SECTOR ASSESSMENT (SUMMARY): PUBLIC SECTOR MANAGEMENT

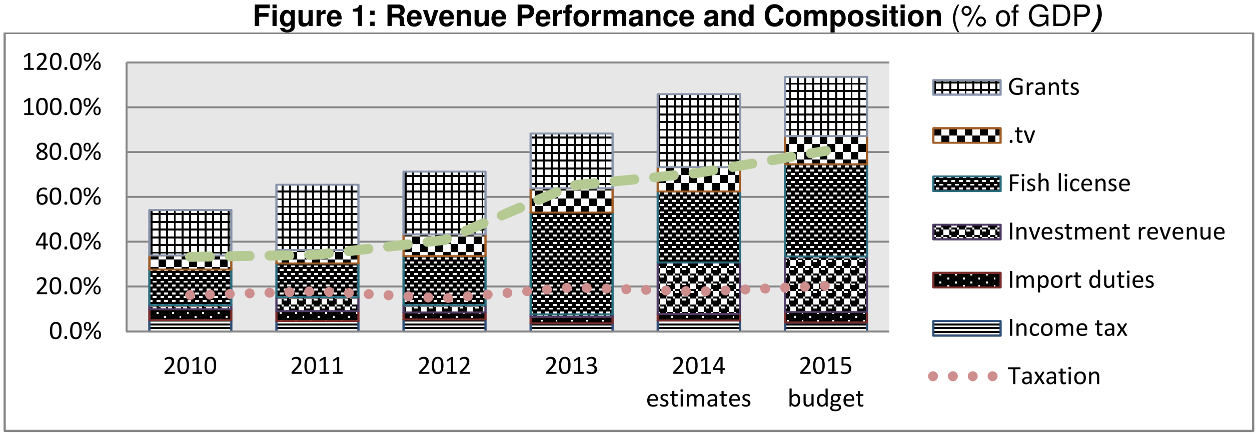
1. Sector Performance, Problems, and Opportunities

1. **Background.** Geographic remoteness and dispersion, a narrow economic base, reliance on external earnings, and a small market naturally limit economic growth in Tuvalu and contribute to macroeconomic volatility. In the absence of a vibrant private sector, high public spending drives growth. Without independent monetary policies, given the adoption of the Australian dollar, and with limited leverage of banking regulation and interest rate policy, the government is reliant on fiscal policy to manage the impact of shocks and stimulate inclusive growth.

2. Tuvalu's growth strategy is set out in the National Strategy for Sustainable Development, 2005–2015, which was developed through an extensive consultative and participatory process with the various island councils, civil society organizations, the private sector, and development partners.[1] The strategy sets eight strategic priorities, including promotion of good governance, macroeconomic growth and stability, employment, and private sector development. The expected outcomes are more employment opportunities, higher economic growth, better health care, better education, better basic infrastructure, and continued social stability.

3. **Revenue policy and performance.** A key challenge for government is the high volatility in several of the country's main revenue sources making it difficult to predict future revenue streams. From 2010 to 2015, the government's revenues including investment returns from the Tuvalu Trust Fund (TTF) have increased as a share of gross domestic product (GDP) from an average of 62% in 2010–2012, to an average of 103% in 2013–2015. This is being driven by strong fishing license revenue performance, good returns from the TTF, backed by budget support contributions from Tuvalu's development partners, including the Asian Development Bank (ADB), the governments of Australia and New Zealand, and the World Bank. The strong revenue performance has enabled the government to rebuild the Consolidated Investment Fund (CIF) from $3.2 million in 2012 to $20.4 million at the end of 2014. The CIF serves as a repository for the automatic distributions from the TTF and acts as a revenue stability mechanism. Withdrawals from the CIF are used to fund the recurrent budget as well as capital investments.[2]

Figure 1: Revenue Performance and Composition (% of GDP*)*



GDP = gross domestic product,
Source: Government of Tuvalu 2010-2015 National Budget

[1] Government of Tuvalu. 2004. *National Strategy for Sustainable Development, 2005–2015*. Funafuti.

[2] The TTF, originally capitalized by donors in 1987, was established to provide additional funding for budget support. The TTF can be withdrawn only if its market value exceeds a "maintained value" indexed to the Australian consumer price index. The TTF board, representing both donors and the government, can transfer the excess to the budget. The CIF serves as a fiscal buffer and deposit account for grants, and can be withdrawn at the government's discretion. The CIF targets a minimum balance equivalent to 16% of the TFF's maintained value to finance post-grant deficits for 4 years. This is based on the assumption that a "dry spell" up to 4 years could occur when no distribution would be made from the TTF.

4. The government is now seeking to improve the way it operates the CIF to better insulate the budget and the economy from external shocks. On the advice of the International Monetary Fund, the government will aim to achieve a "structural fiscal balance"—a surplus of 0.5%–1.0% in 2016–2018—with excess surpluses being transferred into the CIF.[3] To improve its effectiveness as a fiscal buffer, the CIF will be transformed into a fiscal stabilization fund through changes to existing accumulation and withdrawal rules. The cabinet has approved changes to the Financial Instructions under the Public Finance Act to include detailed rules to guide, replenish and regulate the use of the CIF, ensuring that the target CIF savings balance shall be equivalent to 16% of the maintained value of the TTF and regulated through a CIF contributions and savings Plan. This will help avoid ad hoc fiscal tightening and searching for extraordinary revenues during economic downturns, and will strengthen the foundation for policy setting.

5. 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.[4] Fishing license fees reached a record high of $13 million in 2013 because of improved negotiating power under the Vessel Day Scheme. In June 2013, Tuvalu and 14 other countries in the Pacific, renewed a Multilateral Treaty on Fisheries Between Certain Governments of the Pacific Island States and the Government of the United States of America (commonly known as the US Treaty) for US purse seiners to fish in the waters of the Pacific Island countries on an interim basis, which saw the value of the regional US treaty triple from $21 million to $63 million per annum.

6. Owing to the introduction of the Vessel Day Scheme and the establishment of fishing joint ventures with Asian companies, both fishing exports and fishing license fees have more than doubled in 2012–2014, accounting for about 57% of gross domestic product (GDP) in 2014. Foreign aid, including both budget support and off-budget project financing, has also hovered at around half of GDP. However, remittances, which used to be one of the most important sources of foreign exchange inflows, have shrunk dramatically since the global financial crisis, to 10% of GDP compared to the pre-crisis levels of nearly 20%. Imports, which closely correlate with fiscal spending, have been generally stable in 2010–2014.

7. Tax revenue outperformed the budget target largely as a result of improved compliance following a tax audit of public enterprises, the favorable performance of a fishing joint venture, and a value added tax rate increase. These developments were further reinforced by higher-than-expected foreign grants. Current spending was generally restrained, and on-budget capital spending was small, reflecting the government's weak implementation capacity. As a whole, the fiscal surplus reached 27.0% of GDP in 2014.

8. **Expenditure performance.** During 2010–2014, government expenditures grew steadily as offshore revenue rose. Much of the extra spending went to capital projects funded by the government (classified as special development expenditures), a pay increase for civil servants, the Tuvalu Medical Treatment Scheme, and government scholarships. Some of the additional expenditure items were recurrent in nature or incurred some level of recurrent costs that will be difficult to reduce in future. During 2010–2013, government expenditures averaged 85% of GDP, and grants and revenue averaged 85% of GDP. In 2014 expenditures increased to 95% of GDP, with revenue at 124% of GDP.

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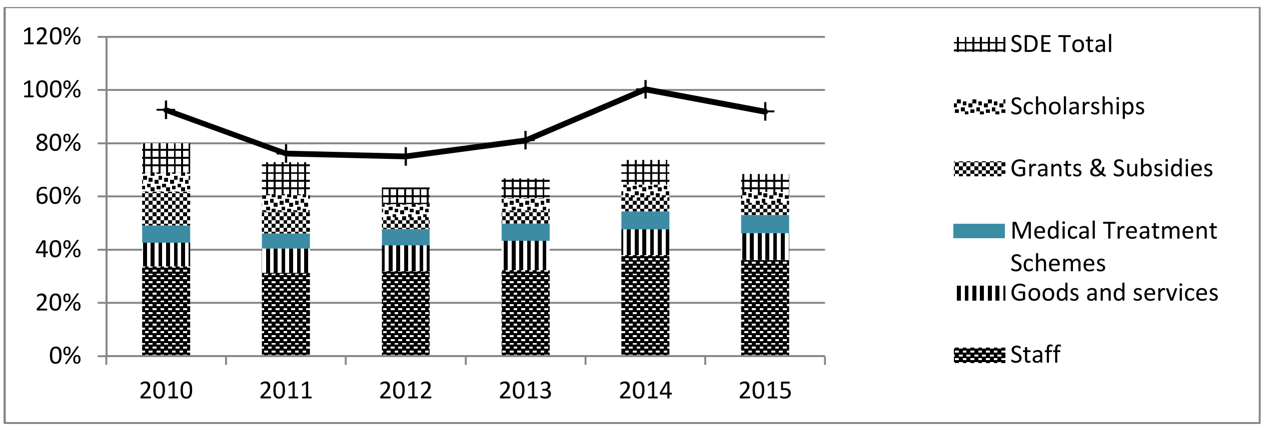
[3] International Monetary Fund. 2014. *Tuvalu: Staff Report for the 2012 Article IV Consultation.* Washington, DC. The structural fiscal balance is derived from breaking down the observed budget result into a cyclical and a structural component.

[4] 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 stimulate competition between distant water fishing nations to purchase units of fishing effort in days. At the ninth Parties to the Nauru Agreement ministerial meeting in Majuro on 12–13 June 2014, ministers agreed to raise the fishing day fee from $6,000 to $8,000 starting on 1 January 2015.

9. High staff costs remain a key source of fiscal pressure in 2015–2018. A wage increase in 2014 saw staff costs increase to 38% of recurrent expenditure. The government has assured development partners that the wage increase in 2014 was necessary given that there has not been any wage increase since 2010. The government is undertaking a phased series of civil service reforms to reduce the wage bill to its target of 30% of recurrent expenditure by 2018. These include the adoption of performance management guidelines to support the performance appraisal and remuneration process in 2015, a wage freeze during 2015–2016, and the implementation of recommendations from a planned wage review in 2016–2017, which will focus on adoption of a wage-setting mechanism to ensure that public sector wage increases are in line with productivity gains in the economy.

10. The National Strategy for Sustainable Development, 2005–2015 identifies basic education, health care, and vocational education as key expenditure priorities (footnote 1). These items receive a very low share of the budget and are largely supported through external contributions. Shifting funds to these priorities requires that resources savings be made elsewhere. Candidates for savings include overseas scholarships, travel expenses, subsidies to public enterprises, and the medical treatment scheme.

Figure 2: Expenditure Performance and Composition
(% of GDP)



GDP = gross domestic product, SDE = special development expenditure.
Source: Tuvalu Government 2010-2015 National Budgets

11. **Procurement**. The 2011 Public Expenditure and Financial Accountability assessment pointed out that efficiency of service delivery is constrained by the lack of a procurement regulatory framework. With ADB's assistance, the government approved the Public Procurement Act 2013. The underlying objectives of the act are (i) to help support the government of Tuvalu in obtaining value for money from its public procurement, and (ii) to help make public procurement cost-effective to implement, recognizing that the economy is small and there are limited private sector providers. The government has also set up the Central Procurement Unit to implement the procurement act.

12. **Public enterprise reform**. Progress has been made in enhancing the governance and performance of public enterprises through improved financial reporting, enforcement of the Public Enterprises Act 2009, and merger and privatization efforts. Nonetheless, given their responsibilities to implement social policies, the poorly managed public enterprises are far from operating on a commercial basis and are mostly making losses despite receiving large government subsidies. A reform plan is needed to put public enterprises on a sustainable footing. The reform package should aim to enhance the enterprises' commercial orientation and financial soundness. In particular, there is a need to clearly define and cost their social responsibilities, which, together with strengthened accounting and auditing practices, would enhance their transparency and accountability.

2. Government's Sector Strategy

13. **Public sector reform strategies.** To address the fiscal and procurement challenges and insulate its fiscal position from revenue volatility and global shocks, the government developed a medium-term fiscal framework in June 2012 in consultation with the International Monetary Fund. The framework is aimed at maintaining fiscal sustainability. It is supported by the government's multiyear Policy Reform Matrix (PRM), which was prepared in March 2012 in collaboration with ADB, the governments of Australia and New Zealand, and the World Bank. The PRM explicitly targets a sustainable fiscal framework through reform actions in six areas: public financial management, fiscal policy, public administration, public enterprise performance and rationalization, and health and education management.

14. **Implementation of sector strategies.** The PRM explicitly targets a sustainable budget framework, which will be accomplished by strengthening fiscal controls, making budgeting and budget execution more effective, improving service delivery, protecting essential social services, reforming the government's public enterprises, and increasing revenue mobilization. Implementation of the PRM will help ease fiscal constraints by boosting economic growth, improving tax collections, reducing nonpriority expenditure, and unlocking additional budget support.

3. ADB Sector Experience and Assistance Program

15. **ADB support.** ADB's support will continue to focus on effective fiscal management because poor expenditure allocation decisions have significant opportunity costs in small sized economies such as Tuvalu. ADB's first policy-based lending program to Tuvalu in 2008—the Improved Financial Management Program—was instrumental in addressing weaknesses in government oversight and corporate governance and management. The second program in 2012—Strengthened Public Financial Management Program—built upon the success of the first program and supported the government's efforts to exercise sound macroeconomic and fiscal management, exert fiscal discipline so that government budgets are fiscally sustainable, and strengthen and improve public enterprise management.[5] Both projects are rated as successful.[6]

16. ADB's Interim Pacific Approach 2015, which serves as the country partnership strategy for Tuvalu, recognizes strengthened public sector management and an improved private sector environment as key drivers of change.[7] ADB's country operations business plan, 2015–2017 for Tuvalu focuses on strengthening public financial management to help the government manage its financial resource better as well as improve public expenditure management, which is critical for restoring fiscal sustainability and stimulating economic growth.[8] These objectives are aligned with Tuvalu's growth strategy as set out in the National Strategy for Sustainable Development, 2005–2015, particularly strategic areas of good governance and macroeconomic growth and stability.

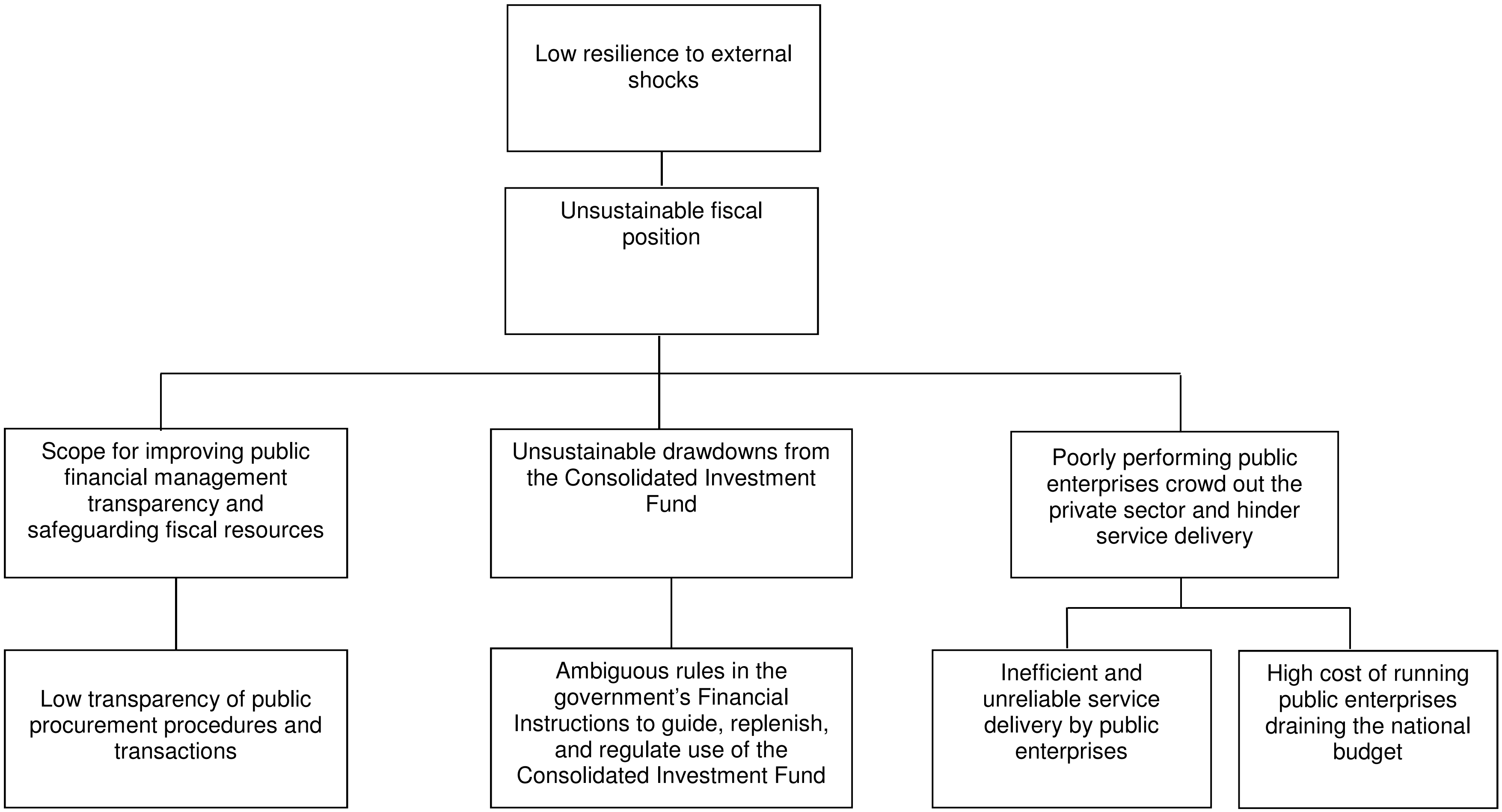
[5] ADB. 2008. *Report and Recommendation of the President to the Board of Directors: Improved Financial Management Program.* Manila; ADB. 2012. *Report and Recommendation of the President to the Board of Directors: Proposed Grant to Tuvalu for the Strengthened Public Financial Management Program*. Manila

[6] ADB. 2012. *Improved Financial Management Program Completion Report*. Manila; ADB. 2014. *Strengthened Public Financial Management Program Completion Report*. Manila.

[7] ADB. 2015. *Interim Pacific Approach*. Manila.

[8] ADB. 2014. *Tuvalu Country Operations Business Plan, 2015–2017*. Manila.

Problem Tree for Public Sector Management



Sector Results Framework (Public Sector Management, 2016–2018)

Country Sector Outcomes		Country Sector Outputs		ADB Sector Operations	
Outcomes with ADB Contribution	**Indicators with Targets and Baselines**	**Outputs with ADB Contribution**	**Indicators with Incremental Targets**	**Planned and Ongoing ADB Interventions**	**Main Outputs Expected from ADB Interventions**
Sound macroeconomic management through strengthened and sustainable fiscal discipline, corporate governance, and public enterprise reforms	National budget deficits not to exceed sustainable levels of 2-3% of GDP. (Baseline: surplus of 27% in 2014) Increase private sector share of GDP by 50% by 2015. (Baseline: 24% in 2013) External debt not to exceed 60% of GDP. (Baseline: 52% in 2014)	Strengthened public procurement practices Sustainability of the fiscal buffer strengthened Strengthened commercial footing for public enterprises and private sector development	Procurement annual report for 2014 developed and submitted to Cabinet Government procurement website developed and launched The revised Financial Instructions under the Public Finance Act approved by Cabinet. Cabinet approval of the PERP Cabinet approval of the concession sale of the VLH, VLH land surveyed, and preparation of sale and tender documents Cabinet approval of the PWD rationalization strategy	**Planned target subsectors** Public expenditure and fiscal management (70%) Reform of Public Enterprises (30%) **Pipeline projects with estimated amounts** Strengthening Fiscal Sustainability TA in 2017 ($0.6 million) **Ongoing projects with approved amounts** Strengthened Fiscal Sustainability Program ($2.0 million) Institutional Strengthening of the Ministry of Finance and Economic Development ($1.2 million)	**Planned target subsectors** Improved macroeconomic management Improved public expenditure and fiscal management **Pipeline projects** Improved public expenditure and fiscal management **Ongoing projects** Improved public expenditure and fiscal management

ADB = Asian Development Bank, CIF = Consolidated Investment Fund, GDP = gross domestic product, PERP = public enterprise reform plan, PWD = public works department, TA = technical assistance, VLH = Vaiaku Lagi Hotel.
Source: Asian Development Bank