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Report No. 124638-TV

INTERNATIONAL DEVELOPMENT ASSOCIATION

PROGRAM DOCUMENT

FOR A

PROPOSED DEVELOPMENT POLICY GRANT

IN THE AMOUNT OF SDR 5.2 MILLION (US$7.5 MILLION EQUIVALENT) TO

TUVALU

FOR THE

FOURTH DEVELOPMENT POLICY OPERATION

August 3, 2018

Macroeconomics and Fiscal Management Global Practice
Country Management Unit for Papua New Guinea and Pacific Islands
East Asia and Pacific Region

TUVALU -GOVERNMENT FISCAL YEAR
January 1 – December 31

CURRENCY EQUIVALENTS
(Exchange Rate Effective as of March 31, 2018)

Currency Unit – Australian Dollar (AU$)
US$1.00 = AU$1.25
SDR 1 = US$1.45

ABBREVIATIONS AND ACRONYMS

AU$	Australian Dollar
ADB	Asian Development Bank
ANS	Assessment of National Systems
CIF	Consolidated Investment Fund
DBT	Development Bank of Tuvalu
DHS	Demographic Health Survey
DPO	Development Policy Operation
DSA	Debt Sustainability Analysis
ECCE	Early Childhood Care and Education
EGRA	Early Grade Reading Assessment
EU	European Union
FTF	Falekaupule Trust Fund
GDP	Gross Domestic Product
GoT	Government of Tuvalu
GRS	Grievance Redress System
HIES	Household Income and Expenditure Survey
HIPC	Heavily Indebted Poor Countries
IBRD	International Bank for Reconstruction and Development
IDA	International Development Association
IFC	International Finance Corporation
IMF	International Monetary Fund
MOE	Ministry of Education
MOFED	Ministry of Finance and Economic Development
MOH	Ministry of Health
MP	Member of Parliament
NBT	National Bank of Tuvalu
NCD	Non-Communicable Disease
NSSD	National Strategy for Sustainable Development
NZ$	New Zealand dollar
NZIPR	New Zealand Institute for Pacific Research
OBAA	Objective-based Asset Allocation
OI	Outer Islands
PCRAFI	Pacific Catastrophe Risk Assessment and Financing Initiative
PE	Public Enterprise
PEARL	Pacific Early Age Reading and Learning Program
PER	Public Expenditure Review
PFM	Public Financial Management
PILNA	Pacific Islands Literacy and Numeracy Assessment
PNA	Parties to the Nauru Agreement
PRM	Policy Reform Matrix
RPF	Regional Partnership Framework
SCD	Systematic Country Diagnostic
SDR	Special Drawing Rights
SIOP	Statement of Investment Operations and Procedures
SPREP	Secretariat of the Pacific Regional Environment Program
TKIII	Te Kakeega III
TESP	Tuvalu Education Sector Plan
TMTS	Tuvalu Medical Treatment Scheme
TSF	Tuvalu Survival Fund
TTF	Tuvalu Trust Fund
UNDP	United Nations Development Program
US$	United States Dollar

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TUVALU – FOURTH DEVELOPMENT POLICY OPERATION

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SUMMARY OF PROPOSED GRANT AND PROGRAM
TUVALU
FOURTH DEVELOPMENT POLICY OPERATION

Borrower	Tuvalu
Implementation Agency	Ministry of Finance and Economic Development
Financing Data	SDR 5.2 million (US$7.5 million equivalent) IDA Grant. Standard IDA Grant terms.
Operation Type	The proposed operation is the second in a programmatic series of two development policy operations. It will be provided in a single tranche.
Pillars of the Operation and Program Development Objective(s)	First pillar: Improving the delivery of education and health services through: i) enhancing inclusiveness and equity of secondary education; and ii) reducing risk factors for non-communicable diseases. Second pillar: Improving macroeconomic sustainability through: i) strengthening the management of reserve assets; ii) improving the effectiveness of payroll controls and linkages to the budget; and iii) enhancing banking sector oversight and sustainability.
Result Indicators	Indicator #1: Increased enrolment in secondary education • Baseline (2015): Gross secondary enrolment rate (total/male/female) = 66.7/57.5/76.8 percent • Target (2019): Gross secondary enrollment rate (total/male/female) at least 5 percentage points higher Indicator #2: Increase in relative price of tobacco, alcohol and added-sugar drink products • Baseline: 2017 = no change • Target: Increase in the average price of these products from 2017 to 2019 exceeds overall CPI inflation rate over the same period by 2 percent Indicator #3: International best practice applied to TTF investment management • Baseline (2015): Investment managers not selected on competitive basis and annual management fee average 63 basis points • Target (2019): Investment managers selected on competitive basis and annual management fee reduced by 20 basis points Indicator #4: Adopting a medium-term perspective to civil service pay changes in budget documentation • Baseline (2017): Budget documentation does not clearly identify three-year ahead costs of changes in civil service pay policy • Target (2019): Budget documentation reports estimated costs of such policy changes, if any Indicator #5: Increased oversight of the banking sector • Baseline (2014): No regular monitoring • Target: 2019 = Monitoring reports are produced at least annually, including information on non-performing loans, and tabled to the Cabinet for information
Overall risk rating	Substantial
Climate and disaster risks	Yes ☒ No☐
Operation ID	P161867

IDA PROGRAM DOCUMENT FOR A PROPOSED GRANT TO TUVALU

1. INTRODUCTION AND COUNTRY CONTEXT

1. **The proposed development policy operation (DPO) of US$7.5 million equivalent is the second of a programmatic series of two DPOs.** Building on the first DPO, the proposed operation continues to support the reform agenda of the Government of Tuvalu (GoT) in the critical areas of: (i) improving health and education service delivery; and (ii) building macroeconomic sustainability. These two areas are central to the GoT's National Strategy for Sustainable Development (NSSD) or Te Kakeega III (TKIII), and to the Regional Partnership Framework (RPF) for nine small Pacific Island Countries FY2017-FY2022 (Report #120479) including Tuvalu. The DPO is part of a coordinated budget support mechanism through which Australia, New Zealand, the Asian Development Bank (ADB), and the European Union (EU) also provide budget support[1].

2. **The proposed DPO focuses on improving the delivery of education and health services and improving macroeconomic stability.** The reforms under the first pillar, improving social service delivery, are focused on improving longer-term education outcomes through supporting improved early childhood education and care (ECCE); and supporting improved health sector outcomes through reducing risk factors for non-communicable diseases (NCDs). The reforms under the second pillar of the operation aim at improving macroeconomic stability through strengthening the investment management of the country's reserve assets; improving the costing and budgeting for public sector wage-bill decisions; and operationalizing the framework for banking oversight. Financing provided through this operation will continue to directly support the maintenance of fiscal buffers and meet Tuvalu's long-term financing needs. The operation will also sustain the reform momentum built throughout the previous operations in the current and the previous programmatic series of DPOs.

3. **The government returned in the 2015 elections has continued since then, affording a stable political environment.** The next general election is scheduled for 2019. The politics of Tuvalu take place in a framework of a parliamentary representative democratic monarchy, whereby the British monarch is the head of state, represented by the Governor General, while the Prime Minister (elected by the parliament by secret ballot) is the head of government. Executive power is exercised by the government. There are 15 Members of Parliament (MPs), including one female, in the unicameral legislature, each serving a four-year term. Traditional chiefs also still play a significant role in influencing island affairs, particularly on the Outer Islands (OIs).

4. **Tuvalu's economic development is manifestly affected by its very small size, geographic isolation and related economic conditions.** Tuvalu is comprised of three reef islands and six atolls. With a total land area of only 26km^2 and a population of 11,000, it is one of the smallest and most remote states in the world. The private sector is small and undeveloped (consisting mainly of small firms in the wholesale and retail sectors), and has struggled to grow – partly due to the inherent lack of economies of scale and high transaction costs resulting from the dispersion of a small population across nine islands. The public

[1] Based on discussions to date, the indicative disbursement amounts for 2017 from development partners based on PRM IV are as follows: EU, Euro 2 million; Australia, AU$1.5 million; and New Zealand, NZ$0.5 million.

sector is the main driver of economic activity, accounting for around 36 percent of GDP in 2015[2], as well as the majority of formal sector employment. Agriculture contributed around 19 percent of GDP in the same year. 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 and cyclones, as well as the effects of El Niño have also had a further negative effect on crop yields and the contribution of this sector to the economy. 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 shifting with demand for seafarers disappearing – partly offset by increased opportunities related to temporary labor schemes offered by regional partners.

5. **As is the case with many other small, open and import-dependent economies, Tuvalu is highly vulnerable to exogenous economic shocks and price spikes.** Natural disasters such as cyclones, king-tides, and droughts are relatively frequent and devastating occurrences in Tuvalu. Given the small size of the economy in nominal terms, these exogenous shocks have the potential to significantly impact fiscal outcomes. Tropical Cyclone Pam, for example, resulted in AU$14 million in damages and losses, equivalent to around 30 percent of GDP in 2015. Therefore, maintaining adequate buffer assets is critical to Tuvalu's ability to absorb inevitable future shocks[3].

6. **With no monetary independence[4], a high level of import dependency and minimal financial infrastructure, fiscal policy, supported by the Tuvalu Trust Fund (TTF) and Consolidated Investment Fund (CIF), is the main tool available for the GoT to manage the economy.** Tuvalu's fiscal position has historically been very tight with regular fiscal deficits providing limited space for government investment or operations, particularly in times of crisis. The combination of volatile revenues, exposure to shocks, and expenditure rigidity have resulted in large swings in fiscal deficits over the years. The TTF and its auxiliary fund, the CIF, are the main stabilizing tools for volatile fiscal outcomes, with adequate buffers in these funds key to both smoothing shocks and providing long-term budget financing. The TTF is a capital preserving fund established to contribute to Tuvalu's fiscal sustainability. Surplus returns on the investments of the TTF are accumulated in the CIF. Funds in the CIF are generally sufficient to provide a limited, regular source of funding for the budget, and provide a fiscal buffer at times when TTF earnings are low or when unexpected financing gaps arise. In addition, the Tuvalu Survival Fund (TSF) was established recently to finance climate change adaptation and recovery.

7. **Tuvalu's limited economic opportunity, coupled with vulnerability to shocks, poses risks to achieving and sustaining gains in poverty reduction and inclusive growth.** A series of shocks including natural disasters, global economic crises and increasing prices have led to living standards stagnating, and on some measures, poverty increasing, particularly for the OIs, while NCDs present an ongoing risk to health for a large segment of the population. Obesity is a serious problem, and disproportionately affects women, with the latest Demographic and Health Survey (DHS) showing 46 percent of men and 68 percent of women were obese. However, the latest available Household Income and Expenditure Survey (HIES)[5] shows that just a small proportion (3.3 percent) of the population were living below the international

[2] Based on latest available data.
[3] The GoT has officially requested a Catastrophic Deferred Drawdown Option following completion of the current DPO series.
[4] Tuvalu does not have a central bank, and uses the Australian dollar as its currency.
[5] Another HIES was conducted in 2015/16, but analyses to derive poverty estimates are yet to be completed.

poverty line of US$1.90[6] per person per day in 2010. A similar share (3.4 percent) experienced food poverty, down from 4.9 percent in 2005. On the other hand, 26.3 percent of the population experienced material deprivation (benchmarked against the local cost of basic needs), up from 21.2 percent in 2005. The ratio of the average consumption of the top 60 percent of households against the bottom 40 percent is estimated at 3.5 based on HIES[7] data, which is significantly below the cross-country median of 4.7. Poverty is generally concentrated in the OIs and the gap with the capital Funafuti has increased over time[8]. Lack of access to services, employment opportunities and remittances, and exposure to shocks (such as food price shocks) are some of the factors underlying vulnerability to poverty. Female headed households are less likely to be identified as poor on average, although women's share of paid employment in particular is lower than men's, despite a relatively high level of access to education.

8. **The GoT has laid out an agenda to address these challenges and improve macroeconomic sustainability**. As set out in the TKIII, the GoT has been and will continue to focus on ensuring continued provision of adequate services to all Tuvaluans and pursuing both revenue and expenditure efficiencies (as reflected in the policy areas supported by this operation). The GoT has put together a medium-term development matrix including reforms in key areas of focus. These measures are in turn aimed at reducing vulnerabilities, easing fiscal constraints, and enhancing the effectiveness of key government programs, including in both health and education, and are articulated in the government's Policy Reform Matrix (PRM).

9. **This second operation of a programmatic series is expected to support the GoT's development objectives and contribute to the improved wellbeing of Tuvaluans, while supporting the maintenance of buffers to meet long-term financing needs.** Drawing from the PRM, reforms to improve health and build macroeconomic sustainability have been identified as critical areas to support. The supported reforms under the first pillar are to increase taxes on consumption goods that contribute to NCD risks and to begin to process of bringing the ECCE sector under the purview of the Government, via its Ministry of Education. These reforms will, over time, help to reduce NCD risk factors and improve quality of quality of education at entry to formal school and subsequent education participation rates, and are expected to will disproportionately benefit the poor as the impact is felt over time. The supported reforms under the second pillar, building macroeconomic sustainability, are to implement a new process of medium-term budgeting for government wage-bill costs, to implement reforms to TTF institutional arrangements, and to operationalize the Banking Commission. These reforms are expected to contribute to reduced poverty and improved social outcomes in Tuvalu by increasing the capacity for enhanced and sustainable public service provision, and the ability for the government to respond effectively to shocks. This will benefit particularly those living on the OIs, where some of Tuvalu's poorest households reside. Financing provided through the operations will support the maintenance of buffers to meet long-term financing needs, including those arising from future climate-related shocks.

10. **The proposed operation carries risks stemming from thin institutional capacity in the GoT, and an uncertain external and domestic 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

[6] In 2011 Purchasing Power Parity prices.
[7] As presented in the Global Income Dynamics Dataset
[8] The 2012 National Population and Housing Census notes that in the decade to 2012, the relative proportion of the population living in the capital (and only urban centre), Funafuti, has grown by more than 10 percentage points.

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 and domestic risks stemming from financial market volatility, commodity price volatility, uncertain external aid environment and slower domestic policy reform could place a strain on Tuvalu’s fiscal situation. The Bank will continue to engage in dialogue with the authorities and the International Monetary Fund (IMF) to monitor macroeconomic risks and provide policy advice as needed. Finally, Tuvalu’s high degree of vulnerability to external shocks, including from natural disasters, poses a risk to the operation. Whenever Tuvalu experiences a major natural disaster, its macroeconomic stability can be threatened and large parts of the bureaucracy will have to shift their attention to disaster recovery and reconstruction plans. This is partly mitigated by separate reforms currently underway to increase disaster preparedness.

2. MACROECONOMIC POLICY FRAMEWORK

2.1 RECENT ECONOMIC DEVELOPMENTS

11. Tuvalu’s macroeconomic performance has been favorable over recent years, owing to strong fishing license revenues and increased capital investments. Real GDP growth is estimated at 3.0 percent in 2016 (down from 9.1 percent in 2015), and is expected to increase slightly to 3.2 percent in 2017, reflecting the impact of ongoing public works. Inflation increased to 4.4 percent year-on-year in 2017 driven by higher oil prices and increases on consumer prices for transportation and imported food. Government and donor funded investments, including outer island school and clinic projects have also contributed to the pick-up in growth over recent years. Credit growth moderated to 6 percent in 2017 from 13 percent in the previous year, with supply constrained by a high level of NPLs with state-owned enterprises (SOEs).

12. Tuvalu has prudently maintained post-grant fiscal surpluses over recent years, owing to stronger revenue collections, building up fiscal buffers. Except for 2017, when a sharp drop in fishing license fees led to a small deficit, the overall budget balance after grants has been in surplus in recent years. Tax mobilization has been broadly stable, albeit with a temporary spike in corporation taxes in 2015 arising from higher fishing joint venture profits in that year, and strengthening of indirect taxes in 2017. Nevertheless, Tuvalu has a very narrow domestic economic base and over three-quarters of domestic revenues are not taxes but non-tax revenues (rents) derived principally from oceanic fisheries and dot.tv internet domain license fees. External grants are also a critical source of budget financing.

13. While revenues have spiked in recent years, major sources such as fishing license fees are inherently volatile in nature. Fishing license fees have increased dramatically in recent years, from 22 percent of GDP in 2012 to nearly 70 percent of GDP by 2016. This large rise in fisheries revenues reflects a combination of structural and cyclical factors. The full implementation of the Vessel Day Scheme from 2012 onwards has seen an increase in the value captured by participating Pacific island nations, more generally. More recently, the appreciation of the US Dollar against the Australian dollar and high fish stocks in Tuvalu water due to El Niño weather patterns have also contributed to this increase. However, these revenues are very volatile, and in 2017 they fell back to around 50 percent of GDP.

14. Given the volatile nature of Tuvalu's domestic revenues, development assistance has been, and continues to be, essential to support the delivery of adequate public services and good fiscal management. Development grants amount to between 20 and 50 percent of GDP from year to year and are thus key in covering the budget deficit. The overall budget balance before grants has remained in deficit by a considerable margin. Considering the role of international partners in establishing the TTF framework, overall, development assistance contributes significantly to the health of Tuvalu's public finances and over time could help to increase Tuvalu's fiscal independence.

Table 1. Tuvalu: Selected Social and Economic Indicators 2015-20

	2015 Est.	2016 Est.	2017 Est.	2018 Proj.	2019 Proj.	2020 Proj.
Real sector	(Percent change unless otherwise indicated)					
Real GDP growth	9.1	3.0	3.2	4.3	4.1	4.4
Consumer prices (end of period)	4.0	2.6	4.4	4.0	3.4	2.6
Money and credit	(Percent change, unless otherwise indicated)					
Deposits	2.0	…	…	…	…	…
Credit 1/	3.0	13.0	6.0	6.0	5.0	7.0
Lending interest rate (in percent)	9.1	…	…	…	…	…
Balance of payments	(In millions of Australian dollars, unless otherwise indicated)					
Current account balance	-24.9	11.3	3.2	2.9	-0.6	-7.3
(In percent of GDP)	-53	23	6	5	-1	-11
Exports of goods and services	6.6	6.9	6.9	6.8	7.3	7.9
Imports of goods and services	107.6	73.0	81.1	93.5	92.7	99.5
Current transfers (net)	37.6	33.3	41.9	34.8	46.4	44.8
Capital and financial account balance	34.8	2.5	-1.1	5.1	4.9	5.3
Capital transfers (net)	8.9	11.3	8.5	6.3	6.7	6.6
Gross Official Reserves 2/	57	70	73	81	85	83
(In months of next years' imports)	9	10	9	10	10	10
Debt indicators	(In percent of GDP, unless otherwise indicated)					
Public Sector Debt	57	47	37	28	22	17
Of which: foreign-currency denominated	53	45	37	28	22	17
Exchange rates						
Australian dollars per U.S. dollar (period average)	1.33	1.34	1.30	…	…	…
End-period	1.38	1.36	1.31	…	…	…
Real effective exchange rate (2010=100)	104	108	113	…	…	…
Nominal GDP (In millions of Australian dollars)	47	49	53	57	61	66

Sources: Tuvalu Authorities, IMF and World Bank staff estimates
1/ Banks' and pension fund lending to non-government domestic sector
2/ Defined as the sum of foreign assets in the National Bank of Tuvalu, the balance of the CIF, and SDR holdings

15. Government expenditures have also grown markedly, in line with the increased fiscal space. From only 6 percent of GDP in 2012, public investment expenditure has risen sharply, reaching 28 percent of GDP in 2017. Current expenditure has grown from 69 percent of GDP in 2012 to peak at 112 percent in 2016, before falling back to 96 percent in 2017. While these changes seem dramatic, two factors help explain this trend in a country like Tuvalu. Firstly, the government copes with extreme volatility by, as much as possible, living within a current revenue envelope. In previous years when receipts were low, capital expenditure was under-budgeted, with a growing infrastructure deficit. Secondly, new capital spending items often have a minimum scale which makes them look disproportionately large in a very small country. For instance, while capital expenditure stood at 28 percent of GDP in 2017, this translates to AU$15 million or US$11.5 million. That said, while much of this increased expenditure is addressing high-priority needs, the rapid scale-up in expenditure may also present some sustainability and expenditure quality risks. Although on both the current and capital side of the budget, expenditure levels were higher in 2016 due to post-cyclone recovery, certain programs with high unit costs, such as the Tuvalu Medical Treatment Scheme (TMTS), which finances tertiary treatments overseas, continue to rise and have persistently exceeded their budgeted amount. In 2017, the TMTS alone constituted 11 percent of all current government expenditure, and exceeded the budgeted amount by more than 60 percent. Wages and salaries contracted by 1.1 percentage points of GDP in 2017, after rising by 4 percentage points in 2016.

Box 1. Building Resilience: The Tuvalu Trust Fund and associated funds

The TTF was established in 1987 to provide a long-term source of funding for recurrent expenditures and to set the country on a path towards greater financial autonomy. The TTF was capitalized by development partners (initial contributors included Australia, New Zealand, the United Kingdom, Japan and South Korea), and the GoT in 1988. The TTF is not fully sovereign with the Australian and New Zealand governments represented on its Board.

The TTF is a capital-preserving fund that only distributes returns that exceed a 'maintained value' that grows in line with the Australian Consumer Price Index (CPI). In surplus years, the TTF is typically supplemented by contributions by the GoT from the CIF; and this has supported growth of the TTF over time. Conversely, distributions are transferred to the CIF for use as budget financing when needed.

Since the capital of the TTF is invested in international financial markets, annual investment returns have typically shown high levels of volatility, and when a negative shock moves the TTF below its maintained values, it does not distribute again until it reaches the maintained value again. In 10 out of the past 25 years, the TTF did not make distributions to the CIF (post 1987, 2000 and 2008 crises).

Figure 1: TTF balance

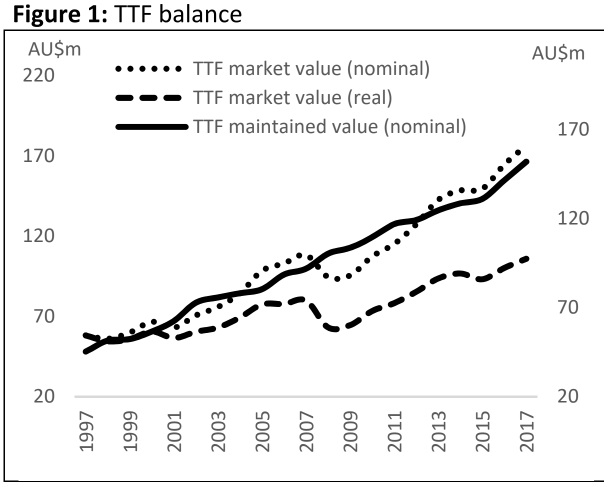
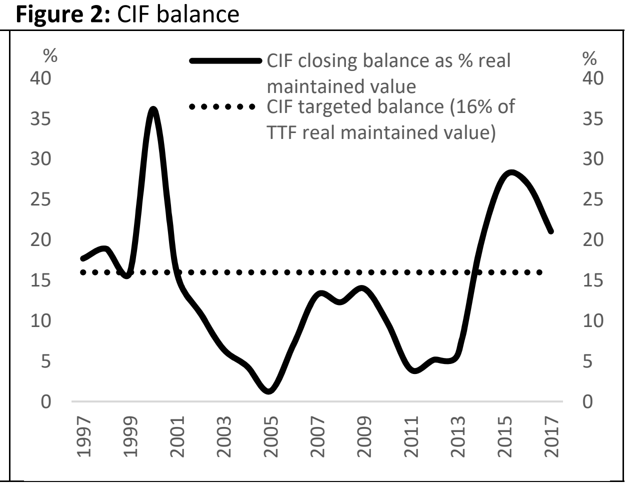


Figure 2: CIF balance



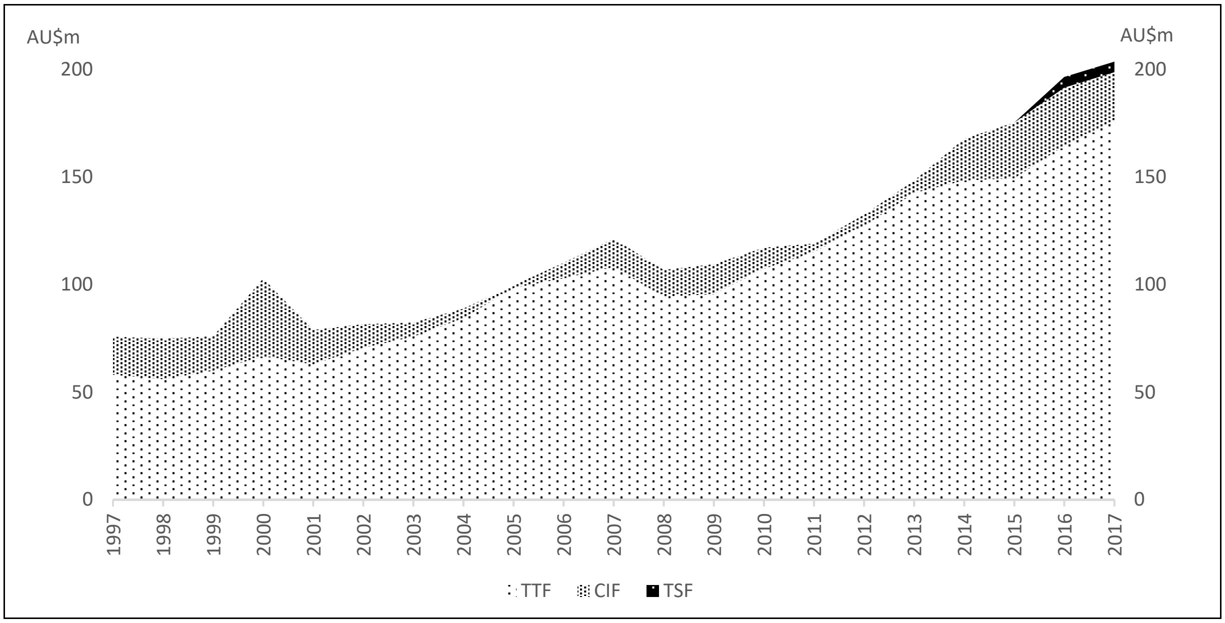
Source: World Bank staff estimates based on data provided by the authorities.

The CIF, which is under full control of the government, provides a budget financing buffer and targets a minimum balance equivalent to 16 percent of the TTF's real maintained value (or around 45-50 percent of GDP, which would enable GoT to continuously finance post grant deficits of around 11 percent of GDP for four years). This is based on the assumption that a "dry-spell" up to four years which could occur where no distribution would be made from the TTF. In recent years, the closing balance of the CIF has declined (although in end-2017 remained at 21 percent of the real maintained value of the TTF, primarily reflecting transfers to the higher-return TTF and the TSF.

The Falekaupule Trust Fund (FTF) and the Tuvalu Survival Fund (TSF) run in parallel to the TTF. The local governments (Kaupules) together with donor partners capitalized the FTF, which aims to provide a sustainable source of funding for OI development. It is fully governed by the Kaupules, and makes distributions to the Kaupules when the market value exceeds the maintained value. The TSF was established in 2016 to finance climate change adaptation and to enable the government to respond rapidly to natural disaster shocks.

The combined value of the TTF, TSF and CIF has increased substantially over recent years (by 91 percent in the decade to 2017), and this build-up of assets provides the GoT with flexible buffers to address both short-term financing gaps, and the scaling-up of reserve assets over the longer-term – increasing the country's resilience to shocks.

Figure 3: Total value of reserve assets (AU$ million, Sept. 30, 2017)



Source: World Bank staff estimates based on data provided by the authorities

16. Higher domestic revenues combined with development assistance have nevertheless helped Tuvalu build resilience. The government has tried to maintain post-grant surpluses in recent years. These surpluses have been used to replenish the CIF and, more recently, to capitalize the TTF and newly established TSF. This has enabled the CIF to recover its value after providing budget financing in difficult years in the wake of the global financial crisis and to grow the total asset value of Tuvalu's trust funds. At end-2017, assets in the CIF stood at AU$22 million, while the value of the TTF rose to AU$177 million in 2017, and the TSF was capitalized with AU$5 million. The combined value of the government's short and longer-term fiscal buffers increased from AU$168 million in 2013 to AU$204 million by the end of 2017. The public debt stock in end-2017 is estimated at 37 percent of GDP.

17. The current account, which is driven by volatile income flows from non-residents, is estimated to have been in surplus in 2016 and 2017. Tuvalu runs a structural trade of goods and services deficit which was unusually high in 2015 due to elevated disaster-reconstruction imports, and was around 70 percent of GDP in 2016 and 2017. In most years, this deficit is more than offset by fishing license fees, .tv domain license fees, investment income and development grants. While a significant contributor in the past, the labor market for Tuvalu's seafarers has collapsed in recent years (owing to increased international competition), and remittances have fallen to a negligible level. Steady returns on assets invested in the TTF have resulted in higher income flows, as have record fishing license revenues and fish export earnings. Gross reserves remain ample, covering nine months of imports in 2017.

18. The use of the Australian dollar remains broadly appropriate. The 2018 Article IV concluded that the external position is broadly in line with medium-term fundamentals and the use of the Australian dollar remains appropriate. Despite data limitations to carry out a full external assessment, the IMF notes that based on gross international reserve levels and projections, there is no evidence of external imbalance. The IMF note that Tuvalu's REER appreciated by 5 percent in 2017, while the NEER has depreciated as the Australian dollar weakened.

2.2 MACROECONOMIC OUTLOOK AND DEBT SUSTAINABILITY

19. The Tuvaluan economy is expected to grow moderately and economic performance will remain dependent on the public sector and donor-funded expenditures. Domestic value-added by the private sector is severely constrained by the geographical realities, and the greatest opportunities lie offshore or overseas. Over the next three years, real growth is projected to be in the 4.0 to 4.5 percent range: slightly above the rate in the last two years as economic activity is raised by the growing public investment program. Inflation is expected to fall from its peak of 4.4 percent in 2017 to 4.0 percent this year, and towards 3.5 percent in future years as oil price pressures ease in the outer years. Income flows such as fishing license revenues are volatile and difficult to predict. One-off factors should boost fishing revenues in 2018, but beyond that there is a good chance they will decrease from their recent peak as migratory routes of tuna change across the Pacific (in line with weather patterns).

20. A moderate current account deficit is projected to emerge over the next three years. The deficit in goods and services is expected to rise as a slight increase in exports (largely unprocessed fish catch) is more than offset by higher imports. As mentioned, fishing licenses fees should be higher in 2018 due to a one-off payment of revenues accumulated since 2012 in a sub-regional facility under the Parties to Nauru Agreement (PNA). From 2019 onwards, income from abroad is expected to fall back to around 2017 levels. Despite a higher level of budget support in 2018, overall transfers are expected to be lower in 2018, driven by a fall in off-budget grants. Although remittances have declined since the Global Financial Crisis, the employment outlook is becoming more positive given the opening of the Australian seasonal labor scheme for the service industry. Overall, Tuvalu is expected to see a slightly lower current account surplus in 2018, turning to a deficit in 2019 and 2020. International reserves are expected to remain ample over the medium-term, not falling below ten months of import cover.

Table 2. Tuvalu: Government Budget 2015-20

	2015 Est.	2016 Est.	2017 Est.	2018 Proj.	2019 Proj.	2020 Proj.
	(In percent of GDP, unless otherwise indicated)					
Total revenue and grants	136.2	138.8	120.8	159.6	113.1	106.2
Tax revenue	19.1	14.3	17.0	15.8	14.8	15.2
Direct taxes	10.6	6.1	7.5	7.0	8.2	9.1
Indirect taxes	8.5	8.2	9.4	8.8	6.6	6.1
Non-tax revenue	85.1	98.0	81.1	101.8	67.2	63.7
Of which: fishing license fees	51.0	67.3	49.1	78.9	45.9	44.0
Of which: .TV domain license fees	12.8	12.2	15.1	12.3	11.5	10.6
Grants	34.0	24.5	24.5	42.1	31.1	27.3
Total expenditure and net lending	121.3	130.6	124.5	154.4	118.0	100.8
Current expenditures	100.0	112.2	96.2	101.8	101.6	100.1
Wages and salaries	34.0	38.8	37.7	42.1	39.3	39.4
Goods and services	27.7	42.9	26.4	28.1	27.9	25.8
Subsidies and transfers	48.1	44.2	32.3	31.0	26.9	26.4
Interest payments	0.1	0.1	0.1	0.1	0.1	0.4
Capital expenditures and net lending	23.4	18.4	28.3	50.9	16.4	10.6
Overall balance (excl. grants)	-19.1	-16.3	-28.3	-36.8	-36.1	-31.9
Overall balance (incl. grants)	14.9	8.2	-3.8	5.3	-4.9	-4.6
Primary balance	14.8	8.1	-3.9	5.2	-5.0	-5.0
General government financing	-14.9	-6.1	3.8	-7.0	4.9	4.6
External (net)	0.0	-2.0	-1.9	-1.8	-0.8	-1.5
Domestic (net)	0.0	0.0	0.0	0.0	0.0	0.0
CIF (net, -=increase)	-14.9	-6.1	3.8	-5.3	5.7	6.1
Memorandum items						
Total stock of Trust Fund balances	175.3	196.5	204.1	221.2	226.3	244.3
Stock of TTF (AU$ millions)	149.5	164.6	176.5	179.6	182.4	197.1
Stock of CIF (AU$ millions)	25.9	27.0	22.3	33.6	33.6	34.0
Stock of TSF (AU$ millions)	0.0	4.9	5.3	8.0	10.4	13.2

Sources: Tuvalu authorities, World Bank and IMF staff estimates and projections

21. After a projected surplus in 2018 driven by one-off revenues, the post-grant fiscal position is expected to return to deficit. In the decade to 2016, Tuvalu returned pre-grant structural fiscal deficits averaging 29.1 percent of GDP, and the pre-grant deficit is expected to continue into the future, particularly if fisheries receipts decline. Although policy measures are expected to support some additional domestic revenue mobilization, the tax base is narrow and scope for further growth is limited. TTF distributions, which have been made for the last three years, were possible because the market value of the TTF exceeded its maintained value. With an uncertain outlook for financial markets, the level of future TTF distributions is equally as uncertain, and development grants will continue to play a critical role in filling a financing gap in 2018 and beyond. Grants are expected to cover the majority of financing shortfalls, particularly with IDA resources for Tuvalu substantially expanded from 2018. The small budget deficit that is projected for 2019 and 2020 would be financed by the CIF. Even with conservative TTF distribution assumptions, the balance in the CIF is projected to grow in 2018, and then be maintained in the outer years. The value of the TTF is expected to grow gradually, but in the absence of additional contributions, may not quite reach the Government's target of reaching AU$200 million by 2020.

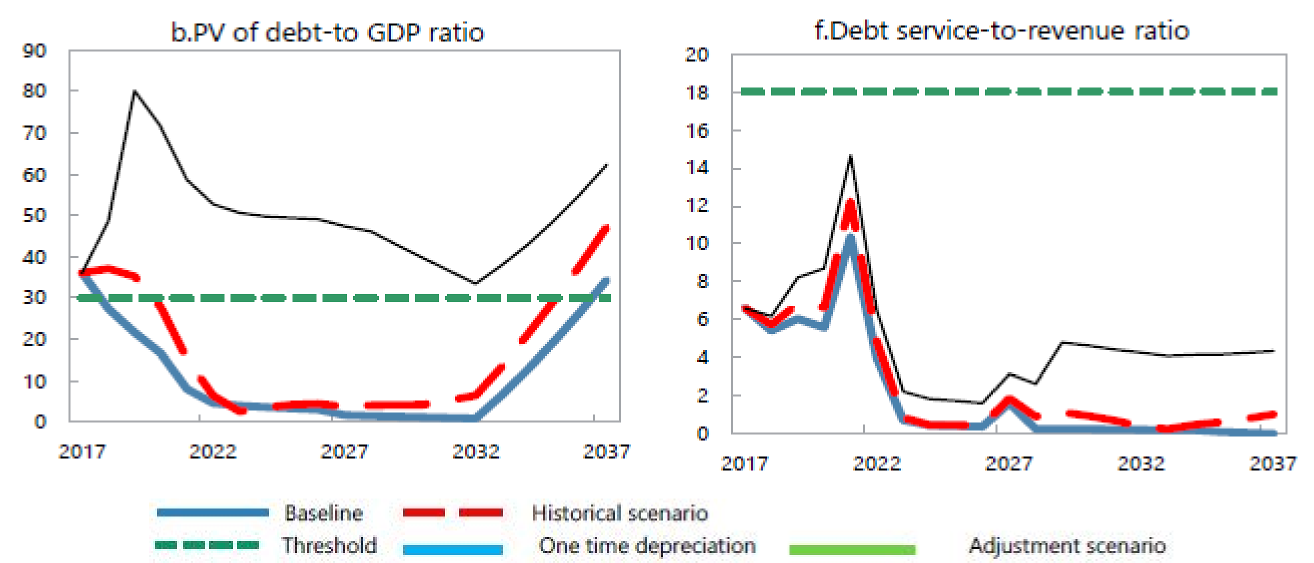
22. Going forward, given the tightening overall resource envelope, improving the quality of expenditure and pulling back the public investment stimulus as soon as possible will be important. The fiscal outturn in 2017 shows a capacity to consolidate expenditures whilst protecting high-priority areas like infrastructure development and social sectors, and a continuation of this vigilance will be needed to maintain a budget balance consistent with constant or growing real balances in Tuvalu's trust funds. On the recurrent side, expenditure growth peaked in 2016 in the aftermath of Cyclone Pam, and is projected to remain below current revenues in the medium-term. However, key risks relate to high-cost programs which may easily expand beyond control, such as the TMTS and the overseas scholarship scheme, warranting a focus on value-for-money across the board, including in considering public service pay and establishment changes.

23. A sharp spike in public spending in 2018 will need to be unwound to avoid an unsustainable budget position. An early supplementary budget (fully-funded through accumulated fishing revenues) of AU$10.9 million has sharply raised public investment in 2018. The vast majority of new capital spending in both the original and supplementary budgets are of a one-off nature and support improved public service delivery and/or social outcomes; and are expected to be utilized on an ongoing basis. Two expenditure items account for over two-thirds of the supplementary appropriation, namely the upgrade of the Queen Elizabeth II (QEII) park on reclaimed land, and the building of the nation's only court house. The upgrade of the QEII Park ahead of the Pacific Islands Forum Leaders meeting presents an important improvement to what is considered a high value asset. The reclaimed area of land expands the habitable land mass on Fongafale (the main islet on the Funafuti atoll) by 5 percent – a notable expansion, noting over 50 percent of the country's population resides there. The project currently employs around 210 people, representing 3.4 percent of the working age population in Funafuti (based on latest population estimates – SPC, 2015). Following the PIF Leader's meeting, the government will explore the possibility of tendering the management rights of the bungalows to a private sector operator, which could increase the number of tourism accommodation. The new Court House will co-locate the Judicial Office, the Office of the People's Lawyer, and the Office of the Ombudsman – currently located in different areas on Funafuti atoll – improving the efficiency of judicial services offered to the public. Investments in ICT equipment are expected to further improve the efficiency and cost-effectiveness of, as well as reduce the waiting period for, court cases. Given these additional investments are of a one-off nature, capital expenditures are expected to normalize in 2019 and beyond. To improve the quality of government expenditures and ensure these do not result in an unsustainable fiscal position, it will be important to carefully align the scale and pace of future infrastructure investments with the government's capacity to implement these projects, and the economy's overall absorption capacity.

24. To strengthen public investment management, reforms are currently underway to develop a multi-year capital budgeting framework. Through technical assistance provided by the Pacific Financial Technical Assistance Centre (PFTAC), the Ministry of Finance and Economic Development (MFED) is developing a multi-year framework for capital budgeting to ensure capital spending falls within fiscally sustainable parameters, and smoother implementation of multi-year projects. It will also ensure full compliance with the government's existing procurement framework, and minimize the practice of transferring surplus and/or unexpended project funds for other unplanned purposes – thus improving the quality of expenditures.

25. **Climate change is likely to impose additional long-term fiscal costs.** Tuvalu is situated in the Pacific ring of fire and is prone to natural hazards such as tropical cyclones and king tides. Climate change will exacerbate the impact of natural hazards, particularly a rise in sea levels, and will lead to higher structural and cyclical fiscal costs. The Pacific Catastrophe Risk Assessment and Financing Initiative (PCRAFI) estimates that on average, Tuvalu should expect annualized disaster-related losses and damages of 2 percent of GDP. Although the GoT is also undertaking reforms to improve resilience to shocks, as is reflected in the higher capital spending in the baseline[9], the costs associated with physical adaptation, mitigation and disaster response are very large relative to the size of the economy and may necessitate higher development assistance than would otherwise be required.

Figure 4: PV of debt-to-GDP ratio **Figure 5:** Debt service-to-revenue ratio



Source: Joint IMF - World Bank Debt Sustainability Analysis (DSA) 2018

26. **Tuvalu is assessed to be at high risk of debt distress. The government is committed bringing public external debt down to sustainable levels, and has refrained from any new borrowing in the last year.** The joint IMF-WB Debt Sustainability Analysis (DSA) undertaken in 2018 classifies Tuvalu at a high risk of debt distress, although the government does not face debt servicing risks. As of end-2017, total public and publicly guaranteed (PPG) debt was estimated at 37 percent of GDP, while debt servicing requirements were equal to 6.5 percent of revenues. External debt stood at 37 percent of GDP, and all domestic debt has been cleared. The majority of public debt is non-concessional loans contracted by joint ventures in the fisheries sector, following by ADB and European Investment Bank debt. Under the baseline scenario, three indicators substantially breach the policy-dependent thresholds early on in the forecast period, while two are still in break in the latter years. Stress tests show that the external and public-sector debt dynamics are also susceptible to shocks. Ensuring debt risks remain contained while addressing the

[9] Pacific Possible estimated that building resilience against climate change such as through coastal protection will require Tuvalu to invest annually an additional 5.8 percent of GDP.

country's development needs will require continued donor assistance in the form of grants. The government has not taken any new loans in 2017 and has stated in the 2018 Budget documentation its commitment to strictly manage public debt.

27. The macroeconomic policy framework is adequate for this operation. The government has achieved fiscal surpluses arising from record-high fisheries revenue in recent years, which have been prudently saved. As these revenues are expected to moderate downward, a small budget deficit is expected to open, which should be adequately financed from trust fund returns without depleting the real value of the asset. Recent expenditure growth has been partly due to disaster-response in the wake of Cyclone Pam and one-off capital expenditures[10] in 2018, and is expected to gradually fall. Avoidance of new debt commitments and maintaining an ample CIF balance support the GoT's capacity to deal with shocks in the future[11]. The Bank and the IMF share the same assessment of the adequacy Tuvalu's macroeconomic policy framework. A variety of risks are likely to present themselves over the medium and longer-term in Tuvalu, an inherently vulnerable context. Adequate foreign exchange reserves and a significant fiscal buffer afford an ability for the government to manage these shocks. In the event of shocks of significant magnitude, continued willingness of development partners to provide assistance will be crucial to finance recovery expenditure while enabling Tuvalu to maintain its commitment to long-term fiscal sustainability via effective management of the TTF and related trust funds.

3. THE GOVERNMENT'S PROGRAM

28. In 2016, the GoT endorsed the *National Strategy for Sustainable Development 2016 to 2020*, also known as the TKIII, which focuses on reducing Tuvalu's vulnerabilities and improving social service delivery. The TKIII resulted from broad-ranging consultation and was endorsed by Parliament in April 2016. It continues the priorities set out in the previous national development plan while addressing growing challenges, such as climate change. The TKIII mission is to achieve a greater level of security and prosperity for all Tuvaluans, including through the achievement of higher standards of quality health and education. It aims to: (i) significantly reduce Tuvalu's unique vulnerabilities by building resilience to better respond to global economic and environmental crises; (ii) increase the proportion of work force employed in the formal economy and real household income; (iii) increase the proportion of Tuvaluans living comfortably abroad; (iv) increase the number of people educated and trained in skills appropriate to higher earning potential; and (v) provide better protection against land loss and erosion and more effective extraction of marine resource rents. These objectives are expected to be achieved through 12 strategic areas of focus which are: climate change; good governance; the economy; health and social development; outer island development; private sector, employment and trade; education and human resources; natural resources; infrastructure and support services; environment; migration and urbanization; oceans and seas.

29. The GoT leads the Policy Reform Matrix (PRM) process to focus and coordinate reform efforts. The GoT developed the PRM in 2012, in consultation with development partners, to map out a clear and selective path to achieving goals identified in the TKIII. The preparation of the PRM has helped foster a

[10] The recurrent maintenance costs of these additional investments have been factored into medium-term planning.
[11] The combined balance of the CIF and TSF stood at 25.7 percent of the real maintained value of the TTF in 2017, and is forecast to remain above the 16 percent target over the projection period.

shared strategic, coordinated, and focused policy dialogue around a limited set of reform priorities amongst government and development partners. The PRM also adopted a phased approach with annual priorities set through a consultative process to best meet the government's priority goals while being cognizant of the capacity constraints faced by the GoT. The PRM has proven to be an effective tool for delivering a practical reform agenda and has enhanced government ownership and reform momentum tackling difficult areas of reform. The ADB, Australia, New Zealand, the EU and the World Bank have all provided policy-based grants against the PRM. The implementation of the fourth phase of PRM (PRM IV) commenced in July 2016. Drawing from the TKIII as the overarching strategy, PRM IV was informed through consultations among all stakeholders including the central government, public enterprises, as well as civil society organizations, and presents a consolidated set of reform measures for the TKIII period, with expected biannual updates. Priority areas include improving social service delivery (education, health and infrastructure), and improving macroeconomic management (fiscal sustainability, PFM, and public-sector management). The policy focus for this operation was underpinned by a process of policy dialogue and analysis aligned with the PRM.

30. Equitable and comprehensive quality early childhood education will support greater school readiness, leading to improved participation and learning outcomes at all subsequent levels. Government is continuing to focus on improving participation in, and quality of secondary education, however, the prior action for this operation has changed from the original indicative trigger. Supported under the previous operation, the government has removed all secondary school fees to encourage greater secondary school participation (which is already effective). A lack of readiness for secondary school, however, has been identified as a barrier to improved secondary outcomes[12], and in this respect, the government is focused on systematically approaching education pathways to secondary education, starting at the early child care and education (ECCE) level. This sector lacks resources and coordination**,** and health and education measures for pre-school children are concerning[13]. Government prepared a new education sector plan in late 2016, which maps out a series of measures to improve learning outcomes and, building on that, is working to address issues in the ECCE sub-sector, including by formal incorporation of the sub-sector into the Education Act (new prior action). While significant work is underway in this area, the preparation of the Education Sector Plan has meant that the envisaged national education action plan for early childhood literacy and school readiness (original trigger) is now to be prepared at a later stage, once initial steps to improve coordination and planning for the sector have been implemented.

[12] According to the 2012 Pacific Islands Literacy and Numeracy Assessment (PILNA), only 19 percent of year 4 students were performing at the expected level for literacy and 25 percent of students met literacy benchmarks in year 6.
[13] A 2016 Early Grade Reading Assessment (EGRA) found that despite improvements in some areas, reading comprehension remained low, and this remains an issue at later levels of education, with 40 percent of year 3 pupils having zero reading comprehension. Based on the latest Demographic and Health Survey (DHS) in 2007, stunting is also a significant issue with a prevalence of 10 percent, with similar levels confirmed in the Early Human Capability Index.

4. THE PROPOSED OPERATION

4.1 LINK TO GOVERNMENT PROGRAM AND OPERATION DESCRIPTION

31. **This development policy program supports the GoT's TKIII mission to achieve a greater level of security and prosperity for all Tuvaluans, including through the achievement of higher quality health and education outcomes.** Financing provided through the operation will support the maintenance of buffers to meet long-term financing needs, including those arising from future climate related shocks, and Tuvalu's ability to absorb future shocks without disruption to existing levels of service delivery. The first pillar of the proposed operation supports reforms to improve health and education service delivery. Changes to taxation policy will encourage healthier lifestyles for all Tuvaluans. Improved oversight of the ECCE sector is expected to improve readiness for schooling at entry, and thereby secondary education participation. The second pillar of the proposed operation supports reforms to improve macroeconomic sustainability. Reforms will help to ensure sustainability the public wage-bill, strengthened investment management, and better financial sector regulation. These reforms are not only aligned with TKIII objectives, but are also aligned with the broader World Bank goal of boosting shared prosperity.

32. **The design of this operation was informed by lessons learned from the implementation of development policy operations in Tuvalu.** The proposed operation draws on lessons from previous DPOs in Tuvalu and other Pacific island countries that recognize capacity constraints, selectivity, and continuous engagement in policy dialogue. The design of the program is based on a small number of critical, government-led reforms, that are supported as part of a coordinated budget support mechanism with other budget support partners. Given the thin capacity, dependence on technical assistance for many reforms and high exposure to external shocks, flexibility to adjust the reform program (including the flexibility to adjust indicative triggers) is important to ensure multi-year reform programs remain relevant and informed by the latest evidence. Furthermore, development partner engagement has assisted the GoT to clarify and sequence reforms, and continues to provide momentum to implement them.

33. **Despite some revisions to the supported reform program, the GoT remains firmly committed to maintain its strong reform momentum across a number of critical areas.** Specifically, two triggers under the first operation in the series were amended under the current operation (prior actions 1 and 5). For prior action 1, the amendment reflects a re-prioritization in the sequencing of education sector reforms. Formal recognition of the ECCE-sub-sector as a government competency is critical to the effectiveness of further reforms in this space. Prior action 5 was amended to reflect an essential institutional step to operationalize the banking commission framework, which was set up under the first operation in the current series, with the proposed trigger proving too ambitious in view of limited capacity to fully implement supported reforms. In the context of limited and thinly stretched capacity across government, the proposed program has flexibly adapted to the reprioritization of reform efforts, without detracting from the longer-term sustainability of the program and the GoT's reform momentum.

Table 3. Indicative triggers and prior actions for the second operation

Trigger under DPO-3	Prior action under DPO-4	Explanation for change / status
Pillar 1: Improving the delivery of education and health services		
The recipient endorses and begins piloting a national action plan to improve school readiness and early literacy.	The Recipient, through its Cabinet, has approved a proposal to amend the Education Act, in order to formally recognize early childhood care and education as a government competency, overseen by the Ministry of Education, Youth and Sports.	The trigger for this operation has been amended. While government is prioritizing early child education, and is intending to complete an action plan in the future, as a first step they intend to review and revise the Education Act – to formally recognize the ECCE sub-sector and improve coordination and planning across the broader education sector.
The recipient increases selected excise taxes, including on tobacco products, to reduce NCD risk factors.	The Recipient, through its Cabinet, has approved increases to selected excise and import duties, on certain tobacco, alcohol and sugary beverage products, to reduce non-communicable disease risk factors.	No change. The rewording refines the substance of the policy reform action, as articulated in the main text.
Pillar 2: Improving Macroeconomic Sustainability		
The recipient implements key reforms to better align investment management with the reserve assets' objectives.	The Recipient has: (a) appointed a representative of the Recipient's Government to the TTF Investment Committee; and (b) through its participation in TTF Board decision-making: (i) increased TTF secretariat staffing and, (ii) decided to commission an investment strategy review to better align investment management with strategic objectives.	No substantive change. The rewording refines the substance of the policy reform action, as articulated in the main text.
The recipient adopts a wage-bill model as part of the annual budget cycle to improve the linkage between personnel decisions with budget implications and to support sustainable public service delivery.	The Recipient, through its Ministry of Finance and Economic Development, has approved and circulated a revision to the financial instructions mandating the documentation of annual and medium-term budgetary impact of changes in civil service pay policy.	No substantive change, with the action made more precise.
The recipient revises financial sector regulations to enhance controls in taxpayer registration system.	The Recipient, through its Ministry of Finance and Economic Development, has taken steps to make the Banking Commission fully operational by approving a supervision plan, and budgeting and advertising for an international supervision expert.	Given very limited capacity in Tuvalu, the trigger was revised to support implementation of critical steps to fully operationalize the Banking Commission, a previous step of which was supported in DPO3 and in line with the intended outcome. The indicative trigger is expected to be addressed in future, aided by the Banking Commission.

4.2 PRIOR ACTIONS, RESULTS AND ANALYTICAL UNDERPINNINGS

Pillar I: Improving the delivery of education and health services

Prior action 1: The Recipient, through its Cabinet, has approved a proposal to amend the Education Act, in order to formally recognize early childhood care and education as a government competency, overseen by the Ministry of Education, Youth and Sports.

34. Early childhood literacy and school readiness remains low in Tuvalu, with early childhood education services lacking resources and coordination. Despite the government's commitment to education and high enrollment rates[14], literacy rates remain alarmingly low. According to the 2012 Pacific Islands Literacy and Numeracy Assessment (PILNA), only 19 percent of year 4 students were performing at the expected level for literacy and 25 percent of students met literacy benchmarks in year 6. More recently, an Early Grade Reading Assessment (EGRA) performed in 2016, found that early literary skills had improved, with students scoring on average over 50 percent on listening comprehension and dictation. However, reading comprehension remained low, with students scoring on average only 16 percent. While research suggests a minimum reading fluency rate of 45-60 words per minute, overall reading fluency scores averaged 20 correct words per minute. Further reading comprehension levels were identified as low across all years of primary school, with the majority of students in years 1 and 2, and 40 percent of students in year 3 having zero reading comprehension. Lastly, according to the latest Demographic and Health Survey (DHS) undertaken in 2007, stunting was found to be a significant issue amongst children in Tuvalu (with a prevalence of 10 percent). Similar levels of stunting were confirmed more recently in the Tuvalu Early Human Capability Index. International evidence suggests that i) stunting between 12 and 36 months of age is associated with poorer cognitive performance and lower school achievement, and ii) that interventions at early stages of childhood learning – particularly in the cognitive, language and socio-emotional development areas are important predictors for future cognitive development and learning outcomes. Efforts by government to improve early childhood learning outcomes are made more difficult because such services are not explicitly included in the Education Act, and as such, central government has neither an explicit mandate, nor a clear role in overseeing the sub-sector (e.g. at present, early education provisions are managed by a mix of Management Committees, Kaupules, or private providers).

35. As a prior action, the Recipient, through its Cabinet, has approved a proposal to amend the Education Act, in order to formally recognize early childhood care and education as a government competency, overseen by the Ministry of Education, Youth and Sports. Global evidence suggests that it is most effective to achieve improved learning throughout school with a focus on early years of education. With data suggesting that 70 percent of the students in Year 4 are already falling behind in literacy and 45 percent in mathematics in Tuvalu, focusing on school readiness becomes even more imperative to allow students the best chance to complete primary education and progress to secondary education. To this end, and in line with the education strategy of improving effectiveness and quality of curriculum and learning programs, the government has taken the decision to amend the Education Act to formally bring the ECCE sub-sector into the purview of the Ministry of Education. Formal and legal recognition of ECCE

[14] The first operation in this programmatic series supported the abolition of secondary education school fees to enhance inclusiveness and equity of secondary education

would have a significant impact on teacher staffing, teaching quality, professional support, the provision of adequate school infrastructure and materials, and the regulation of private day care center providers. It would also enable the government to support the implementation of the recently endorsed ECCE roadmap and improve policy coordination and standards across Tuvalu. More broadly, the review of the Education Act aims to modernize the legislative framework by incorporating other key provisions including (but not limited to) child protection, gender and diversity, and consolidating existing pieces of legislation which have recently been passed. Formal recognition of ECCE will greatly enhance the effectiveness and longer-term sustainability of subsequent reforms to the sector.

Table 4. DPO Prior actions and analytical underpinnings

Prior actions	Analytical Underpinnings
Pillar I: Improving the delivery of education and health services	
Prior action #1: The Recipient, through its Cabinet, has approved a proposal to amend the Education Act, in order to formally recognize early childhood care and education as a government competency, overseen by the Ministry of Education, Youth and Sports.	The 2012 World Bank Education policy note and the 2010 HIES identified the lack of investment in basic education and school fees being a potential constraint to secondary education.
Prior action #2: The Recipient, through its Cabinet, has approved increases to selected excise and import duties, on certain tobacco, alcohol and sugary beverage products, to reduce non-communicable disease risk factors.	The 2014 World Bank NCD Roadmap Report found that NCDs pose a major risk to Pacific island countries and included recommendations to strengthen tobacco control (including raising taxation levels to at least 70 percent of their retail price) and introduce policies on reducing consumption of food and drink products directly linked to obesity, heart disease and diabetes especially salt and sugary drinks. More recently, the WB has provided TA in Tuvalu to appraise policy options for increasing NCD-related customs duties.
Pillar 2: Improving Macroeconomic Sustainability	
Prior action #3: The Recipient has: (a) appointed a representative of the Recipient's Government to the TTF Investment Committee; and (b) through its participation in TTF Board decision-making: (i) increased TTF secretariat staffing and, (ii) decided to commission an investment strategy review to better align investment management with strategic objectives.	A 2016 World Bank TTF Investment Management Review and a NZIPR review of sovereign wealth funds in the Pacific made a number of recommendations towards improving aspects of the investment management of the TTF, including clarification of the objectives of the TTF, strengthening the capacity of the TTF Secretariat, adding government representation to the Investment Committee, and conducting a strategic investment review to ensure investment management objectives were aligned with strategic objectives for the fund, and competitively retendering the investment management contracts on a periodic basis.
Prior action #4: The Recipient, through its Ministry of Finance and Economic Development, has approved and circulated a revision to the financial instructions mandating the documentation of annual and medium-term budgetary impact of changes in civil service pay policy.	The 2015 PEFA self-assessment identified weaknesses in the effectiveness of payroll controls, with particular weakness in the reconciliation process between the Personnel and Training and Treasury Departments. WB TA on "Pay and Wage Bill Management for the Government" identified that while public sector pay was sufficient in attracting and retaining strong candidates in the labor market, uncontrolled wage bill growth places pressure on fiscal sustainability and is likely to have a high opportunity cost in terms of public sector investment and public service delivery.
Prior action #5: The Recipient, through its Ministry of Finance and Economic Development, has taken steps to make the Banking Commission fully operational by approving a supervision plan, and budgeting and advertising for an international supervision expert.	The IMF's 2014 and 2016 Article IV reports, and Pacific Financial Technical Assistance Centre (PFTAC) reports have identified weaknesses in the current banking sector regulatory framework and identified the actions required to establish a context-appropriate banking sector regulatory framework.

36. Equitable and comprehensive quality early childhood education will support greater school readiness, leading to improved participation and learning outcomes at all subsequent levels. The first operation supported a removal of secondary school fees, addressing one clear constraint to accessing secondary education. However, another major constraint identified was a lack of readiness for secondary leading to poorer learning outcomes, and in line with global evidence, the prior action will support better education outcomes starting in the pre-school years. The prior action has been revised from the indicative trigger (piloting national action plan for school readiness and early literacy) in line with ongoing discussion that have highlighted the importance of the revised prior action to enable the GoT to prepare an effective action plan in this sector. The supported reforms are expected to over time contribute to the results indicator of improved secondary school participation, although necessarily for significant human capital investments, the quantified impact will fall beyond the results period of this program. The results indicator in this area targets secondary gross enrollments, disaggregated by sex.

Prior action 2: The Recipient, through its Cabinet, has approved increases to selected excise and import duties, on certain tobacco, alcohol and sugary beverage products, to reduce non-communicable disease risk factors.

37. NCDs are a leading cause for death in Tuvalu and their treatment poses a major fiscal cost to the GoT. Based on latest available data from the WHO (2010), NCDs account for 73 percent of all deaths in Tuvalu. Available data from SPC in 2011 show that circulatory diseases are one of the leading NCDs causing mortality in Tuvalu (295 per 100,000), followed by diabetes (92 per 100,000). Tuvalu is in the top ten countries in the world for prevalence of diabetes amongst 20-79 years of age. In addition to being a major threat to public health, NCDs also pose a large and increasing burden on public finances in Tuvalu, with the TMTS alone consuming a large, and increasing, proportion of the government's recurrent budget, rising from 8.4 percent on average from 2012 to 2014, to 9.8 percent between 2015 and 2017. At the same time, there are significant gaps in the current application of excise taxes which could be tightened to provide clear prices signals to disincentivize consumption of unhealthy products.

38. As a prior action, the Recipient, through its Cabinet, has approved increases to selected excise and import duties, on certain tobacco, alcohol and sugary beverage products, to reduce non-communicable disease risk factors. Global evidence and Bank-led regional work has shown that greater use of tax policy to promote healthy consumption choices is one of the top priorities to address the burgeoning NCD epidemic. Taxes collected from tobacco, alcohol and sugary beverages constituted around 8 percent of total tax collections in 2015. Tuvalu already levies excise and import duties at a combined rate of 210 percent on cigarettes, and loose tobacco attracts a 15 percent import duty and no excise duty. Unsurprisingly then, the majority of tobacco consumed in Tuvalu therefore does not attract any excise duty (loose tobacco accounted for 57.9 percent of total tobacco imports in 2015). In a similar vein, wine is taxed at less than half the rate of beer on an alcohol-equivalent basis, and drinks with added sugar are relatively lightly taxed. The GoT has adopted a revised tariff schedule as presented in Table 5 to encourage healthy lifestyle choices, and provide uniformly higher price signals. Overall, the changes increase the tax burden for all the sin goods presented, and reduce discrepancies between them. For tobacco, this moves Tuvalu closer to the WHO recommended taxation level[15]. For alcoholic drinks, the

[15] For a pack of 20 cigarettes that costs AU$1.00 at point of import, the price including customs and excise duty would have been AU$3.10 and would now be AU$3.60.

revised tariff moves towards an alcohol content-based system, in line with good practice. Not only will reducing NCDs support more healthy and productive lives but also help to contain rising costs associated with treating these diseases and in turn support fiscal sustainability over the longer-term, particularly related to costly tertiary care overseas[16]. The results indicator for this area has been revised, since the originally proposed indicator is not updated on a timely basis to capture the results of the operation. The new indicator will capture price changes of targeted products relative to overall consumer price inflation.

Table 5. Excise and import duty rates on selected items	Existing combined rate	New rates
Unmanufactured tobacco	15%	60% & AU$15 per kg
Cigarettes, containing tobacco	210%	60% & 10c per stick
Other manufactured tobacco	35%	60% & AU$15 per kg
Water with added sugar	35%	40%
Cordials	25%	40%
Beer (alcohol content < 5%)	70%	80%
Wine (alcohol content <15%)	80%	125%
Spirits (alcohol content > 15%)	175%	225%

Source: Tuvalu Customs Tariff Schedule 2017, and approved new rates

Notes: Rates presented are combined import duty and excise duty rate schedule.

Pillar II: Improving Macroeconomic Sustainability

Prior action 3: The Recipient has: (a) appointed a representative of the Recipient's Government to the TTF Investment Committee; and (b) through its participation in TTF Board decision-making: (i) increased TTF secretariat staffing and, (ii) decided to commission an investment strategy review to better align investment management with strategic objectives.

39. In a volatile environment, the TTF framework is of critical importance to both Tuvalu's long-term fiscal sustainability and resilience to short-term volatility and shocks. The TTF plays a critical role in financing structural fiscal deficits in perpetuity and ensuring long-term fiscal and service delivery sustainability of the country, while the associated CIF enables the government to hold a fungible fiscal buffer to manage short-term volatility[17]. However, the TTF is impacted by unpredictable fluctuations of international financial markets, and the TTF Board, advised by the Investment Committee, is tasked with managing the trade-off between target returns and acceptable levels of portfolio risk. Enhancing the management of the TTF to ensure the overall strategic objectives for the fund are well expressed in its day-to-day management is important in ensuring the best outcomes possible for Tuvalu. The GoT requested the World Bank to provide an analysis of the overall management and structure of the TTF compared to global good practice, and as a prior action in the first operation of the current series

[16] Previous analysis showed that on average, reducing 1 diabetic patient requiring overseas treatment would save around AU$65,000 per year; and for cardiac patients – savings of around AU$40,000 could be achieved per case. To put this in context, AU$65,000 is over 100 times what the GoT currently spends, on average, per capita on health care in Tuvalu

[17] With climate related events becoming more frequent and rising costs associated with adaptation, mitigation and response, the government established a new fund – the Tuvalu Survival Fund (TSF) in the 2016 budget. The TSF – capitalized at AU$5 million in 2017 – will fund recurrent disaster mitigation expenses, and provide rapid financing in the event of an extreme natural disaster.

commissioned an independent review of the TTF, undertaken by the New Zealand Institute for Pacific Research (NZIPR). These reviews identified several weaknesses including the: (i) relatively low return compared to the risk profile; (ii) relatively high management fees compared to return; and (iii) weaknesses in investment management governance structure. These weaknesses could hamper the optimization of returns on the TTF relative to the investment objectives, which in turn could dampen the distribution from the TTF to support the GoT in delivering critical services.

40. As a prior action, the Recipient has: (a) appointed a representative of the Recipient's Government to the TTF Investment Committee; and (b) through its participation in TTF Board decision-making: (i) increased TTF secretariat staffing; and (ii) decided to commission an investment strategy review to better align investment management with strategic objectives. The TTF Board endorsed the NZIPR review, and has adopted a series of key recommendations, with others incorporated into their annual work program. In line with the recommendation of the report, the TTF has increased the staffing of the TTF Secretariat, to improve its capacity to monitor and oversee TTF operations, and provide essential support to the TTF Board directors. The Secretariat now consists of two staff members, with an additional focus on strategic engagement, rather than solely administrative matters. The GoT has also formally assigned its own representative to the TTF Investment Committee, which previously only included representatives of the New Zealand and the Australian Board directors. This will afford the GoT a clearer line of sight on the operationalization of the fund's investment strategy and ensure their voice is clear as part of future decision-making. Finally, as recommended, the Board has decided to commission a full investment strategy review, with the aim of evaluating the current (objective-based asset allocation) investment strategy against other alternatives and the strategic objectives of the fund, and provide recommendations to ensure investment management continues to be well-aligned with strategic objectives going forward. The current investment strategy focuses on lowering risk to ensure a specified target return, which might be lower than should a higher risk threshold be accepted. This is in line with the aim of ensuring regular disbursements for budget financing. Yet at the same time, the government has an objective to build the value of the fund, to AU$200 million by 2020. If growth is indeed the main objective, it may lead to a different set of investment practices.

41. These reforms will help to ensure the alignment of TTF operations with broader fiscal objectives, and improve the cost-effectiveness of investment management. The measures supported by this operation are expected to lead to improved alignment between the government's medium-term budget financing requirements and long-term goals for the TTF, and to support more efficient investment management. By ensuring strategic alignment with investment objectives, the cost-effectiveness of the fund's investment management can be expected to improve and support a lower cost of investment management.

42. By strengthening the TTF management framework, which is also adopted by the Tuvalu Survival Fund (TSF), these reforms will also directly support Tuvalu to cope with the severe impacts of climate change. The TSF, which was recently established, is expected to benefit from the investment strategy review and strengthened Secretariat function of the TTF, which it currently shares. The introduction of the TSF is a significant development in Tuvalu's trust fund framework and may enable the different objectives of each trust fund to be more precisely articulated. By ensuring that the TSF is managed to ensure that maximal resources are available to support climate adaptation and recovery, this prior action is substantially contributing to the ability of one the countries that is most vulnerable to extreme impacts of climate change, to better manage these risks in future.

Prior action 4: The Recipient, through its Ministry of Finance and Economic Development, has approved and circulated a revision to the financial instructions mandating the documentation of annual and medium-term budgetary impact of changes in civil service pay policy.

43. The annual and medium-term budget implications of public sector pay have, in the past, only been weakly linked and the wage-bill budget has both grown rapidly and become less credible as a predictor of actual wage-bill spending. The 2015 PEFA self-assessment identified weaknesses in the effectiveness of payroll controls, in particular with the reconciliation process between the Personnel and Training and Treasury Departments[18.] The first operation in this program supported the introduction of an automated payroll system to improve the effectiveness of payroll controls. This was achieved via the deployment of a new wage-bill management system that is linked to the financial management information system (ACCPAC), to include a new payroll and human resource module with the view to improve the integrity of payroll data and effectiveness. While these reforms are expected to improve the accuracy of payroll budgeting, the link between personnel policy decisions and budget formulation remains weak. Several pay increases (a 5 percent increase across the board between 2016 and 2017; and a further AU$30 net per person per fortnight budgeted for in 2018) have driven wage-bill costs far beyond the increase in the cost of living. Between the years 2012 and 2016, the public service wage-bill grew by over 50 percent, despite cumulative consumer inflation over the period of only 10 percent and the number of civil servant positions increasing by 11 percent. While these pay increases were in response to public pressures, they were considered problematic because: i) they entailed unanticipated pro-cyclical increases in public spending; ii) they appeared to be primarily politically motivated; and iii) they could set a risky precedence for future ad-hoc increases. In addition, aggregate variance in outturn against original budget is relatively high, at nearly 7 percent over the years 2015 to 2017, and has increased from just over 4 percent from 2012 to 2014.

44. As a prior action, the Recipient, through its Ministry of Finance and Economic Development, has approved and circulated a revision to the financial instructions mandating the documentation of the annual and medium-term budgetary impact of changes in civil service pay policy. With technical assistance from the World Bank, the Government has developed a new framework for assessing the short- and medium-term budgetary implications of various forms of personal policy changes, utilizing a simple micro-simulation costing and forecasting model developed for the purpose. This model will complement GoT's existing medium-term fiscal framework and enable the government to more precisely estimate the fiscal impact of new pay settlements and changes to the public service establishment. The process of appraising the budgetary impacts of budget proposals has been integrated into the standard budget formulation process by way of amendments to the Financial Instructions issued by the Minister of Finance instructing estimates to be prepared. Adopting the model as part of the annual budget cycle will support the GoT to balance public service improvement with fiscal sustainability over the medium-term.

[18] The Personnel and Training Department is situated under Office of the Prime Minister while the Treasury Department is situated under the Ministry of Finance and Economic Development.

45. The reforms supported under this program are expected to strengthen budget planning and preparation, transparency around personnel decisions, and promote fiscal sustainability. Improved alignment of budget with personnel data, and accurate forecasting, will support effective policy-making and transparency around personnel decisions and has the potential to create room for reallocation to priority areas to improve service delivery. These reforms will enable government to explicitly report on the expected costs of personnel policy changes (such as new establishment positions or pay settlements) in the budget documentation. This results indicator has been introduced following completion of the policy program, replacing the previous indicator which targeted a reduced variance between budgeted and actual wage-bill expenditure. The revised indicator is expected to more accurately capture the intended outcomes of the supported reforms, and be less subject to change that is not attributable to the supported reforms.

Prior action 5: The Recipient, through its Ministry of Finance and Economic Development, has taken steps to make the Banking Commission fully operational by approving a supervision plan, and budgeting and advertising for an international supervision expert.

46. Weak banking sector monitoring in the past has led to the realization of contingent liabilities. Tuvalu has a non-complex banking sector. The country has two banks, both of which are state-owned: the National Bank of Tuvalu and the Development Bank of Tuvalu. No other banks have a presence in Tuvalu. However, in the unsupervised state-owned dual-bank system, asset quality remains poor as half of the loan portfolio is non-performing. This is partly caused by Government-sponsored programs implemented a few years ago, and partly by public enterprise borrowing. To address this, the GoT has undertaken a series of reforms to strengthen PEs, including the privatization of the Vaiaku Lagi Hotel and reforms to improve the performance of Tuvalu Telecom and Tuvalu Energy through contract renegotiations and renewable energy initiatives to ensure that nonperforming loans arising from PEs remain low. In addition, both banks have restricted their exposure to public enterprises and made substantial capital provisions. However, an accurate estimate of capital adequacy is impeded by the lack of a regulatory framework. The DBT—accounting for about 10 percent of banking sector assets—has made substantial losses, with its net capital having depleted to AU$0.7 million (1.7 percent of GDP) in 2014 and subsequently requiring an equity injection from the GoT in 2015 of AU$0.35 million (0.9 percent of GDP), draining already tight public resources. Given the substantial vulnerabilities in the banking sector, which in turn pose a contingent liability to the GoT, recent IMF assessments have noted an urgent need to establish a framework of banking supervision to avoid future liquidity constraints and contingent liabilities.

47. As a prior action, the Recipient, through its Ministry of Finance and Economic Development, has taken steps to make the Banking Commission fully operational by approving a supervision plan, and budgeting and advertising for an international supervision expert. Reforms supported under the last operation supported the effectiveness of the Banking Commission Act, and the appointment of the Minister of Finance as Banking Commissioner on an interim basis. However, in a country with very few specialists available, it is essential to ensure the Banking Commission is appropriately resourced and staffed to ensure the Commissioner can effectively exercise his powers. Therefore, this operation supports the approval of a supervision implementation plan, as well as the resourcing of a position of an international Supervision Expert, who will lead the technical activities under the guidance of the Commissioner and in conjunction with Tuvaluan Banking Commission staff. The prior action has replaced an indicative trigger in this policy area, which supported improved financial sector regulations to enhance controls in taxpayer registration systems. The indicative trigger is still expected to be carried out, but its completion has proven too ambitious given the need to establish the regular operation and activities of the Banking Commission first. The results indicator for this area will target increased oversight of the banking sector through regular production of monitoring reports, including information on non-performing loans, tabled to Cabinet for information.

4.3 LINK TO CPF, OTHER BANK OPERATIONS AND THE WBG STRATEGY

48. **The proposed operation is aligned with the priorities identified in the Regional Partnership Framework (RPF) for Nine Pacific Island Countries (Report #120479)[19].** The RPF is focused around four themes, namely: i) fully exploiting the available economic opportunities; ii) enhancing access to employment opportunities; iii) protecting incomes and livelihoods; and iv) as a cross-cutting theme, strengthening the enablers of growth opportunities (macroeconomic management, infrastructure, and addressing knowledge gaps). The proposed operation will contribute directly to these priorities by supporting reforms to improve social service delivery and improved health and education outcomes, further improve the management of the TTF, and provide more efficient and evidence-based public expenditure management, which will in turn improve the investment climate and encourage private sector growth.

49. **Policy actions supported by this operation are also closely aligned with the priorities identified under ongoing World Bank projects and the IDA special theme "Governance and Institutions":** (i) the Reserve Advisory and Management Program, led by the Treasury, which is helping the government improve the governance, asset allocation, and selection of external managers of the TTF; (ii) the Telecommunications and ICT Development Project, led by the Transport and ICT Global Practice, which is helping the country achieve the transition to a market-driven telecommunications sector and expand services to the OIs; and (iii) the Pacific Early Age Reading and Learning Program (PEARL), led by the education Global Practice, aimed at improving evidence-based policy and programming decisions on school readiness and early grade reading in Pacific island countries. The operation is aligned with the IDA18 special themes, in particular the operation's focus on increasing domestic revenue mobilization (through prior action 1), and improving the quality and efficiency of public expenditures (through prior action 3).

4.4 CONSULTATIONS, COLLABORATION WITH DEVELOPMENT PARTNERS

50. **This programmatic series of operations has been developed through an extensive and high-level consultation process, with a broad range of stakeholders, drawing on the TKIII.** The proposed operation was developed through established consultative processes in place for the last four years, including regular meetings between representatives of the MFED and with representation from all budget support donors and government stakeholders. The program also draws heavily on the TKIII, which was developed and updated through a series of extensive consultations with Parliament, island chiefs and residents, government officials, businessmen, Non-Government Organization (NGO) representatives, religious

[19] The RPF was developed for Kiribati, the Republic of Nauru, the Republic of the Marshall Islands, Federated States of Micronesia, Republic of Palau, Independent State of Samoa, Kingdom of Tonga, Tuvalu and Vanuatu – drawing on the PIC-8 SCD.

leaders, and women, youth and the community more broadly. The proposed programmatic series also reflects broader stakeholder consultation including NGOs and community groups. Discussion with women's groups and NGOs highlighted the importance of increased employment opportunities for women and the inadequacy of services and disproportionate costs being borne by women associated with basic health and education services. Consultation with church and community groups provided insights regarding the greater extent of poverty and hardship faced by OIs and the potential impact on poverty and hardship following any large reduction in public employment or expenditure.

51. **The Bank is working in coordination with other development partners to provide budget support to Tuvalu.** The authorities have requested development partners to provide coordinated budget support, where possible, 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 first PRM) that might be associated with budget support going forward, culminating in agreement on the multi-year policy matrix. The ADB, Australia, New Zealand and the EU are all supporting the implementation of the PRM via varying combinations of budget support and technical assistance and have arranged for joint missions when possible. The World Bank and the IMF also maintain a close working relationship in Tuvalu, with the Bank participating in Article IV missions, facilitating the discussions on structural reforms. Based on this cooperation, the Bank and the IMF teams share a common view about Tuvalu's macroeconomic and structural reform priorities.

5. OTHER DESIGN AND APPRAISAL ISSUES

5.1 POVERTY AND SOCIAL IMPACT

52. **The policy actions supported under the proposed operation are expected to have a significant positive impact on poor people and vulnerable groups.** Measures supported under the program address the long-term challenges that Tuvalu faces, and by doing so create conditions for better, and more sustainable, public services in future, and lives that are less afflicted by the debilitating burden of NCDs. Strengthening the investment management of the TTF is focused on achieving increased returns by aligning to strategic objectives. For instance, adopting a strategy to build the TTF real value, at least over a period of years, will increase the financing and overall budget envelope in future, enabling greater prosperity and inclusive government service provision than would otherwise have been available. The amendments to excise taxes on tobacco, alcohol and sugary drinks are expected to have a net positive impact on the poor over the long-run. In the short-term, the higher taxes on sin goods will have an adverse impact on household budgets for the poor, particularly where members continue to consume the affected products unabated. However, the magnitude of the impact could be relatively small, at least according to the HIES data, which report low levels of spending on sin goods (e.g. on average, poor households report spending 1.5 percent of their household budget on tobacco). This illustrates the potential of establishing a clear price signal via taxation, as these commodities are currently very low-cost. Over the longer-term, for tobacco products specifically, the 2014 Pacific NCD Roadmap shows that the poor benefit significantly more than the rich in terms of overall improved health outcomes, and less of the tax burden, because the poor are more likely to stop smoking, or not take it up in the first instance. By increasing the cost of these unhealthy goods, in conjunction with other policy supporting behavior change such as under the Tobacco

Control Act supported under the first operation, consumption is expected to fall, leading to strongly positive health impacts.

53. Aspects of the program tackle gender gaps, and women are expected to be disproportionately better off as a result of some of the actions supported, as well as proportionately benefiting from many others. The benefits arising from lowering the consumption of tobacco, alcohol and sugary drinks will disproportionately accrue both to poorer households, and women. Women are 20 percent more likely to be obese than men according the latest DHS, and will disproportionately benefit from a shift from obesity-causing consumption of e.g. sugary drinks. Using education levels as a proxy for poverty, individuals with less education are much more likely to be at risk from NCDs. According to the latest available DHS, women without secondary education are more than twice as likely to smoke than women with more than secondary education, while similarly less-educated men are about 50 percent more likely to smoke. Women with lower education are also more likely to be obese (75 percent compared to 71 percent). Alcohol consumption rates are high, particularly for men. There is insufficient information to correlate this to poverty, but similar trends to tobacco consumption would be expected. A reduction in the consumption of alcohol could be expected to contribute to lower levels of domestic violence against women, which is a serious problem in Tuvalu. The DHS reported that 4 in 10 women have been subjected to some type of physical violence, with their current husbands or partners being the main perpetrators (84.6 percent). The same survey indicates that men who drink excessively are far more likely (72 percent) to subject their partners to abuse than those who do not drink (27 percent). In the long-term, reducing the cost of treatment for NCDs will create room to reorient expenditure towards primary, preventative and maternal care, which women disproportionately depend on. Reforms to improve early childhood literacy and school readiness are expected to disproportionately benefit women through affording improved quality of education outcomes, given attendance rates are higher for girls[20]. While overall, paid employment rates are lower for women than men (25 percent of 15+ women compared to 32 percent of men were paid employees according to the 2012 Census), women are more likely to work in professions that require secondary or higher education, such as 'technicians and associate professionals', 'professionals', and 'clerical support workers', while men dominate the agriculture and fisheries sector.

5.2 ENVIRONMENTAL ASPECTS

54. The policy reforms supported by this operation are unlikely to have any negative effects on Tuvalu's environment. Reforms to support macroeconomic sustainability through the strengthening of the investment management of the country's reserve assets and improving the effectiveness of payroll expenditures are not likely to have any significant environmental impacts. The prior actions supported under this operation are not expected to create negative impacts on Tuvalu's environment, forests and other natural resources. In particular, strengthening the management of the TTF would likely have positive second round effects on the TSF (given its co-reliance on the TTF Secretariat function and investment strategy), therefore enhancing resilience and contributing to the country's ability to respond to climate change risks.

[20] For secondary, female net enrollments were 76.8 percent and male 57.5 percent in 2015 and for primary, female net enrollments were 84.6 percent and male 79.7 percent in 2015.

55. In general, Tuvalu's environmental protection regime is adequate and has been strengthened over time through substantial project engagements and technical assistance from development partners. The Environmental Protection Act (2008) provides the overarching legislative framework for environmental protection and management, including the requirement to perform environmental impact assessments for larger projects. Capacity in the Department of Environment, however, remains thin – such that the GoT will continue to remain heavily reliant on outside expertise provided by regional organizations, notably the Secretariat of the Pacific Regional Environment Program (SPREP). Substantial project engagements and technical assistance from development partners, including from the World Bank, in recent years have supported the strengthening of the environmental protection framework and capacity for risk management. As such, it is generally considered that adequate protection would be provided by the existing legal and administrative frameworks for environmental assessment and land management in Tuvalu.

5.3 PFM, DISBURSEMENT AND AUDITING ASPECTS

Public financial management environment.

56. Tuvalu's PFM environment is improving. Key documents relating to PFM include the PEFA assessments, the PFM reform roadmap, and the Assessment of National Systems (ANS) conducted by DFAT. The 2015 PEFA self-assessment and the 2015 ANS reported improvements in a number of PFM indicators, notably legislative scrutiny, cash management, and reporting, Annual Financial Statements of the GoT are submitted for audit within six months of the end of fiscal year in accordance with regulations and are audited by the Auditor General applying international auditing standards. The Auditor General's report in recent years have noted improvements in PFM implementation from year to year, however the Auditor-General has issued a qualified disclaimer[21] of audit opinion, raising concerns around the effectiveness of the management control environment. Annual budget documentation is made publicly available, both in printed form and on the website of the Auditor General.

57. The GoT is leading a coordinated reform program to address weaknesses identified in its PFM system. Government reforms in this area are guided by a rolling 5-year PFM reform roadmap – the latest of which was endorsed by Cabinet in May 2017. The 2011 PEFA identified weaknesses in predictability and control in budget execution, the latter including long outstanding reconciliations and overspending by line ministries due to lack of internal controls over commitments. To address these weaknesses, the GoT has strengthened the integrity of its revenue management systems and in year expenditure management. Prior actions supported under the previous series of operations further addressed the need for regular reconciliation of fisheries and treasury records and strengthening the effectiveness of commitment controls, and the reporting of subnational fiscal data. Government reforms in this area are guided by a PFM reform roadmap which was endorsed by Cabinet in 2012.

Foreign exchange environment

[21] The auditor has cited a number of scope limitations as the basis for the disclaimer of audit opinion including valuation issues, lack of evidence, non-consolidation, and lack of certain reconciliations.

58. 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. The overall fiduciary risk for the operation is assessed as Substantial. A set of mitigation measures have been proposed below, 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.

Disbursement and Auditing

59. The proposed operation is the second in a two-year programmatic series 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 disbursed, in Australian dollars, by IDA into a deposit account in a separate government account at the National Bank of Tuvalu, provided that the implementation of the program is satisfactory and the macroeconomic policy framework remains adequate. The National Bank's 2016 annual financial statements received an unqualified audit opinion, and it has previously been used for the designated account for previous DPOs and the Pacific Aviation Investment Program in Tuvalu. As a due diligence measure, within 30 days of receipt the Recipient 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 General Conditions. If, after being deposited in a government deposit account, the proceeds of the operation are used for ineligible expenditure as defined in the General Conditions, IDA will require the Recipient to refund the amount directly to IDA. Any such amounts refunded to IDA shall be cancelled.

60. As an additional mitigation measure, 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) show 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) show that an equivalent amount was accounted for in the Recipient's budget management system. This will enable IDA to review compliance with the Financing Agreement and achievement of the operation's objectives.

5.4 MONITORING, EVALUATION AND ACCOUNTABILITY

61. The implementation of this program's policy actions will be the responsibility of the GoT under the coordination of the MFED. Tuvalu's reform efforts 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. The MFED will coordinate and monitor the program and the related indicators described in the policy matrix (Annex 1), and provide regular reports to the World Bank against agreed timelines. The MFED has adequate capacity to coordinate and monitor the program related indicators, although data availability can be limited.

62. **Grievance Redress.** Communities and individuals who believe that they are adversely affected by specific country policies supported as prior actions or tranche release conditions under a World Bank Development Policy Operation may submit complaints to the responsible country authorities, appropriate local/national grievance redress mechanisms, or the WB's Grievance Redress Service (GRS). The GRS ensures that complaints received are promptly reviewed in order to address pertinent concerns. Affected communities and individuals may submit their complaint to the WB's independent Inspection Panel which determines whether harm occurred, or could occur, as a result of WB non-compliance with its policies and procedures. Complaints may be submitted at any time after concerns have been brought directly to the World Bank's attention, and Bank Management has been given an opportunity to respond. For information on how to submit complaints to the World Bank's corporate Grievance Redress Service (GRS), please visit http://www.worldbank.org/GRS. For information on how to submit complaints to the World Bank Inspection Panel, please visit www.inspectionpanel.org.

6. SUMMARY OF RISKS AND MITIGATION

63. **The overall risk level for the program is rated as substantial.** One risk category, *institutional capacity for implementation and sustainability* is rated high, while four risk categories are rated substantial. The overall risk rating is therefore considered to be substantial.

64. **Macroeconomic risks.** Tuvalu's macroeconomic and fiscal framework is vulnerable to shocks that are characteristic of small Pacific economies. On the external front, commodity price shocks could be readily translated into higher or lower domestic prices given the extent which consumption relies on imported goods, particularly food and fuel. In 2015, with global fuel prices halving, this resulted in an approximately 6 percent reduction in the wholesale fuel price in Tuvalu, with the trend continuing in 2016. Global or regional economic downturns could yield a shock to Tuvalu's remittance flows, diminish employment opportunities abroad, and create an uncertain aid environment. Similarly, the returns on the TTF are exposed to the unpredictable fluctuations of international financial markets. Finally, an unexpected decline in receipts from fisheries contracts or donor grants would cause a strain on Tuvalu's fiscal position. Tuvalu is also vulnerable to extreme weather events that could incur high recovery costs. Beyond external shocks, slower domestic policy reform, for instance on PE restructuring, including of the banking sector, could also affect fiscal sustainability. The GoT has taken a prudent approach in estimating revenues and grants to provide a cushion against external uncertainties; continued donor engagement will support reform momentum, including reforms to improve the efficiency of public expenditures and strengthening TTF investment management, reducing these risks. These idiosyncratic risks could also counteract one-another, reducing their impact. Finally, the Bank will also continue to work with IMF staff to monitor macroeconomic risks and provide policy advice to government as needed.

65. **Very limited institutional capacity for implementation and sustainability of reform present risks to the results of the operation.** Tuvalu suffers from an extreme case of the thin capacity that is typical of public sectors in very small states, with a small number of public servants called upon to implement the many tasks of a central government. The limited number of staff with the required technical qualifications and experience to undertake supported reforms means that poor performance or departure of staff working on the program can directly affect the speed and quality of implementation of the reform

program. This risk is being mitigated by close and ongoing dialogue through which the Government and the Bank have carefully selected a limited number of policy actions that are key priorities for the Government. The Government, Bank and other partners have discussed the implementation requirements for each action at length, to ensure that expectations regarding the timeframes for implementation are realistic. Limited capacity is also being mitigated through the provision of dedicated technical assistance from various development partners to the achievement of nearly all specified actions, while the development of the results framework considers the limitations of what data is available. Complex and significant reform programs such as the one supported under this operation, require ongoing commitment and engagement throughout implementation and so this program has been designed to as support a gradual, phased approach to reform, as part of an ongoing, broader budget support engagement between the Government, Bank and other development partners.

66. **Fiduciary risks.** The overall fiduciary risk for Tuvalu is assessed as Substantial primarily due to the ongoing issues with PFM implementation identified in the Auditor-General's report and the high dependency on key personnel in a 'thin' capacity environment. Mitigation measures include a Local Currency Deposit Account opened in the government's Consolidated Fund held at the National Bank of Tuvalu, together with an audit.

67. **Environment and social risks.** Tuvalu's high degree of vulnerability to external shocks, including from natural disasters, poses a risk to the achievement of the development objectives under the second pillar of the operation. If the country experiences another major natural disaster over the medium-term, Tuvalu's macroeconomic stability will be threatened and large parts of the bureaucracy will have to shift their attention to disaster recovery and reconstruction efforts. It is not necessarily feasible or desirable to mitigate this risk entirely, because in the event of such a major natural disaster, restoring existing capacity would actually be the most important thing Tuvalu could do to restore the livelihoods, particularly for the poor. However, to mitigate this risk the GoT is developing Standard Operating Procedures (SOPs) for cyclones and tsunamis, to increase its comprehensiveness and in turn enhance preparedness for future climate and disaster risks. Although large-scale natural events do not occur frequently in Tuvalu, TC Pam demonstrated weaknesses in the current response framework. In June 2015, the GoT endorsed the Tuvalu TC Pam Vulnerability Reduction Plan, which in addition to providing guidance on short- to medium-term recovery efforts, also provides a longer-term road map to building resilience and reducing vulnerability, including through climate-proof investments. Learning from this experience, the GoT is developing SOPs which previously did not exist for key disasters of cyclones and tsunamis. These will then be tested at the national and island levels to ensure their effectiveness while at the same time building the capacity of the national and island disaster committees. Once tested and revised, these SOPs will be approved by the Cabinet and communicated to the relevant ministries and stakeholders in several workshops. This will also inform any need to update the National Disaster Management Act in 2017. To complement these activities, the GoT is also planning to mainstream climate change in the school curriculum throughout the country. Improving disaster preparedness and building community resilience to disasters such as TC Pam will not only save lives, but reduce future response and recovery costs. In the Philippines, Typhoon Haiyan claimed more than 7,000 lives in 2013. Yet, when another potentially destructive storm, Typhoon Hagupit, passed over similar areas just over a year later, the death toll was much lower, at 27 people. According to the Red Cross, this is partly attributable to strengthened emergency plans.

68. The policy framework includes some reforms which could be met with opposition by vested interests which could affect the achievement of the program development objectives. A focus of the current operation is to support sustainable future public pay increases, and providing disincentives to consume tobacco and alcohol products, and sugary drinks; which could give rise to opposition from individuals that benefit from the existing system. For the latter, these risks are mitigated through extensive awareness raising led by the GoT and for the former, through ensuring that changes to civil service pay policy are conducted in a transparent way and communicated publicly.

Table 6. Systematic Operating Risk Rating

Risk Categories	**Rating (H, S, M or L)**
1. Political and governance	M
2. Macroeconomic	S
3. Sector strategies and policies	M
4. Technical design of project or program	M
5. Institutional capacity for implementation and sustainability	H
6. Fiduciary	S
7. Environment and social	S
8. Stakeholders	S
Overall	S

ANNEX 1: POLICY AND RESULTS MATRIX

Prior actions and Triggers		
Prior Actions under DPO 3	**Prior Actions under DPO 4**	**Results**
Pillar A – Improving the delivery of education and health services		
The Recipient's Cabinet has endorsed the removal of secondary education school fees to enhance the inclusiveness and equity of secondary education.	The Recipient, through its Cabinet, has approved a proposal to amend the Education Act, in order to formally recognize early childhood care and education as a government competency, overseen by the Ministry of Education, Youth and Sports.	Increased enrolment in secondary education[22] • **Baseline:** 2015 gross secondary enrolment rate (total/male/female/= 66.7/57.5/76.8 percent • **Target:** 2019 gross secondary enrollment rate is at least 5 percent higher for total, male and female.
The Recipient's Cabinet has approved the Tobacco Control (Amendment) Bill and directed that the amendments be introduced to Parliament to reduce risk factors for non-communicable diseases.	The Recipient, through its Cabinet, has approved increases to selected excise and import duties, on certain tobacco, alcohol and sugary beverage products, to reduce non-communicable disease risk factors.	Increase in retail price of unmanufactured tobacco, wine, spirits and cordial • **Baseline:** 2017 = 0 • **Target:** Increase in the average price of these products from 2017 to 2019 exceeds overall CPI inflation rate over the same period by 2 percent[23].
Pillar B – Improving macroeconomic sustainability		
The Recipient commissioned a review of the Tuvalu Trust Fund, which provided recommendations to strengthen reserve asset management by focusing on improving governance and investment policy, and this review has been submitted to the Tuvalu Trust Fund Board for endorsement of the recommendations.	The Recipient has: (a) appointed a representative of the Recipient's Government to the TTF Investment Committee; and (b) through its participation in TTF Board decision-making: (i) increased TTF secretariat staffing and, (ii) decided to commission an investment strategy review to better align investment management with strategic objectives.	International best practice applied to TTF investment management • **Baseline:** 2015 = Investment managers not selected on competitive basis and annual management fee average 63 basis points • **Target:** 2019 = Investment managers selected on competitive basis and annual management fee reduced by 20 basis points
The Recipient has introduced an automated payroll system to improve the effectiveness of payroll controls.	The Recipient, through its Ministry of Finance and Economic Development, has approved and circulated a revision to the financial instructions mandating the documentation of annual and medium-term budgetary impact of changes in civil service pay policy.	Adopting a medium-term perspective to salary and staffing changes in annual budget documentation • **Baseline:** 2017 = Budget documentation does not clearly identify three-year ahead costs of changes in civil service pay policy. • **Target:** 2019 = Budget documentation reports estimated costs of such policy changes, if any.
The Recipient's Parliament has enacted the Banking Commission Amendment Act and a framework for monitoring of the Banking sector was established to improve oversight and sustainability.	The Recipient, through its Ministry of Finance and Economic Development, has taken steps to make the Banking Commission fully operational by approving a supervision plan, and budgeting and advertising for an international supervision expert.	Increased oversight of the banking sector • **Baseline:** 2015 = No regular monitoring reports • **Target:** 2019 = Monitoring reports are produced annually, including information on non-performing loans, and tabled to the Cabinet for information.

[22] Source is annual Government of Tuvalu Education Statistical Report. The baseline and target for this results indicator have been revised as new data has become available.
[23] Measured with baseline price levels corresponding to pre-excise duty change announcement, i.e. end 2017.

ANNEX 2: LETTER OF DEVELOPMENT POLICY

GOVERNMENT OF TUVALU
OFFICE OF THE MINISTER OF FINANCE AND ECONOMIC DEVELOPMENT

Vaiaku, Funafuti, TUVALU
Phone: (688) 20408; Facsimile (688) 20210; Email: mtoafa@gov.tv

April 24, 2018

Letter of Development Policy

Mr. Jim Yong Kim
President
The World Bank
Washington D.C.
20433, USA

Dear President Kim,

Our development vision is for a healthy, more prosperous and more well-protected people of Tuvalu and our plan for achieving it is set out in detail in the National Strategy for Sustainable Development - Te Kakeega III 2016 - 2020. The program that I present to you in this letter reflects key means through which we aim to achieve this vision for Tuvalu, continuing our close and productive development policy partnership with the World Bank Group, coordinated with other development partners.

One of our most pressing challenges is to build the resilience and security of our country and people. Tuvalu is a very small and remote island nation, with a population of 10,000 people. Our islands, which lie at sea-level, are especially vulnerable to cyclones, king tides and sea-level rise. The industrial-country scourge of climate change presents a very real threat to Tuvalu and we are responding by strengthening our focus on climate change adaption and resilience-building.

Our fiscal strategy is fundamental to building resilience and prosperity now and for future generations in Tuvalu. Fiscal sustainability is a major challenge for a small and remote country like Tuvalu, where the domestic economic base is very limited. Yet over time, we have taken advantages of opportunities to sustainably utilize our resources, and currently enjoy significant receipts from fishing activities in Tuvaluan waters, as well as other revenues such as fees from use of the ".tv" domain name. These revenues are very volatile and in the last few years have been heightened, providing some space for improved service delivery and investment. But we continue to rely on development grants from our partners, which fill a critical gap in public funding and bring valuable technical expertise and knowledge.

We are building our long-term fiscal resilience by increasing fiscal buffers, through the use of trust funds. The Tuvalu Trust Fund (TTF) has continued to grow over time and provides a source of essential budget financing through capitalizing the Consolidated Investment Fund (CIF) which can be drawn on when needed. We have now also established the Tuvalu Survival Fund (TSF), which will support response to climate change and disaster threats. In the last two years, we have made capital payments into the TTF and TSF totaling more than AU$ 16m, and we intend to further capitalize the TTF to attain our objective of reaching a balance of AU$200m by 2020. This fiscal prudence now enables us to smooth volatile revenue trends and enhances our capacity to delivery essential services in the future.

Given the importance of our trust fund framework to achieving our goals, we are focusing on ensuring it is as effectively managed and aligned with our objectives as possible. In line with recommendations from two reviews of the TTF, including one prepared by the World Bank Group, we have increased the capacity of the TTF Secretariat role and included a Tuvalu representative on the Investment Committee, to ensure that decisions relating to TTF investments are carefully discussed and all members of the Board, including myself as Chair of the Board, are well briefed to make appropriate decisions. The TTF Board has also commissioned a strategic investment review, with a view to ensuring that the investment strategy adopted by the TTF is well aligned with government objectives for the fund, risk-return tradeoffs are optimal and investment management is competitive and cost-efficient.

I have already emphasized the importance of development grants from our valued bilateral and multilateral partners, and another pillar of our fiscal strategy is to operate within our means as far as possible, avoiding contracting of new debt unless it is absolutely necessary. In the last year, we have remained committed to this policy and not contracted any new public or publicly-guaranteed loans, and in line with the 2018 Government budget, we do not expect any new lending this year or in future years. While managing existing and new debt carefully, we expect to remain at high risk if debt distress due to the small, undiversified and volatile nature of our economy and revenue base.

While maintaining fiscal sustainability, this government has placed priority on raising the standards of living in Tuvalu by improving public service delivery and investments in essential infrastructure. We are placing a strong focus on improving education foundations for all, and lowering health risks. Supported under the last development policy operation, we removed all secondary school fees to encourage universal attendance, and we are also directing increased funding to the maintenance, renovation and supply of schools at both primary and secondary level, and improving teaching standards. Early child care and education (ECCE) is also of great importance to us, and we are continuing the roll-out of the PEARL program in 2018. To improve policy and service delivery, we have also committed to revising and modernizing our education legislation, to formerly recognize the ECCE sub-sector as a government competency, overseen by the Ministry of Education, Youth and Sports (MEYS). Overall our budgetary expenditure on the ECCE sector is to nearly double in 2018 to AU$870,000.

In the area of health, our population faces some severe risks, especially of non-communicable disease (NCD). It is difficult for a small country like Tuvalu to effectively address such health problems and we rely heavily on overseas tertiary medical care, at a significant cost to the public sector. We are now placing increased focus on averting such late-stage medical problem by improving the effectiveness of our primary and secondary healthcare and extending our services at these levels where appropriate. But in addition to healthcare problems, a broader package of policy and regulation to support health promotion will be essential, and that is why this year we have implemented significant increases to the excise and import duties on some of the most harmful consumption goods – like tobacco and strong alcohol – as well as introducing higher taxes on obesity-causing goods like sugary drinks.

We intend to maintain close control over public spending, recognizing that increases in expenditure must bring significant economic and social benefits, and otherwise wasteful expenditure will quickly become unaffordable. While we recognize the importance of the public sector to the majority of households in Tuvalu, we need to carefully manage wage-bill costs and ensure that any increase is commensurate with growing skills and competency in the public service. We are pleased to be continuing to work with the World Bank on wage-bill management, and have implemented a new budgetary forecasting model that will enable us to appraise the medium costs of proposed wage-bill policy and ensure that it is consistently reported in budgets. This, along with an assessment of inflationary pressures and productivity gains, will enable us to maintain a stable wage-bill and a productive and affordable public service.

Lastly, the government has moved towards strengthening the monitoring of the banking sector, to reduce the potential for contingent liabilities and support fiscal sustainability. As such, in my capacity as banking commissioner, I have taken steps to make the Banking Commission fully operational, including through the approval of a supervision plan and advertising for an international supervision expert.

The government is committed to continue to implement its medium-term reform agenda, with support and continued dialogue with the World Bank and other development partners. I can say that we have made considerable progress since we began our policy partnership five years ago, and have been able to stabilize the public finances and begin major reform undertakings. In particular, through the implementation of the government's PFM Roadmap, we have been able to make targeted improvements to our PFM systems, which has been critical to improving social service delivery, promoting macroeconomic and fiscal sustainability, and building resilience to natural disaster shocks and the ongoing impact of climate change. We remain committed to implementing the medium-term reform agenda to support a healthy, well-educated and prosperous Tuvalu that is as resilient as possible to climatic and economic variation and shocks. 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,

Honorable Maatia Toafa
Deputy Prime Minister and
Minister of Finance & Economic Development

ANNEX 3: FUND RELATIONS ANNEX

INTERNATIONAL MONETARY FUND

COMMUNICATIONS DEPARTMENT

Press Release No. 18/277
FOR IMMEDIATE RELEASE
July 5, 2018

International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Executive Board Concludes 2018 Article IV Consultation with Tuvalu

On June 22, 2018, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation[1] with Tuvalu.

Tuvalu has maintained macroeconomic stability. Real GDP growth is estimated to have risen to 3.2 percent in 2017 on large infrastructure and housing projects, in preparation for the Polynesian Leaders' Summit in 2018 and the Pacific Forum Secretariat Summit in 2019. Inflation accelerated to 4.4 percent in 2017 due to higher food and transportation prices. Reserve coverage is broadly sufficient at 9 months of imports at end-2017. The fiscal balance turned into a deficit of 4 percent of GDP in 2017 on lower fishing revenue and higher capital expenditure in preparation for the two regional summits.

The macroeconomic outlook is broadly positive. In 2018, growth is projected to accelerate to 4.3 percent on higher fiscal expenditure and infrastructure projects. Inflation is expected to reach 4 percent on higher public wages, partly offset by moderating food prices. In the medium term, growth is expected to remain robust at 4 percent, factoring in the implementation of infrastructure projects funded by development partners, including the Green Climate Fund. Reserves are expected to remain sufficient at 10 months of imports at end-2018. The fiscal balance is projected to turn into a surplus of 6 percent of GDP in 2018, on higher fishing revenue.

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board.

Since joining the Fund in 2010, Tuvalu's macroeconomic performance has improved. The fiscal deficit has narrowed and fiscal buffers have been replenished partly on strong fishing revenue. The authorities have also made progress in strengthening climate change resilience.

Nonetheless, the economy remains susceptible to downside risks, reflecting climate change and natural disasters, volatile fishing revenues, reliance on external grants, weak state-owned enterprises, and limited financial supervision.

Executive Board Assessment[2]

Executive Directors commended the authorities for the improved macroeconomic performance and for their work on strengthening climate change resilience. Directors welcomed the broadly positive outlook but noted that Tuvalu remains highly susceptible to external shocks, especially to climate change effects and uncertainties stemming from volatile fishing revenues and reliance on grants. The country's geographical remoteness, small size, and limited infrastructure pose additional challenges. Directors emphasized that strong commitment to sound policies and structural reforms is necessary to build resilience to shocks and generate sustainable growth.

Directors welcomed the progress made in promoting climate change resilience, including securing access to the Green Climate Fund. Going forward, Directors highlighted the importance of ensuring continuous access to multilateral climate change schemes. They noted that the priorities are implementing reforms under the PFM Roadmap, exploring multilateral risk-sharing mechanisms, and improving the financial management of the Tuvalu Survival Fund.

Directors underscored that strengthening the medium-term fiscal framework is key to macroeconomic stability. They emphasized that undertaking gradual fiscal consolidation should help contain fiscal and debt pressures, and build fiscal buffers. In this context, they encouraged the authorities to mobilize tax revenue, eliminate tax exemptions, and contain current spending. Prioritizing capital spending and strengthening fishing revenue forecasts will also be important. Directors also encouraged accelerating reforms of state-owned enterprises, including raising electricity tariffs and linking them to oil price changes.

Directors emphasized that greater financial sector oversight will help tackle the high non-performing loans, increase financial sector efficiency, and promote financial inclusion. They stressed the need for a financial supervisory framework covering the two banks and the pension fund. Directors called for measures to improve credit risk management of the Development Bank, enforce existing financial regulations, and develop bankruptcy legislation.

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[2] At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. An explanation of any qualifiers used in summing up can be found here: http://www.imf.org/external/np/sec/misc/qualifiers.htm.

Directors emphasized that structural reforms aimed at increasing potential output and diversifying the growth base are critical. They encouraged the authorities to give priority to stimulating private sector development by improving the business environment. Directors called for stepped up efforts to strengthen human capital, develop tourism and goods exports, and enhance water resource management. They noted that continued action to enhance macroeconomic statistics will assist in policy formulation and agreed that technical assistance from the Fund will be helpful.

Tuvalu: Selected Social and Economic Indicators, 2015–2019 1/

	2015 Est.	2016 Est.	2017 Est.	2018 Proj.	2019 Proj.
Real sector					
Real GDP growth	9.1	3.0	3.2	4.3	4.1
Consumer price inflation (end of period)	4.0	2.6	4.4	4.0	3.4
Government finance					
Revenue and grants	136	138	122	161	113
Revenue	102	113	97	118	82
Of which: Fishing license fees	51	68	50	80	46
Grants	34	25	25	43	32
Total expenditure	121	131	126	155	118
Current expenditure	99	111	97	103	101
Capital expenditure 1/	22	19	29	52	17
Overall balance	15	7	-4	6	-4
Of which: Domestic Current balance 2/	-47	-67	-49	-65	-65
Financing	-15	-7	4	-6	4
Consolidated Investment Fund	15	7	-4	6	-4
Tuvalu Trust Fund (in percent of GDP)	318	336	333	315	299
Consolidated Investment Fund (in percent of GDP)	55	55	42	59	55
Tuvalu Survival Fund (in percent of GDP)	...	10	10	14	17
Monetary Sector					
Credit growth (percent change) 3/	3	13	6	6	5
Balance of payments (in percent of GDP)					
Current account balance	-53	23	6	5	-1
Goods and services balance	-216	-135	-141	-154	-140
Capital and financial account balance	74	5	-2	9	8
Of which: capital transfers	19	23	16	11	11
Overall balance	21	28	4	14	7
Gross reserves 4/					
In $A million	57	70	73	81	85
In months of prospective imports of goods and services	9	10	9	10	10
Debt indicators					
Gross public debt	57	47	37	28	22
External	53	45	37	28	22
Domestic	3	2	0	0	0
Exchange rates					
Australian dollar per U.S. dollars (Period average)	1.33	1.34	1.30	...	...
Australian dollar per U.S. dollars (End-period)	1.38	1.36	1.31	...	...
Real effective exchange rate (2010=100)	104	108	113	...	...
Nominal GDP (In $A million)	47	49	53	57	61

Sources: Tuvalu authorities; PFTAC; SPC; ADB; World Bank; 2018 IMF's BOP TA; and IMF staff estimates and projections.

1/ Includes Special Development Fund and infrastructure investment.

2/ Domestic current balance excludes fishing revenue, grants, and capital expenditure.

3/ Banks' and pension fund lending to non-government domestic sector.

ANNEX 4: ENVIRONMENT AND POVERTY/SOCIAL ANALYSIS TABLE

Prior actions	Significant positive or negative environment effects	Significant poverty, social or distributional effects positive or negative
Pillar 1: Improving Social Service Delivery		
The Recipient, through its Cabinet, has approved a proposal to amend the Education Act, in order to formally recognize early childhood care and education as a government competency, overseen by the Ministry of Education, Youth and Sports.	No	No
The Recipient, through its Cabinet, has approved increases to selected excise and import duties, on certain tobacco, alcohol and sugary beverage products, to reduce non-communicable disease risk factors.	No	Yes
Pillar 2: Improve Macroeconomic Sustainability		
The Recipient has: (a) appointed a representative of the Recipient's Government to the TTF Investment Committee; and (b) through its participation in TTF Board decision-making: (i) increased TTF secretariat staffing and, (ii) decided to commission an investment strategy review to better align investment management with strategic objectives.	No	No
The Recipient, through its Ministry of Finance and Economic Development, has approved and circulated a revision to the financial instructions mandating the documentation of annual and medium-term budgetary impact of changes in civil service pay policy.	No	No
The Recipient, through its Ministry of Finance and Economic Development, has taken steps to make the Banking Commission fully operational by approving a supervision plan, and budgeting and advertising for an international supervision expert.	No	No