local development projects. *Kaupules*[32] play a key role in providing services such as basic infrastructure, although their planning, implementation, and reporting capacity is very thin (e.g. limited number of qualified staff and high staff turnover). Fiscal transfers from the national government (administered by Treasury and the Ministry of Home Affairs) and returns from the FTF[33] finance the operations of *Kaupules*, public service delivery and outer island development projects.

75. **Execution of outer island development projects has been poor, affecting service delivery and development outcomes.** Around 40 percent of Tuvalu's total capital budget is allocated to outer island development projects. The purpose of these projects is to help the islands to invest in community development. The projects develop and maintain core infrastructure such as schools, clinics, water and sanitation facilities and local roads. They also help communities to invest in assets for to support income generating activities such as communal farming and fishing. Furthermore, the projects, when well-managed, are the main source of employment opportunities and economic activities in most of the outer islands. The execution of these projects has been poor. Undefined project standards meant that the majority of project submissions by the *Kaupules* were not accompanied by detailed project proposals, resulting in many projects being under budgeted, poorly designed and not meeting their objectives. Weak planning and thin capacity resulted in duplicate submissions and until recently, there were no procedures for prioritizing project selection based on outer island needs. Moreover, the implementation of the projects has never been evaluated and hence, government has not been able to assess their development impact. Ultimately, these issues reduce the value for money achieved by these projects and affects service delivery and development outcomes for the outer islands.

Table 4: Outer Island Development Expenditures

	Actual	Budget	Variance
2010	1,906,265	1,800,000	5.9%
2011	1,386,353	1,200,000	15.5%
2012	993,180	1,200,000	-17.2%

Source: MFED

76. **To address these issues, the GoT endorsed an Outer Island Project Management Policy aimed at improving implementation and development impact of outer island projects.** The GoT approved the outer island project management policy in August 2012 aimed at strengthening project selection, implementation and monitoring, and has commenced implementation by establishing the Kaupule Project Management Task Force **(prior action).** Prior to the adoption of the policy, detailed consultations were held with the outer island

[32] Other than the national government, Tuvalu has eight Kaupules (traditional island councils, one for each outer island) established under the Falekaupule Act. The Act provides for significant level of autonomy from the national government for the Falekaupule, It also requires that the annual accounts of the Kaupules are submitted to the Minister of Home Affairs and to the Auditor General for audit and submission to parliament.

[33] The outer islands' trust fund. FTF invests and operates in a similar manner to the TTF. Correspondingly, FTF suffered losses post the GFC, which has resulted in lower distributions to the outer islands placing a strain on outer island financing.

councils to review its contents and the roles and responsibilities of the various parties that are involved in the management of projects. The new policy aims to improve the implementation and development impact of the projects by establishing clear project standards and by providing for implementation support to minimize capacity burden on Kaupules. It is also designed to help ease the bottlenecks stemming from capacity constraints at the local level by providing for a framework of centralized planning, implementation and monitoring support from a cross section of central government ministries under the coordination of the Ministry of Home Affairs. The key project management requirements of the policy are:

Project standards

- Projects must in line with the outer island development plans and be of benefit to the development of the community.
- Clearly defined development objectives and activities.
- Identified costs and benefits.
- Procedures to clearly distinguish each project or activity to avoid duplicate submissions, which had hitherto been a source of leakage.
- Defined and limited implementation period.

Implementation support

- A multi-sectoral Kaupule Project Management Task Force to oversee the implementation and monitoring of projects.
- Centralized proposal submissions to one designated government department (Department of Rural Affairs, Ministry of Home Affairs), reducing duplication and enabling better prioritization.
- Implementation support from the Ministry of Home Affairs, particularly in coordinating procurement and compliance with the procurement policy[34].
- A new template for project proposals that requires local councils to set out clear project objectives, linkages to local and national strategies, an implementation plan, and key outputs.
- An annual report that evaluates project implementation and outcomes will be prepared for the Ministers of Home Affairs and Finance, and Parliament.

77. **To build on the reforms that will improve governance in outer islands, the GoT plans to strengthen outer islands financial reporting.** With assistance from the central government, a streamlined and context appropriate financial reporting framework will be developed for outer island councils that will reduce administrative burden on the Kaupules, and enable timely production of financial statements **(trigger).** Weak capacity, multiple financial reporting requirements, and the lack of a financial reporting framework tailored to the outer islands context and capacity have caused delays in the preparation of financial statements by the outer island councils and the audit of their accounts. Establishing a simple mechanism for financial reporting will reduce capacity burden on the outer island councils, bring the audits of outer island accounts up to date, and allow for consolidation with the

[34] The procurement policy (aimed at achieving value for money on GoT procurement), which was endorsed by cabinet in October 2012 is expected to be rolled out to the whole of government and incorporated into the outer island project management policy.

whole of government accounts. This will further increase transparency and oversight for their operations.

78. **In the medium term these reforms are expected to improve the quality and the development impact of outer island expenditure.** Implementation of the outer island project management policy is expected to result in greater prioritization of the projects by *Kaupules* to satisfy each island's needs, while encouraging and supporting timely and on budget delivery of projects. This policy, along with the adoption of a streamlined, context appropriate, financial reporting and audit process, is also expected to strengthen outer island governance through increased transparency and accountability. In the medium term these reforms together with procurement reforms supported by other development partners, are expected to improve the quality and the development impact of outer island expenditure.

Prior Action 4: The Recipient has: (a) on a pilot basis, implemented measures, designed to reduce health care costs and improve the quality of care provided through the Tuvalu Medical Treatment Scheme; and (b) submitted to its Parliament the report and recommendations from the TMTS pilot.

79. **Although TMTS is one of the most important healthcare programs in Tuvalu, expanding amounts spent on a relatively small number of TMTS patients make it difficult for the GoT to achieve key healthcare policy objectives[35].** The TMTS, which provides overseas medical treatment to patients in need of tertiary level care, is one of the most important government programs. Given the small size of Tuvalu, the significant cost and highly technical nature of tertiary care, it is uneconomical, and in many cases it not possible, to provide specialized procedures domestically. The Scheme was introduced in 2005, with the aim of funding tertiary health treatment for patients who need advanced surgical procedures that cannot be provided domestically at Tuvalu's only hospital. Although the program will continue to be a core part of Tuvalu's healthcare system, there has been increasing recognition that it has expanded rapidly, resulting in fewer resources available for basic health services including prevention. This in turn makes it difficult for GoT to achieve key stated policy objectives of providing balanced, cost effective, equitable healthcare, particularly basic healthcare, to all Tuvaluans.

80. **The TMTS has expanded rapidly in recent years (both in patient numbers and per patient spending), resulting in increased recognition of the need to improve the efficiency of the program.** The initial annual budget of the TMTS was under AU$0.5 million in 2005. However, since then, spending under the scheme escalated rapidly to consuming more than 50 percent of the national health budget. The growing costs of the TMTS are largely attributable to the rising number of patients (116 patients participated under the scheme in 2012) and increases in treatment and subsistence costs[36]. As a result there is increasing recognition of significant scope for improving the overall value for money of the program.

[35] As expressed in TKII and the Strategic Health Plan 2009 – 2019.

[36] Tuvalu Medium Term Expenditure Review, 2010; TMTS Annual Report, 2012.

Table 5: TMTS expenditure 2008-2012

	2008	2009	2010	2011	2012
Tuvalu Medical Treatment Scheme Costs (AUD)	2,488,070	2,152,840	2,728,223	2,778,186	2,057,805
Medical scheme as a % of health budget	57%	51%	55%	53%	44%
Medical scheme as a % of total budget	9%	7%	8%	9%	7%

Source: MFED

81. **The quality of care provided to Tuvaluan patients under the TMTS has recently been declining.** As is the case for other Pacific island countries, a large proportion of the patients under the TMTS are normally referred to medical facilities in Fiji[37]. Recently, the capacity of Fiji's medical system has been strained with growing demand for services from domestic and international patients, and for some procedures such as cardiac surgery, waiting times for treatment or onward referrals have been increasing. At the same time, the GoT has been increasingly aware that hospitals and medical centers in other parts of the world have been delivering full suite of sophisticated and high quality services at more competitive prices.

82. **The GoT has piloted measures to improve the quality of care provided through the TMTS and to reduce the costs of the program.** The Ministry of Health (MoH) has piloted measures to improve the quality, timeliness, and cost effectiveness of care. These measures include a new referral system for complex treatments such as cardiac surgery to accredited high quality hospitals in India to reduce the cost[38] and timeline for referrals. They also include cost reduction measures to restrict accompaniment and reduce accommodation costs which involve requiring patients to be accommodated in GoT leased houses or private homes instead of hotels. The GoT is now in the process of formalizing these piloted reforms. As a first step to this end, the cabinet has endorsed and presented to parliament the first annual report for the TMTS, which presents the piloted reforms and recommendations to further strengthen the TMTS **(prior action).** This report is based on systematic compilation of key program information to monitor expenditure on patient treatment, including length of stay, accommodation and caretaker accompaniment costs. The report has also been made public to increase transparency of the scheme. Cabinet endorsement of these reforms will pave the way for the revision of the TMTS policy to institute the piloted efficiency measures and to strengthen the patient referral process **(trigger).**

83. **Savings from the TMTS are expected to enable increased investment in primary and preventative care, benefiting the broader population in line with the national development strategy.** TMTS savings have contributed to an increase in budget allocations to primary and preventative healthcare by 5 percent in 2012, and the GoT has committed to doing the same in 2013. The MoH has also been able to recruit a surgeon for Funafuti hospital in 2013 to treat relevant surgery cases domestically on a timely basis. Looking ahead, continued implementation of these reforms could result in significant savings. Preliminary health sector expenditure analysis estimates that by referring cardiac cases to India for treatment, per patient savings of around AU$15,000 could be achieved. Reducing treatment time of non-dialysis patients from around 70 to 60 days could results in savings of around

[37] Patients are also referred to regional hospitals in New Zealand and Australia.

[38] The costs of the new referral system to India are significantly lower than for comparable interventions in Fiji or New Zealand.

AU$1,900 per patient, and introducing shared long-term accommodation could result in savings of around AU$1,750 per patient. Fully implemented, these reforms could result in potential cost savings of around AU$0.5 million (equivalent to around 1½ percent of GDP). Given this potential for savings, TMTS reforms are a priority for enabling increased investment in primary health services, including those offered in the outer islands. In the longer term, increasing investments in the primary and preventative programs would benefit the broader population and improve healthcare outcomes, reducing the need for specialized tertiary care in the future.

Prior Action 5: The Recipient has approved the revised pre-service and in-service training and scholarship policies in order to tighten the criteria for extension of scholarships.

84. **The Tuvalu scholarship program, which provides Tuvaluans with access to tertiary education at overseas universities, is one of government's key programs.** Given the small size of Tuvalu, it is uneconomical for it to establish its own domestic tertiary institution. The two main academic scholarship programs in Tuvalu are pre-service and the in-service awards. Pre-service awards are for students to attend tertiary institutions in the Pacific region or in donor countries for certificate, diploma or bachelor's degrees. The pre-service program is the main way by which the GoT manages its need for teachers, nurses and other professionals. In-service awards are also for study at a tertiary institution in the Pacific region or in a donor country but are awarded to people already working in the public sector including PEs. Study tends to be at the post-graduate diploma, bachelors or masters level to provide more specific training to expand the skills of those already in work, typically in the public sector.

85. **The scholarship program has dominated the education budget, resulting in an imbalance in education expenditure skewed towards the tertiary level.** As the scholarship program continued to grow, reforms to increase its cost effectiveness had not kept pace and by 2012, the program amounted to one third of the education budget. The GoT recognizes the necessity of balancing the needs of the scholarship program against the overall needs of the education system, especially at the secondary level, whilst still providing its youth with opportunities to attain higher education and employment.

Table 6: Scholarship expenditure 2008-2012

	2008	2009	2010	2011	2012
Tuvalu Scolaship Programs Costs (AUD)	2,436,286	2,569,652	2,490,246	2,142,690	1,880,140
Scholarships as a % of education budget	39%	41%	41%	39%	33%
Scholarships as a % of total budget	9%	8%	7%	7%	6%

Source: MFED

86. **The Tuvalu scholarship programs suffer from a high rate of extensions and non-completion.** The Tuvalu scholarship programs, which have historically offered on average 40 new awards[39] per year typically for 2 - 3 year course, suffer from a high rate of extensions and non-completion. For example, 32 percent of the scholars funded by the GoT between 2008

[39] 2006 to 2011 average, Tuvalu Medium Tern Expenditure Report for health and education, 2011.

and 2010 did not complete their degree, and only 56 percent completed their studies on time. Moreover, 12 percent of the scholars paid by the GoT have yet to complete their degree having requested extensions to their study period[40]. These indicators point to the weaknesses in managing Tuvalu's scholarship programs and the shortcomings of the existing criteria for eligibility or extension of course programs. Given the high cost of the program in proportion to the overall education budget, these indicators also highlight potential inefficiencies in the use of Tuvalu's scarce budget resources.

87. **The GoT has commenced implementing a set of reforms to reduce the cost and improve the management of the scholarship programs.** The GoT placed a cap on the number of students that may be awarded with scholarships from 2012 onwards (at 30 places per year[41]) to contain the size the program. Family accompaniment allowances for scholarship students have also been rationalized and local fee rates have negotiated for all Tuvaluan students attending the Fiji National University. Besides these measures, the GoT revised the in-service training policy in 2012 and the pre-service training policy in 2013 to require a higher course completion rate for continuation of the scholarship and encourage, through financial and in-kind incentives, the completion of study programs within the pre-specified period **(prior action)**. The GoT also commenced implementation by closely monitoring variation in duration of study, which is documented in the first annual in-service scholarship report. These reforms are likely to result in significant cost savings in the coming years. The cap on scholarships alone could result in cost savings of around AU$0.5 million annually. Such savings will enable greater investment in primary and secondary education, and help address the relative under-investment in basic education, which benefits a broader base of Tuvaluans[42]. Furthermore, investment in primary and secondary education could result in better education outcomes in these sectors and better prepare scholars entering the tertiary programs.

88. **The GoT will continue to deepen the reforms to enhance the performance and value for money of its scholarship programs, while increasing efforts to rebalance the expenditure across the education sector.** Going forward the GoT will prioritize better utilization of the numerous scholarship positions offered by development partners and other governments to Tuvaluan students. In addition, the GoT is strengthening its domestic skills and training programs as part of its efforts to rebalance the focus across the education sector. In particular, the Ministry of Education plans to widen the post-primary level of access to Tertiary Vocational Education and Training (TVET) programs designed to broaden the skills of Tuvaluan youth, with specific opportunities for women **(trigger)**. In the past, limited vocational education opportunities have been available for female students. The main vocational training facility, TMTI, is a male only institution. Other vocational courses offered, such as welding and carpentry, while not explicitly excluding women have resulted in very limited female uptake. Broadening of the vocational training programs is an important initiative, with benefits to those excluded from the education system and to expanding

[40] Tuvalu Medium Tern Expenditure Report for health and education, 2011.
[41] Excluding donor funded scholarships.
[42] There are around 2,600 students in primary and secondary schools compared to around 210 students in post-secondary education.

economic opportunities. Moreover, broadening of the TVET programs, with specific opportunities for women could improve female education and employment opportunities.

Box 3: Good Practice Principles for Conditionality

Ownership: The PRM discussions were initiated by the GoT and approved by Tuvalu's cabinet. Implementation of these reforms has mobilized resources from the ADB so far. The prior actions supported by this program are also consistent with the GoT's own national development strategy.

Harmonization: The development partners have harmonized their programs by agreeing upfront with government on a coordinated accountability framework through the development of the PRM, providing coordinated accountability for the current operation. The development partners have also made steps to harmonize their reviews of the PRM through joint missions and through the annual review carried out by the TTF secretariat.

Customization: The accountability framework and modalities of Bank support are tailored to country needs and are consistent with the national development strategy. The policy actions supported by the program are backed up by customized analytical work. The policy actions reflect the government's PRM, which is reviewed and updated at least annually. The triggers are tentative and although they also reflect government reform priorities, they will be reviewed and customized to reflect changing priorities and circumstances.

Criticality: Policy actions have been subject to extensive consultation with the GoT and development partners and aim to minimize the number of supported reforms while ensuring the achievement of program development objectives. The choice of a limited set of focused policy actions reflects the importance of these actions to the achievement of improved service delivery while taking account of the extent of capacity and resource constraints facing government.

Transparency and Predictability: The PRM provides a harmonized framework for evaluation of performance through specific outcomes. Timing for review and financial support is largely determined by GoT. Data constraints exist for evaluation of performance given limited capacity.

VI. OPERATION IMPLEMENTATION

A. PARTICIPATION AND CONSULTATION

89. **The design of this proposed programmatic series is based on the PRM, developed by the GoT in consultation with development partners, which is linked to Tuvalu's national development strategy TK II.** The policy matrix was developed through a series of consultations between the GoT and development partners, with the participation of the World Bank at an early stage. It draws heavily on the TKII, which was developed and updated through a series of extensive consultations. The TKII reflects the outcome of consultations with Parliament, island chiefs, island presidents, government officials, businessmen, NGO representatives, religious leaders, and women, youth and the community in general.

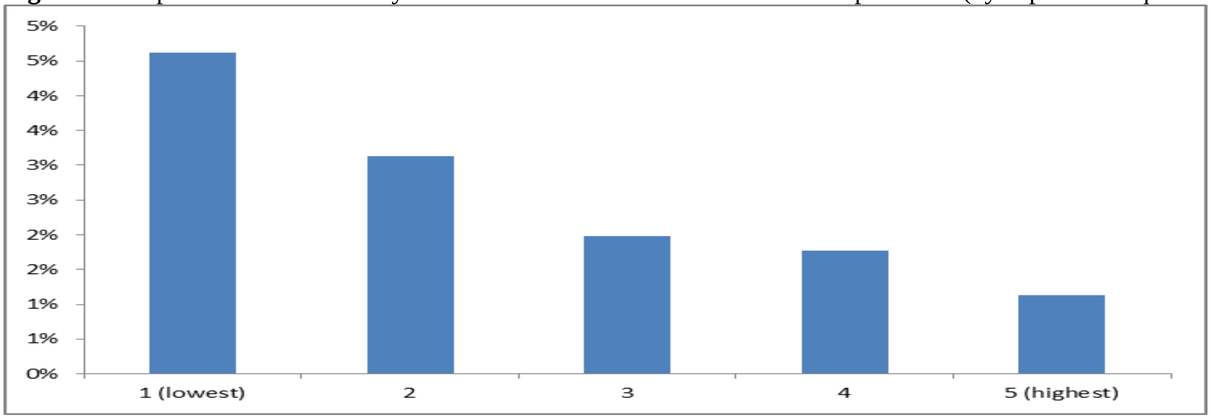
B. POVERTY, SOCIAL IMPACTS[43] AND ENVIRONMENTAL ASPECTS

Service delivery

[43] Access to data on poverty, vulnerability, the cost and access to services is very limited in Tuvalu.

90. **Rebalancing education expenditure towards the non-tertiary levels through improved management of the scholarship programs will contribute to better education outcomes for Tuvaluans, including the poor.** Whilst primary education is provided free of charge with universal access, schools ask parents to pay a "school contribution" and parents provide children with school uniforms and purchase stationary as well as textbooks. Secondary schooling is on a fee basis and enrollment rates at the secondary level are much lower[44]. In recent years, limited non-salary recurrent expenditure has resulted in schools becoming reliant on contributions from communities (parents and Kaupules), implying additional costs to the household. These factors, together with the recent under investment in post-primary education and training have presented both a financial burden and obstacle to secondary education for the poorest households. By supporting cost saving measures that will help to rebalance the focus of the education sector towards non-tertiary education, especially secondary and post-primary vocational training, this operation will contribute to improving education outcomes and potentially reducing costs, especially for the poor households that rely solely on the public provision of services. Increased investment in non-salary recurrent expenditure (to reduce the need for user fees such as textbooks, food, and uniforms) may reduce education expenditure burden on poorer families (see Figure 17) and reduce disadvantage to women[45] from education expenditures making education expenditure more progressive. In addition to this, strengthening Tuvalu's scholarship programs is expected to improve incentives for students to gain qualifications that will enable the use of their skills in Tuvalu or abroad. And since the majority of students enrolled in tertiary education are women[46], these measures are expected to benefit the employment prospects of Tuvaluan women.

Figure 17: Expenditure on secondary education as a share of total household expenditure (by expenditure quintile)



Source: GoT and World Bank estimates

[44] Tuvalu's gross primary enrollment rate was 101 percent, compared with a secondary enrollment rate of 52 percent in 2011.
[45] International evidence indicates that women are more likely to meet children's school costs, which increase when there is insufficient government expenditure on recurrent primary education beyond teacher salaries. Similarly therefore, women are financially more advantaged by expenditure allocation choices more orientated to primary education over tertiary education.
[46] In 2010, two thirds of pre-service scholarship students were women, the reforms are therefore expected to have a positive impact on the performance of female students.

91. **Improving the management of the overseas medical treatment scheme will contribute to better health outcomes for Tuvaluans, including the poor.** Improving the management of the overseas medical treatment program is expected to improve the quality of tertiary health services whilst reducing the costs of the program. This will help the GoT to address the expenditure imbalance in the health sector and to invest more in primary, preventative and maternal care, benefiting a greater proportion of the population. This rebalancing could also improve overall health outcomes. In particular, investing improving access to medical services and drugs in the outer islands would make health expenditure more progressive given their higher poverty levels.

92. **Overall, reforms to the scholarship and medical treatment schemes are designed to be efficiency enhancing rather than rationing measures**. They aim to provide the same level of service delivery at the tertiary level whilst achieving a higher value for money. Hence, these reforms are not expected to worsen poverty or social outcomes for any group. Rather, as described above, they may complement efforts to strengthen service delivery to the poor, especially if additional resources are invested to delivery key services in the outer islands.

Public finance management

93. **Strengthening public financial management is expected to indirectly contribute to improving poverty and social outcomes in Tuvalu**. An effectively executed budget is an important pre-requisite to a functioning public finance system that is able to allocate resources to national development priorities. It also opens up the system's ability to realign resources in the context of unpredictability, and to minimize leakages throughout the process. The reforms supported by this operation to strengthen accounting, revenue management and budget execution are expected to unclog the budget process and allow it to be an effective tool for responding to national poverty and social needs.

94. **The outer island project management reforms are expected to improve access to services for some of Tuvalu's poorest and most remote households**. Outer island projects are the main source of investment in basic services and infrastructure such as water tanks, schools and clinics on Tuvalu's outer islands. They are also an important source of employment and economic activity. The outer island policy is expected to reverse the poor management that has been delaying (and in some cases preventing) the full implementation of projects. Given that hardship in Tuvalu is concentrated in the outer islands, these reforms are expected to improve service delivery to many of Tuvalu's poorest households. Further reforms in outer island governance and accountability, such as improved expenditure reporting and audit will, in due course, further contribute to improvement of service delivery.

Environment

95. **The policy reforms supported by this operation are not likely to have any negative effects on Tuvalu's environment or natural resources**. Specifically, the actions supported by the proposed operation for improving public financial management and service delivery do not have any direct links to environmental factors.

C. IMPLEMENTATION, MONITORING AND EVALUATION

96. **The implementation of this program's policy actions will be the responsibility of the GoT under the coordination of the MFED.** Tuvalu's reform effort and progress against this program's results matrix will be reviewed by the GoT in close coordination with the World Bank team as a part of the annual review of the policy matrix with other development partners. The MFED will coordinate and monitor the program and the related indicators described in the policy matrix (Annex 2), and provide regular reports on the PRM to the World Bank and other development partners against agreed timelines.

D. FIDUCIARY ASPECTS, DISBURSEMENT AND AUDITING

Public Financial Management Environment

97. **Tuvalu's fiduciary and public financial management environment improved between the 2007 and the 2011 PEFA despite capacity constraints.** 10 out of the 31 indicators showed improved scores while the number of 'Not Rated' indicators declined, albeit this is from a low base with 14 indicators still at D/D+ primarily in the areas of Predictability and Control in Budget Execution. These improvements have been led by the GoT with strong support from development partners and Tuvalu's PFM environment is considered adequate to support this operation. Key documents relating to the fiduciary aspects of public financial management include the Assessment of National Systems (ANS), the PEFA assessments and the PFM reform roadmap. The ANS concluded that the country fiduciary risk for Tuvalu is in the range of Moderate to High with the higher risk rating referring to Procurement & Reporting. Tuvalu's budget provides a reasonably comprehensive coverage, particularly for central government activity, and its classification provides administrative, economic and program information. The GoT also makes available to the public the annual budget document. Implementation of the new public enterprise legislation has added to the strength of the PFM system, bringing all PEs under a central performance monitoring and accountability framework for the first time. In year expenditure management has been strengthened with timely reconciliation and in-year reporting. The previous backlog of financial statements and submissions to the Auditor General has also been cleared, and tabled in parliament. Annual Financial Statements of the GoT are audited by the Auditor General applying international standards. The most recent audit report was for 2011 was issued in September 2012 with a qualified opinion. A procurement policy has also been endorsed by cabinet, with new procurement regulations being drafted.

98. **To address the remaining issues, a wide ranging PFM reform roadmap that was endorsed by cabinet in 2012.** The roadmap sets out a medium term reform program to address the remaining key areas of weakness with the most immediate actions planned for to improve reporting, procurement and taxation systems. Ongoing technical assistance support provided to the program through resident PFM advisors to the MFED will need to be maintained to sustain and deepen the reform efforts.

Foreign Exchange Environment

99. **An IMF Safeguards Assessment is not available as Tuvalu does not have a central bank and uses the Australian dollar as its currency.** In addition, Tuvalu has not accessed

IMF funds. There is no indication of major issues within the foreign exchange environment, especially given that Tuvalu uses the Australian dollar. However without a safeguards assessment, nor any previous experience in DPOs, a set of mitigation measures have been proposed including a separate Local Currency Deposit Account opened in the government's Consolidated Fund held at the National Bank of Tuvalu, together with an audit as described below.

Disbursement and Auditing

100. **The proposed SDR 2 million (USD 3 million equivalent) operation is the first in a two-year programmatic operation with funds to be made available upon effectiveness.** The proposed operation will follow IDA's disbursement procedures for development policy grants. Once the operation becomes effective, and at the request of the Recipient, the proceeds will be deposited by IDA into a deposit account in a separate government account at the National Bank of Tuvalu. The National Bank of Tuvalu is deemed an acceptable bank for receiving of World Bank funds. The National Bank of Tuvalu has also been used for the designated account for IDA's Pacific Aviation Investment Program in Tuvalu. As a due diligence measure, within 30 days of receipt the Borrower will provide a written confirmation to IDA when an equivalent amount is accounted for in the government's budget management system. Disbursements would not be linked to specific purchases. The proceeds of the operation would not be used to finance expenditures excluded under the Agreement. If, after being deposited in a government deposit account, the proceeds of the operation are used for ineligible purposes as defined in the Financing Agreement, IDA will require the Borrower to refund the amount directly to IDA.

101. **The Bank will require an audit of the receipt of the disbursement in the deposit account and into the budget management system of the Recipient.** The financial audit report should be furnished to the Bank within 6 months from the last disbursement. In that event the Recipient would i) report the exact sum received into the deposit account and its supporting details; ii) that this account was only used for the purposes of the operation and that no other amounts were deposited into this account, including confirmation from corresponding bank(s) involved in the funds flow; and (iii) that an equivalent amount was accounted for in the Recipient's budget management system. This will enable IDA to review consistency of the withdrawal with the development financing agreement and achievement of the objectives of the operation.

E. RISKS AND RISK MITIGATION

External Shocks

102. Tuvalu's macroeconomic and fiscal framework is vulnerable to shocks that are characteristic of small Pacific economies. Commodity price shocks could be readily translated into higher domestic prices given the extent to which consumption relies on imported goods, particularly food and fuel. Global or regional economic downturns could yield a shock to Tuvalu's remittance flows and diminish employment opportunities abroad. Similarly, the returns on the trust fund are exposed to the unpredictable fluctuations of international financial markets. In recent years the TTF has failed to yield sufficient returns to finance

Tuvalu's budget deficit, and the uncertain nature of this funding mechanism presents a continued risk for Tuvalu's fiscal position going forward. Finally, unexpected decline in receipts from fisheries contracts or donor grants would cause a strain on Tuvalu's fiscal position. Tuvalu is also vulnerable to weather events that could incur high recovery costs.

103. The GoT has taken a conservative approach in estimating revenues and grants to provide a cushion against the above described uncertainties. However, the main buffer at Tuvalu's disposal against macroeconomic shocks is the CIF. As described above, this program will help the GoT to finance fiscal deficit over the next two years and support measures that will contribute to improved revenues and prudent expenditure management in the medium term. The Bank will also continue to work with IMF staff to monitor macroeconomic risks and provide policy advice to government as needed.

Institutional capacity

104. Thin capacity in the public sector presents a risk that could impede the implementation of the reform measures supported by this program. Capacity constraints are typical in the case of Small Island States, especially in the Pacific. The outer islands have particularly high capacity constraints, highlighting the challenge in managing local government affairs. These pose the risk that the actions supported by this program might not be implemented as successfully as expected or in the agreed timeframe.

105. Dialogue with the GoT has included detailed discussion about the implementation requirements for each policy action to ensure that the program is anchored in realistic expectations. The risks caused by weak capacity are mitigated by selectivity in the design of the proposed program. The design of the program emphasizes the need for a focused and strategic set of measures that can be advanced within the capacity of the GoT. A balance was struck between actions that are more administratively demanding and those that are more politically demanding. Additionally, development partners have been active in mapping their technical assistance to areas where gaps arise.

Ownership

106. Dialogue supporting this program builds on a continuing engagement by development partners with the GoT that has demonstrated bipartisan ownership and that reforms can be sustained through political transition. Dialogue and endorsement has typically been sought from both the Development Coordination Committee[47] and the Tuvalu cabinet, which provides a level of continuity, particularly since senior officials tend to remain in position even when political mandates change. Therefore it is unlikely that the general election scheduled for late-2014 would lead to significant deviation in policy. Furthermore, the programmatic operation is in itself considered to be critical for sustaining the progress made in policy dialogue over the last 18 months and the momentum of reform through political transition.

[47] Development Coordination Committee was setup under the Office of the Prime Minister, chaired by the Secretary to Government, and represented by senior officials from line ministries, to assesses draft policies, projects and programs prior to submission for approval by Cabinet.

ANNEX 1: LETTER OF DEVELOPMENT POLICY

TUVALU GOVERNMENT

OFFICE OF THE MINISTER OF FINANCE AND ECONOMIC DEVELOPMENT

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10 September 2013

Letter of Development Policy

Dear President Kim,

Tuvalu is committed to achieving the World Bank Group's vision of 'Living in a World without Poverty' and also the UN Millennium Development Goals by 2015. Tuvalu is the smallest member of the World Bank, our population of 11,000 people, geographic remoteness, and vulnerability to exogenous shocks including natural disasters presents a unique set of development challenges. Nevertheless, the Government of Tuvalu (GoT) is determined to achieve prosperity for all Tuvaluans through the strategies and priorities that are articulated by its people in the National Strategy for Sustainable Development - *Te Kakeega II 2005-2015.* In parallel, Tuvalu is committed to achieving the World Bank Group's vision of 'Living in a World without Poverty' and also the UN Millennium Development Goals by 2015.These priorities and strategies will enable Tuvalu to pursue growth, development and shared prosperity.

Investments in public services together with the support of development partners have resulted in significant steps towards achieving our national development objectives and the Millennium Development Goals (MDGs). According to the 2011 MDG report, we are on track to achieving universal primary school education, reducing child mortality, and improving maternal health. We have also made significant progress in promoting gender equality and empowering women. Extreme poverty is minimal in Tuvalu given customs of mutual support within communities and remittances have been a traditional safety net that still protects many of Tuvalu's households from extreme poverty. However, as highlighted in the 2010 Household Income and Expenditure Survey, poverty had reversed its declining trend since 2005 – especially in the rural areas – partly explained by the spikes in food and fuel prices and the global economic crisis. To combat this, GoT continues to provide employment opportunities in rural areas – where unemployment is high – through investment in infrastructure.

Tuvalu's commitment to achieving its development goals relies, *inter alia,* on building fiscal resilience against exogenous shocks. Our economy is extremely vulnerable to external shocks due to its heavy reliance on income earned from abroad. These incomes from external sources such as fishing licensing fees, leasing of Tuvalu's internet domain 'dotTV', worker's remittances and grants, account for around 80 percent of GDP. The Government role in the economy is necessarily extensive and the private sector is relatively small, accounting for only around a quarter of economic activity. Structural trade deficits – over 50 percent of GDP – result from heavy import dependence. Tuvalu uses the Australian Dollar as the legal tender and as a result it has no independent monetary policy and domestic interest rates are set based on social and development objectives set by the only two local banks that operate in Tuvalu. All of the above indicate that macroeconomic management and the absorption of external shocks rely on fiscal policy.

Effects of Recent Crises: 2008 - 2012

In recent years, Tuvalu has suffered from a number of economic shocks and natural disasters. The global food and fuel price crisis caused increase in costs to households, especially since all grid electricity is generated from imported fuel. The global economic crisis also had a severe impact on the economy through declining remittances – from seafarers and seasonal laborers, and substantial loss to the capital of the national trust and pension funds. Tuvalu also suffered a major drought, with a state of emergency declared on September 28, 2011.

The impact on these crises had been protracted, with the economy contracting in 2009 and 2010, before an incipient recovery in 2011. Exchange rate appreciation has allowed inflation to remain low and steady but has also eroded the local currency value of US dollar receipts from the sale of fishing rights. As fiscal policy is the only tool available for macroeconomic management, the GoT responded to this period of economic hardship with increased public spending, e.g. on capital projects in the rural areas to alleviate poverty. As Tuvalu was already classified as being at high risk of debt distress, this increased spending was enabled by grants and previous savings (from excess returns on the national trust fund). Given the national trust fund suffered a severe loss in the aftermath of the global economic crisis, savings utilized to finance the expansion were not replenished (with returns on capital not reaching target levels in recent years). The resulting exhaustion of existing savings places Tuvalu at a precarious situation, limiting our country's ability to absorb future shocks.

As the economy gradually recovers from the impact of these crises, the GoT is winding back the fiscal expansion. However, the national trust fund is not expected to achieve target returns – which would enable the rebuilding of fiscal buffers – until 2014 at the earliest. This is also contingent on the performance of a volatile and uncertain global financial market. As a result, Tuvalu will need to exert prudence in fiscal management and to begin re-building savings in the Consolidated Investment Fund. To do this, the budget will need continued support from development partners in the medium term. This support is important for strengthening fiscal buffers and to respond to either real (including environmental and climate change) or financial shocks.

The Government of Tuvalu's Reform Agenda: 2013 – 2015

The government of Tuvalu is pursuing a broad reform agenda designed to achieve our vision for sustainable development in the long term. To help implement this vision, the Government developed a Policy Reform Matrix in 2012 and a Priority Roadmap for 2013, in coordination with development partners, to map out the reform agenda in the medium term. The reform agenda is built around eight central themes of the national development plan *Te Kakeega II*: (i) good governance; (ii) economic growth and stability; (iii) social development; (iv) Falekaupule and outer islands development; (v) employment and private sector development; (vi) education and human development resources; (vii) natural resources; and, (viii) infrastructure and support services.

More specifically, to improve macroeconomic and fiscal management the Government has begun implementing a Public Financial Management Reform Plan with an emphasis on strengthening governance, transparency, debt management and budget execution. Financial reports summarizing key revenue and expenditures are now produced quarterly and available to the public. Public accounts have been brought up to date with the submission of the 2009, 2010 and 2011 accounts to the Office of the Auditor General in 2012. The next steps include the development of improved procurement regulations and the production of a budget manual. The Government is committed to continue implementing ongoing activities such as financial and budget execution reports and, to strengthen debt management with the overall goal of improving efficiencies and transparency.

To improve fiscal discipline and sustainability, the Government has approved fiscal ratios to ensure continued fiscal discipline such as, domestic revenue to GDP, recurrent expenditure to GDP and primary balance to GDP as part of the 2013 Budget Circular. The Government has also established a Revenue and Expenditure Review Committee, chaired by the Minister of Finance, to ensure key social services expenditures are protected and at the same time achieve saving targets through the fiscal ratios. The next steps in 2013 include undertaking two tax audits of large tax payers, and continuing to implement tax recovery measures based on assessments on non-complying tax payers.

In order to strengthen public administration, the Government in late 2012 has established a number of committees and taskforces to improve public administration and service delivery, particularly in the outer islands. This includes the Public Service Reform Committee (PSRC) and a national taskforce to review the wage structure. Also in place are new staff appraisal forms and system in place to provide updated appraisal forms and systems. In 2013 the aim is for the PSRC to review the public service, including assessment of the appropriate size, structure, remuneration levels and linking staffing levels and structure to *Te Kakeega II*. In addition, the government recently adopted a new policy and procedures to enhance the development impact of outer island projects.

To improve public enterprise (PE) management and core service delivery, the 2013 Budget provided the necessary funding to ensure continued provision of services to the community, especially in the Outer Islands. Other achievements include the completion of audit reports for most PEs and the merger of Tuvalu Philatelic Bureau, Tuvalu Travel Office and the Tuvalu Post Office for efficiency savings. Next year, the Government will remove public servants from PE boards if there are qualified people to hold Board positions from the private sector.

To strengthen social service delivery, reforms in the health sector with the aim of improving the management of the Tuvalu Medical Overseas Medical Treatment Scheme (TMTS) are underway. A number of cost reduction measures have been undertaken in 2012 including a new referral process for sending cardiac patients to high quality and lower cost facilities outside of the region. The government is committed to proving for a healthy Tuvalu, and to complement the above described reforms with increases in budget provisions for primary and preventive health care in accordance with the objectives of *Te Kakeega II*.

Similarly, education reforms focusing on improving the management of the education system, in particular, scholarships funded by the Government are also underway. The number of new government funded awards has been limited to 30, with development partners taking more scholarships through a stringent selection process. In addition, extensions and variations regulations have been tightened and are being enforced to limit overspending. The Government will continue to prioritize the education sector in its reforms with an emphasis on strengthening primary, secondary, vocational and early childhood education.

The Government continues to deepen this reform agenda, with support and continued dialogue with the World Bank and other development partners. It also seeks to strengthen the reform agenda for improving the management of revenue from fisheries and to increase the use of renewable energy sources in Funafuti and the outer islands.

Mr. President, despite a difficult economic and fiscal situation, we have made significant progress in implementing the reform agenda laid out in the reform roadmap. We remain firmly committed to implementing the medium term reform agenda to create a healthy, educated, peaceful and prosperous Tuvalu. I request, that the World Bank take this operation through the lens of our unique challenges as one of the smallest and most geographically isolated member of the World Bank. The Government and the people of Tuvalu, welcome the continued active engagement of the World Bank in Tuvalu in this earnest and important endeavor.

Yours Sincerely,

Honourable Maatia Toafa
Minister of Finance and Economic Development

MINISTRY OF FINANCE * TUVALU GOVERNMENT *

ANNEX 2: THE PROPOSED TUVALU DPO POLICY MATRIX

Prior Actions for 1st Operation	**Indicative Triggers for 2nd Operation**	**Results by June 2016**
	Public Financial Management	
The Recipient has strengthened its budget execution and transparency through the preparation and publication of quarterly fiscal reports. The Recipient has resolved to offset the tax related cross liabilities that have hindered the operations of the Tuvalu Maritime Training Institute and the Vaiaku Lagi Hotel.	The Recipient introduces centralized commitment control procedures to strengthen treasury commitment and expenditure control. The Recipient updates all financial records in the fisheries management system, and concludes a full reconciliation of fishing revenues for 2013 with treasury records to strengthen oversight of fishing revenues.	Indicator 1: Variance in composition of expenditure[48] ▪ Baseline: Average 2010-12 variance > 10% ▪ Target: Average 2013-15 variance < 10% Indicator 2: Management of revenue records ▪ Baseline: 2012 = Full reconciliation not available ▪ Target: 2015 = Treasury records do not deviate by more than 10 percent from those of the revenue and fisheries management systems[49]
The Recipient has approved the outer islands project management policy aimed at strengthening project selection, implementation and monitoring in its outer islands.	The Recipient pilots a streamlined Outer Island financial reporting framework to reduce administrative burden on the Kaupules and enable better tracking of funds.	Indicator 3: Share of newly approved projects implemented in-line with the outer island plans for community development. ▪ Baseline: 2012 n/a[50] ▪ Target: 2015 = > 50 percent.
	Public Service Delivery	
The Recipient has: (a) on a pilot basis, implemented measures, designed to reduce health care costs and improve the quality of care provided through the Tuvalu Medical Treatment Scheme; and (b) submitted to its Parliament the report and recommendations from the TMTS pilot.	The Recipient revises the Tuvalu Medical Treatment Scheme Policy to strengthen the patient referral process and institutes efficiency measures piloted in 2013.	Indicator 4: Increased budget allocation to primary[51] & secondary health through savings on TMTS ▪ Baseline: 2012 = AU$ 2.3 million[52] ▪ Target: 2015= Increase on average by at least 5 percent per annum
The Recipient has approved the revised pre-service and in-service training and scholarship policies in order to tighten the criteria for extension of scholarships.	The Recipient broadens vocational training programs, to increase post-primary education opportunities, particularly for Tuvaluan women.	Indicator 5: Increased budget allocation to primary & secondary education (including vocational) through savings on tertiary scholarships ▪ Baseline: 2012 = AU$ 3.1 million[53] ▪ Target: 2015 = Increase on average by at least 5 percent per annum

[48] Calculated in accordance with PEFA guidelines for PEFA Indicator II, excluding one-off lumpy items.
[49] The revenue management system is updated by the Inland Revenue Department and the fisheries management system is updated the Fisheries Department
[50] The potential for establishing a baseline for this indicator will be clarified with the GoT.
[51] Indicators 4 and 5 were chosen as data on education / health outputs are very limited and to reflect GoT's planned outcome of improving resourcing and delivery of primary and secondary health and education services through saving at the tertiary level.
[52] Tuvalu MTEF expenditure (estimates) – 2012.
[53] Tuvalu MTEF expenditure (estimates) – 2012.

ANNEX 3: POLICY REFORM MATRIX (PRM)

Government of Tuvalu – Policy Reform Matrix for Budget Support incorporating development partner feedback – 10 March 2012

TK II Strategic Area	Kakeega Objectives and Outcomes	Action	Milestones	TA Availability/ Requirements	Timeframe
1) Macroeconomic Growth and Stability	i) Sound macro-economic and fiscal management and minimize external debt. • Improve transparency and accountability in financial management • Strengthen fiscal management within a medium-term fiscal framework. • External debt kept under 30% of GDP equivalent	a) Improve Public Financial Management by Developing a Public Financial Management Roadmap - 2013-2015, based on 2011 PEFA.	Cabinet Approval *(MFED to provide copy of Roadmap and Cabinet approval)*	AusAID Budget TA, Audit TA and AusAID/NZAID Treasury TA	Q1 2013
		b) Establishment of Procurement policy to improve performance systems for competition, value for money and controls by establishing tender and procurement procedures in the Financial Instructions (or other legally binding documents) and releasing successful tender award contracts.	Cabinet Approval *(MFED to provide Cabinet approval and copy of procurement policy)*	TA to be identified – possibly ADB, WB support	Q2 2013
		c) Maintain and update Medium Term Fiscal Framework – at least quarterly as part of monitoring of National Budget with expansion to include forward Ministry and Program Allocations	MTFF produced quarterly and presented to Cabinet *(MFED to provide MTFF)*	Budget TA	2012 (ongoing)
		d) Prepare and publish a Budget Manual outlining the budget process, policies, definitions, forms, etc.	Budget Manual Prepared and approved by Cabinet *(MFED to provide manual and Cabinet approval)*	Budget TA	2012
		e) Publish and maintain an annual Budget Calendar	Budget Calendar prepared May 2012 *(MFED to provide Cabinet approval of budget calendar)*	Budget TA	Ongoing
		f) Monthly cash flow statements for Minister	Monthly Cash flow reports for Cabinet *(MFED to provide copies of cash flow)*	Budget TA/Treasury TA	Ongoing
		g) bank reconciliations are completed on a monthly basis	Treasury reports *(MFED to provide copies)*	Treasury TA	Q3 2012
		h) Public accounts are brought up to date;	2009, 2010 and 2011 Accounts with Audit Office who completes audit. *(MFED to provide copies of Audit reports)*	Treasury TA/Audit TA	Q4 2012
		i) Adherence to the Tuvalu Debt Risk Management and Mitigation Policy including quarterly debt schedule and arrears update	Debt Updates for Cabinet *(MFED to provide reports)*	Budget TA	Q3 2012
		j) Commitment to implementation of the Tuvalu Infrastructure Strategic Investment Plan (TISIP) and its revision every two years (next revision 2014 with a view to include social infrastructure such as schools and health facilities);	Funding in 2013 Budget corresponds to TISIP, 2014 Revision of TISIP *(MFED to provide 2013 Budget and revised TISIP when available)*	TA to be identified	2013 and 2014

TK II Strategic Area	Kakeega Objectives and Outcomes	Action	Milestones	TA Availability/ Requirements	Timeframe
1) Macroeconomic Growth and Stability (cont'd)		n) Government formalises procedures and regulations for drawdowns from Consolidated Investment Fund (CIF)	Cabinet Decision *(MFED to provide Cabinet Decision and CIF Committee Minutes)*	Budget TA/TTFAC	2013, 2015
		m) Quarterly meetings of the Macroeconomic Policy Committee (MPC)	Minutes of the MPC *(MFED to provide minutes of MPC)*	Budget TA	Q2 2012
	ii) Exert fiscal discipline so Government budgets are fiscally sustainable • Fiscal adjustment for 2012/13 budgets instituted, cutting back on expenditure & raising revenue (tax) for balanced budget OR • with budget deficit, limited deficit to no more than 11% GDP or as can be covered by 'sustainable drawdowns' from CIF. • Clear budget expenditure priorities that offer high rates of return.	ii) The Government through RERC will have made a commitment to adopt the following principles in managing its FY2013 budget expenditure in light of reduced revenue forecasts and dwindling reserves –	Formal establishment of RERC, RERC Report to Cabinet, and Recorded in RERC minutes *(MFED to provide Minutes)*	Budget TA/TTFAC/MTEF TA	Ongoing
		a) Essential social services (including primary education and basic health services) will not be cut	2013 Budget *(MFED to supply documents and Cabinet decisions)*	Budget TA/TTFAC/MTEF TA	Q4 2012
		b) Savings will be made through a planned and strategic reduction, such as in low-value added current expenditure.	2013 Budget *(MFED to supply documents and Cabinet decisions)*	Budget TA/TTFAC/MTEF TA	Q4 2012
		c) Increase TCT compliance to 75% of TCT registered entities including 100% of Public Enterprises;	Internal Revenue Department Internal reports *(MFED to provide reports)*	AusAID Tax TA	Q1 2013
		d) Conduct tax audit training and undertake at least 3 tax audits of large taxpayers	Internal Revenue Department Internal reports *(MFED to provide reports)*	AusAID Tax TA	Q4 2012
		e) Increase the TCT rate to 7% in 2013 and 10% by 2015 (currently 4%);	Ministerial Regulation issued *(MFED to provide copy of Regulation)*		2013, 2015

TK II Strategic Area	Kakeega Objectives and Outcomes	Action	Milestones	TA Availability/ Requirements	Timeframe
2) Good Governance	Strengthen Public Administration	i) Government undertake a review of the Public Service including assessment of appropriate size, structure, remuneration levels, etc. - link staffing levels and structure to TK II priorities, affordability based on budget constraint	Presentation of Report to Government *(MFED to copy of Public Service Review Report)*	TA to be identified for Public Service Review to address a), b) and c) – potentially UNDP, AusAID, NZAID, etc.	Q4 2012
		a) Revive the Public Service Reform Committee	Cabinet approval to reinstitute PSRC with ToRs *(MFED to provide Cabinet decision and ToRs)*		Q3 2012
		b) New wage structure for public service wage levels to ensure wages reflect responsibility and relativities	2013 Budget with new wage structure incorporated *(MFED to provide 2013 Budget)*		2013
		c) Update and revise staff appraisal process	New staff appraisal forms and system in place *(MFED to provide updated appraisal forms and system)*		Q3 2012
	Strengthen and Improve Public Enterprise Management	The Government will continue to implement the requirement of the Government's Public Enterprise Policy and Public Enterprise (Performance and Accountability) Act. This will include taking the following actions –			
		i) All public servants removed from Public Enterprise Boards (except as allowed under the Public Enterprise (Performance and Accountability) Act)	Cabinet approval of new Board Memberships *(MFED to provide list of new memberships)*		Q2 2012
		ii) All PE Board Members to have undergone Director training	Report of Director Training and List of Board Memberships *(MFED to provide list of memberships and thos that have undergone training)*	Possibly ADB TA follow up to PE Reforms?	Q2 2012
		iii) Community Service Obligations (CSOs) clearly defined between Government and PEs with corresponding budget allocations made in National Budget	2013 Budget *(MFED to provide copy of 2013 Budget)*	ADB PE TA/BMS	Q4 2012
		iv) Designated Public Enterprises complete Audits and Annual Reports (including audited financial statement) presented to Parliament at next session	Office of the Auditor General Summary report of Public Enterprise Audits presented to Parliament *(MFED to provide copy of Audit and Annual reports)*	ADB PE TA/Audit TA	Q4 2013
		v) Rationalisation of at least one SOE (eg corporatized, merged, fully/partially privatised, closed down or management contract applied)	Documentation indicating the change of status of enterprise *(MFED to provide documentation)*	Transaction Adviser TA to be identified possibly under ADB/WB	Q4 2013

TK II Strategic Area	Kakeega Objectives and Outcomes	Action	Milestones	TA Availability/ Requirements	Timeframe
3) Social Development	Provide Tuvaluans with the highest attainable standard of health	Review the Tuvalu Medical Treatment Scheme (TMTS) based on analyses provided on the medical system such as the Medium Term Expenditure Framework (MTEF) for Health. The review would consider: - caps on the number of patients treated - strict caps on budgetary allocations for TMTS - reduction of allowances, entitlements, travel options, etc; and - cost-sharing arrangements Ministry of Health to prepare an annual report to Parliament on the costs, patients and treatments for the TMTS and report on the adherence to the TMTS policy	Publication of the review and Tabling with Parliament *(MFED to provide copy of the TMTS Review)* Publication of the Annual Report and tabling with Parliament *(MFED to provide copy of the TMTS Annual Report)*	MTEF TA, Budget TA. Other Specialist TA?	Q4 2012 Q3 2012
4) Education and Human Resources	Improve Management of the education system	Review the Government's training and scholarship policy informed by analyses provided on the education and training system such as the Medium Term Expenditure Framework (MTEF) for Education. The review would consider: - More rigorous application of the criteria relating to extension/variation which will lead to earlier termination and a saving on expenditure. - Focus scholarships to specific types of study – eg fund only certificate/diploma level study for pre-service awards, and support Bachelor's degrees and all post graduate only as In-service. - Request that donors pick up the costs of an increased number of the lower achieving Pre-service awards so the donors can apply their apparently successful techniques to better manage performance. - Have a close look at the AFP to see if it might be more efficient to increase the funding at this level to enhance the AFP pass rates and better prepare students for scholarship study. - Look at decreasing scholarship awards to TMTI to take account of the limited employment options. Ministry of Education, Youth and Sports to report to Parliament annually on the costs of implementing the scholarship programs and report on the adherence to the training policy.	Publication of the review and tabling with Parliament *(MFED to provide copy of the new policy)* Publication of the Annual Report and tabling with Parliament *(MFED to provide copy of the Training Policy Annual Report)*	MTEF TA, Budget TA, Other Specialist TA?	Q4 2012 Q3 2012

ANNEX 4: IMF ASSESSMENT LETTER

September 23, 2013

Tuvalu continues to experience slow growth, and the outlook remains challenging. Real GDP growth is projected at just above 1 percent in 2013, and inflation is currently low at 1½ percent in mid-2013 but could rise to around 3 percent by end year due to the recent Australian dollar depreciation and rising oil prices. The economy could benefit from a likely transfer (AU$ 2-5 million) from the Tuvalu Trust Fund (TTF)[54] around end year, while remittances remain well below the pre-crisis level. The near-term risks, mainly external, are tilted to the downside. A slowing Australian economy, largely driven by weakening investment and exports, would further undermine the external demand for Tuvaluan seafarers and seasonal workers, and adversely affect TTF that are heavily invested in Australian markets.

Rebuilding fiscal policy buffers is essential to ensure fiscal sustainability. The 2009-10 fiscal expansion nearly exhausted fiscal buffers, and is being unwound slowly. Revenue is boosted by rising license fees from fishing and leasing of the government-owned .tv web domain. On the expenditure side, the government has taken important steps to strengthen budget monitoring and introduced a stringent spending approval process. However, achieving fiscal sustainability remains challenging. Under the medium-term fiscal framework, the fiscal buffers, mainly the Consolidated Investment Fund (CIF), are projected to decline quickly. To reverse this trend, the authorities need to strengthen revenue collection by addressing noncompliance, contain nonessential spending, and reduce subsidies. Medical and scholarship expenses, though necessary, should be brought under tighter scrutiny to optimize the use of available resources. Public debt management needs to be enhanced to safeguard debt sustainability—most importantly, loan guarantees for public enterprises should be phased out, and the ceiling on government's borrowing from banks formalized.

Efforts should be focused to address vulnerabilities in the SOE and banking sectors. The SOE sector is making substantial losses and meanwhile holds a large amount of tax arrears. The government supports SOEs with generous subsidies. To this end, the authorities should develop a comprehensive reform strategy for SOEs, with the priority on cleaning up the balance sheets through a sound accounting and auditing procedure, relinquishing SOEs of social responsibilities, and putting their operations on a commercial basis. The banking sector, which is unregulated, harbors substantial risks as illustrated by a high level of nonperforming loans. Establishing a regulatory and supervisory framework would be crucial to addressing financial vulnerabilities, and writing off bad loans under appropriate regulations would enhance lending capacity.

The 2012 Article IV consultation was completed in August 2012.[55]

[54] The government cannot freely draw upon TTF. Rather, a transfer from TTF to the government is made when the value of TTF exceeds the "maintained value", which is indexed to Australia's CPI inflation.
[55] The 2012 Article IV staff report is available online at http://www.imf.org/external/pubs/cat/longres.aspx?sk=26238.0

Table 1. Tuvalu: Selected Social and Economic Indicators, 2009–2014 1/

	2009	2010	2011	2012 Est.	2013 Proj.	2014 Proj.
	(Percent change, unless otherwise indicated)					
Real sector						
Real GDP growth	-4.4	-2.7	8.5	0.2	1.1	1.3
Consumer prices (end of period)	-4.0	-1.8	1.7	1.3	2.7	2.7
	(In percent of GDP)					
Government finance						
Revenue	89.1	72.6	69.1	86.0	77.1	76.2
of which Taxes	14.7	16.6	16.9	15.0	15.8	15.8
of which Grants	30.0	16.5	21.2	29.4	20.5	17.4
Total Expenditure	87.4	96.6	78.0	76.1	83.7	83.4
Expense	81.1	76.2	66.0	71.1	75.7	75.6
Net Acquisition of Nonfinancial Assets	6.3	20.4	12.0	5.0	8.0	7.8
Net Lending/Borrowing	1.7	-24.0	-8.9	9.9	-6.6	-7.3
Tuvalu Trust Fund (million AUD)	95	108	115	130	134	137
Consolidated Investment Fund (million AUD)	14.4	5.8	1.1	4.7	1.7	-1.7
	(Percent change, unless otherwise indicated)					
Money and credit						
Deposits	-8.1	-3.0	2.7	6.1	-0.4	…
Credit to non-government	-40.5	4.1	-2.8	-4.2	1.0	…
Lending interest rate (in percent) 2/	11.1	10.6	10.6	10.6	10.6	…
	(In millions of Australian dollars, unless otherwise indicated)					
Balance of payments						
Current account balance	7.8	-2.3	-13.7	0.5	-1.2	-3.9
(In percent of GDP)	22.6	-6.6	-35.9	1.4	-3.0	-9.6
Trade balance	-15.7	-16.8	-16.9	-17.4	-17.9	-18.4
Exports	0.6	0.5	0.8	0.4	0.5	0.5
Imports	16.3	17.3	17.6	17.8	18.3	18.9
Services balance	-24.0	-25.5	-31.6	-24.4	-23.1	-23.7
Income balance	27.8	21.3	16.6	22.1	22.9	23.3
Current transfers (net)	19.8	18.7	18.2	20.2	16.9	14.9
of which: government	17.2	16.2	15.8	17.9	14.7	12.4
Remittances	5.2	3.3	3.3	2.7	2.7	2.8
Gross official reserves 3/	29.9	25.8	24.3	25.8	23.0	20.0
(In months of imports of goods and services)	7.7	5.9	6.4	6.9	5.9	5.0
Debt indicators						
Gross external public debt (million AUD)	13.6	11.7	9.8	9.3	8.9	8.5
(In percent of GDP)	39.3	34.1	25.6	24.1	22.4	20.7
Debt Service (million AUD)	0.3	0.6	0.5	0.2	0.6	0.6
(In percent of GDP)	0.8	1.7	1.3	0.5	1.6	1.6
Exchange rates						
Australian dollars per U.S. dollar (period average)	1.3	1.1	1.0	1.0	…	…
Real effective exchange rate (2005=100)	100.2	114.8	123.0	126.1	…	…
Nominal GDP (In millions of Australian dollars)	34.7	34.4	38.1	38.5	39.5	40.7

Sources: Tuvalu authorities, PFTAC, and IMF staff estimates.

1/ Tuvalu uses the Australian dollar as its currency. It has no central bank operations.

2/ Average of personal, business, overdraft and housing loans.

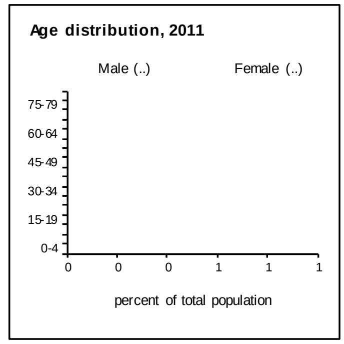
3/ Defined as sum of foreign assets of the National Bank of Tuvalu, the Consolidated Investment Fund, and SDR holdings. Excludes the Tuvalu Trust Fund.

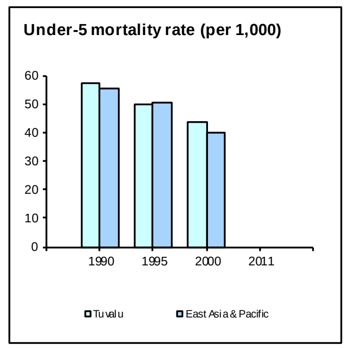
ANNEX 5: TUVALU AT A GLANCE

Tuvalu at a glance

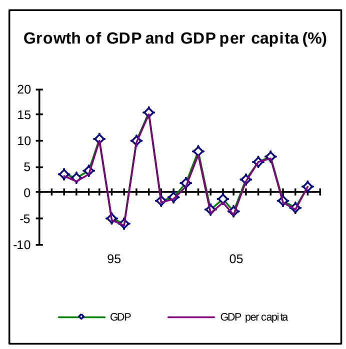
9/12/13

Key Development Indicators	Tuvalu	East Asia & Pacific	Upper middle income
(2012)			
Population, mid-year (millions)	0.01	1,974	2,490
Surface area (thousand sq. km)	*0.0*	16,302	61,034
Population growth (%)	0.2	0.7	0.7
Urban population (% of total population)	*50*	49	61
GNI (Atlas method, US$ billions)	*0.1*	8,387	16,341
GNI per capita (Atlas method, US$)	*5,150*	4,248	6,563
GNI per capita (PPP, international $)	..	7,266	10,703
GDP growth (%)	*0.2*	8.3	6.6
GDP per capita growth (%)	*0.0*	7.6	5.9
(most recent estimate, 2005–2012)			
Poverty headcount ratio at $1.25 a day (PPP, %)	..	14	9.0
Poverty headcount ratio at $2.00 a day (PPP, %)	..	33	20.4
Life expectancy at birth (years)	..	72	73
Infant mortality (per 1,000 live births)	27	17	16
Child malnutrition (% of children under 5)	2	5	3
Adult literacy, male (% of ages 15 and older)	..	96	96
Adult literacy, female (% of ages 15 and older)	..	91	91
Gross primary enrollment, male (% of age group)	102	110	111
Gross primary enrollment, female (% of age group)	98	112	111
Access to an improved water source (% of population)	97	90	93
Access to improved sanitation facilities (% of population)	84	66	73





Net Aid Flows	1980	1990	2000	2012 [a]			
(US$ millions)							
Net ODA and official aid	5	5	4	13			
Top 3 donors (in 2010):							
Australia	1	2	2	6			
Japan	0	1	1	5			
New Zealand	0	1	1	2			
Aid (% of GNI)	..	..	*38.1*	26.2			
Aid per capita (US$)	610	562	428	1,356			
Long-Term Economic Trends							
Consumer prices (annual % change)	..	..	*15*	*0.5*			
GDP implicit deflator (annual % change)	..	*2.6*	12.8	*-12*			
Exchange rate (annual average, local per US$)	..	13	17	*10*			
Terms of trade index (2000 = 100)	..	..	..	..			
					1980–90	**1990–2000**	**2000–12**
					(average annual growth %)		
Population, mid-year (millions)	0.0	0.0	0.0	0.0	1.1	0.5	0.4
GDP (US$ millions)	..	9	14	*39*	..	3.2	*11*
		(% of GDP)					
Agriculture	..	25.6	17.9	*23.3*	..	0.4	*16*
Industry	..	14.5	6.8	*11.9*	..	3.1	*8.4*
Manufacturing	..	3.1	0.8	*15*	..	..	*4.7*
Services	..	59.8	62.9	*57.5*	..	3.3	*0.7*
Household final consumption expenditure	..	..	..	..	..	..	..
General gov't final consumption expenditure	..	..	..	..	..	..	..
Gross capital formation	..	..	..	..	..	..	..
Exports of goods and services	..	..	..	..	..	..	..
Imports of goods and services	..	..	..	..	..	..	..
Gross savings	..	..	..	..			



Note: Figures in italics are for years other than those specified. .. indicates data are not available.
a. Aid data are for 2010.

Development Economics, Development Data Group (DECDG).

Balance of Payments and Trade	**2000**	**2012**
(US$ millions)		
Total merchandise exports (fob)	*0*	*1*
Total merchandise imports (cif)	*11*	*18*
Net trade in goods and services	*-25*	*-42*
Current account balance	*-10*	*1*
as a % of GDP	*-79.4*	*14*
Personal transfers and compensation of employees (receipts)	..	..
Reserves, including gold	..	..

Central Government Finance		
(% of GDP)		
Current revenue (including grants)	..	*86.0*
Tax revenue	..	15.0
Current expenditure	..	*71.1*
Overall surplus/deficit	..	*9.9*
Highest marginal tax rate (%)		
Individual	..	..
Corporate	..	..

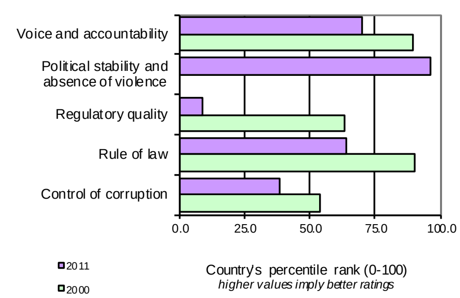
External Debt and Resource Flows		
(US$ millions)		
Total debt outstanding and disbursed	..	..
Total debt service	..	..
Debt relief (HIPC, MDRI)	–	–
Total debt (% of GDP)	..	..
Total debt service (% of exports)	..	..
Foreign direct investment (net inflows)	..	..
Portfolio equity (net inflows)	..	..

Composition of total external debt, 2011
(data are not available)

US$ millions

Private Sector Development	**2000**	**2012**
Time required to start a business (days)	–	..
Cost to start a business (% of GNI per capita)	–	..
Time required to register property (days)	–	..
Ranked as a major constraint to business	**2000**	**2011**
(% of managers surveyed who agreed)		
n.a.	..	..
n.a.	..	..
Stock market capitalization (% of GDP)	..	..
Bank capital to asset ratio (%)	..	..

Governance indicators, 2000 and 2011



Source: Worldwide Governance Indicators (www.govindicators.org)

Technology and Infrastructure	**2000**	**2011**
Paved roads (% of total)	..	..
Fixed line and mobile phone subscribers (per 100 people)	7	36
High technology exports (% of manufactured exports)	*27.8*	*15.0*

Environment		
Agricultural land (% of land area)	67	60
Forest area (% of land area)	33.3	*33.3*
Terrestrial protected areas (% of land area)	0.4	*0.4*
Freshwater resources per capita (cu. meters)	..	..
Freshwater withdrawal (billion cubic meters)	..	..
CO2 emissions per capita (mt)	..	..
GDP per unit of energy use (2005 PPP $ per kg of oil equivalent)	..	..
Energy use per capita (kg of oil equivalent)	..	..

World Bank Group portfolio	**2000**	**2011**
(US$ millions)		
IBRD		
Total debt outstanding and disbursed	–	–
Disbursements	–	–
Principal repayments	–	–
Interest payments	–	–
IDA		
Total debt outstanding and disbursed	–	–
Disbursements	–	–
Total debt service	–	–
IFC *(fiscal year)*		
Total disbursed and outstanding portfolio	–	–
of which IFC own account	–	–
Disbursements for IFC own account	–	–
Portfolio sales, prepayments and repayments for IFC own account	–	–
MIGA		
Gross exposure	–	–
New guarantees	–	–

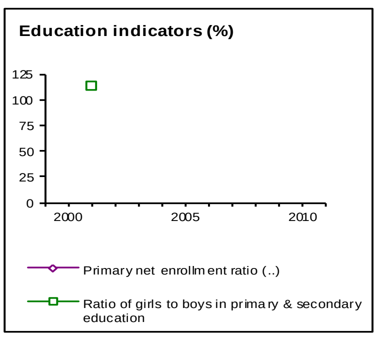
Note: Figures in italics are for years other than those specified. 9/12/13
.. indicates data are not available. – indicates observation is not applicable.

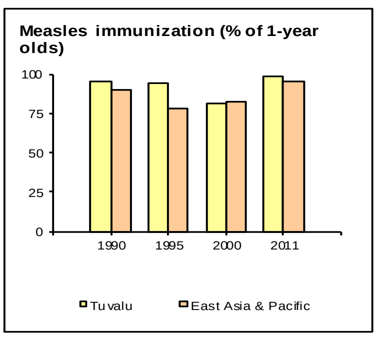
Development Economics, Development Data Group (DECDG).

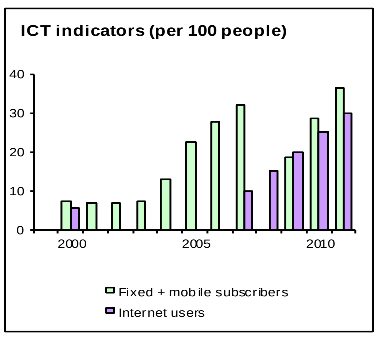
Millennium Development Goals *Tuvalu*

With selected targets to achieve between 1990 and 2015
(estimate closest to date shown, +/- 2 years)

	Tuvalu			
Goal 1: halve the rates for extreme poverty and malnutrition	**1990**	**1995**	**2000**	**2011**
Poverty headcount ratio at $1.25 a day (PPP, % of population)	..	..	..	..
Poverty headcount ratio at national poverty line (% of population)	..	..	..	..
Share of income or consumption to the poorest qunitile (%)	..	..	..	..
Prevalence of malnutrition (% of children under 5)	..	..	..	*16*
Goal 2: ensure that children are able to complete primary schooling				
Primary school enrollment (net, %)	..	..	..	..
Primary completion rate (% of relevant age group)	..	..	110	*99*
Secondary school enrollment (gross, %)	..	..	*80*	..
Youth literacy rate (% of people ages 15-24)	..	..	..	..
Goal 3: eliminate gender disparity in education and empower women				
Ratio of girls to boys in primary and secondary education (%)	..	..	*112*	..
Women employed in the nonagricultural sector (% of nonagricultural employment)	..	..	*34*	..
Proportion of seats held by women in national parliament (%)	8	*8*	0	7
Goal 4: reduce under-5 mortality by two-thirds				
Under-5 mortality rate (per 1,000)	58	51	43	30
Infant mortality rate (per 1,000 live births)	45	40	35	25
Measles immunization (proportion of one-year olds immunized, %)	95	94	81	98
Goal 5: reduce maternal mortality by three-fourths				
Maternal mortality ratio (modeled estimate, per 100,000 live births)	..	..	..	..
Births attended by skilled health staff (% of total)	100	*99*	*100*	*98*
Contraceptive prevalence (% of women ages 15-49)	39	..	*32*	*31*
Goal 6: halt and begin to reverse the spread of HIV/AIDS and other major diseases				
Prevalence of HIV (% of population ages 15-49)	..	..	..	..
Incidence of tuberculosis (per 100,000 people)	536	437	357	228
Tuberculosis case detection rate (%, all forms)	48	89	48	53
Goal 7: halve the proportion of people without sustainable access to basic needs				
Access to an improved water source (% of population)	90	92	94	*98*
Access to improved sanitation facilities (% of population)	80	82	83	*85*
Forest area (% of total land area)	33.3	..	33.3	33.3
Terrestrial protected areas (% of land area)	..	*0.4*	0.4	*0.4*
CO2 emissions (metric tons per capita)	..	..	..	..
GDP per unit of energy use (constant 2005 PPP $ per kg of oil equivalent)	..	..	..	..
Goal 8: develop a global partnership for development				
Telephone mainlines (per 100 people)	13	5.5	7.0	14.7
Mobile phone subscribers (per 100 people)	0.0	0.0	0.0	21.6
Internet users (per 100 people)	0.0	..	5.2	30.0
Households with a computer (%)	..	..	*5.9*	..

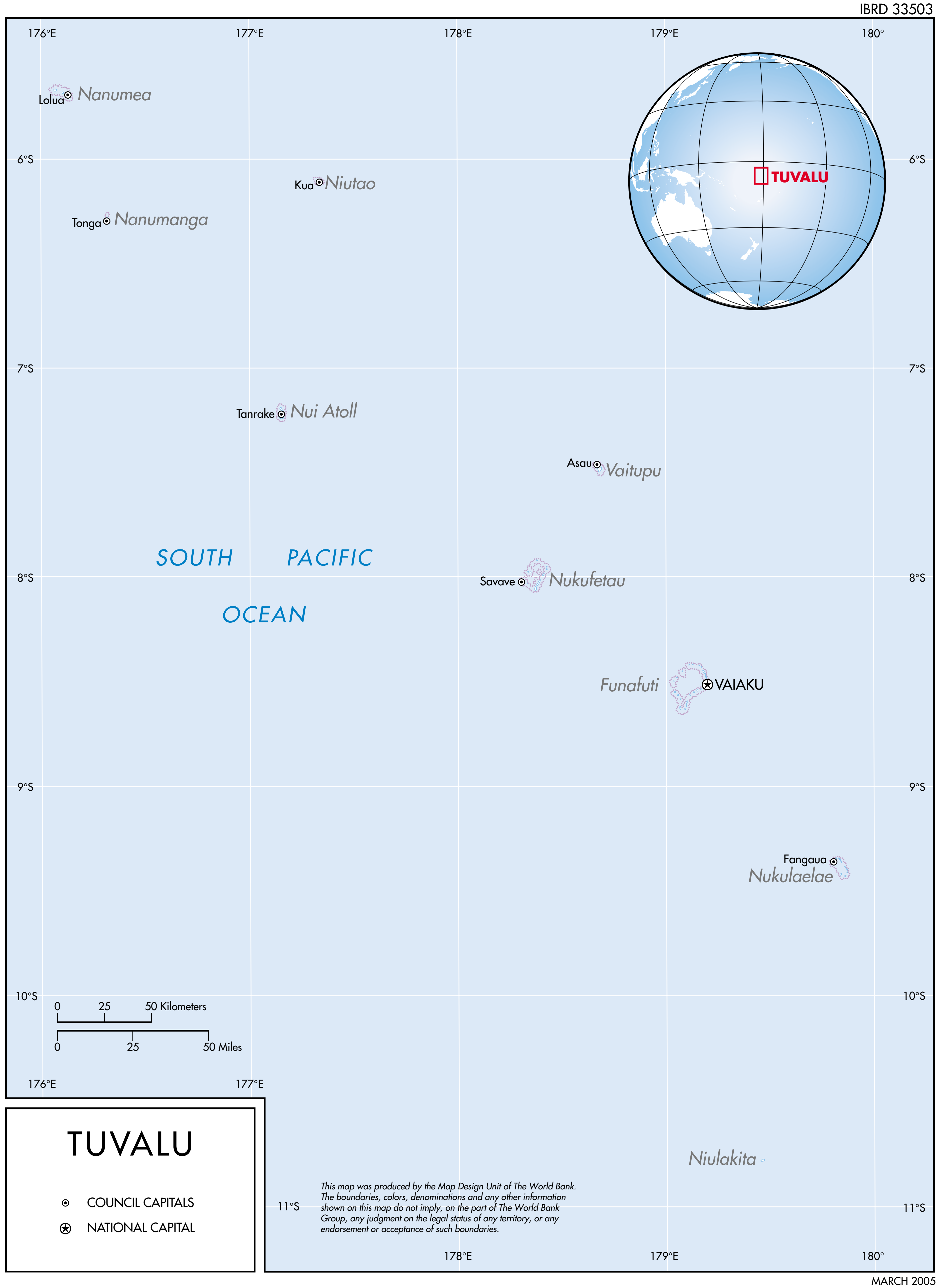






Note: Figures in italics are for years other than those specified. .. indicates data are not available. 3/15/13

Development Economics, Development Data Group (DECDG).


IBRD 33503
176°E
177°E
178°E
179°E
180°
6°S
7°S
8°S
9°S
10°S
11°S
Lolua
Nanumea
Kua
Niutao
Tonga
Nanumanga
TUVALU
Tanrake
Nui Atoll
Asau
Vaitupu
SOUTH PACIFIC OCEAN
Savave
Nukufetau
Funafuti
VAIAKU
Fangaua
Nukulaelae
Niulakita
0 25 50 Kilometers
0 25 50 Miles
TUVALU
COUNCIL CAPITALS
NATIONAL CAPITAL
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MARCH 2005