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TUVALU GOVERNMENT

OFFICE OF THE MINISTER OF FINANCE AND ECONOMIC DEVELOPMENT
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Letter of Development Policy

Dear President Kim,

Tuvalu is the smallest member of the World Bank, our population of 10,000 people, geographic remoteness, and vulnerability to exogenous shocks including natural disasters presents a unique set of development challenges. Nevertheless, the Government of Tuvalu (GoT) is determined to achieve prosperity for all Tuvaluans through the strategies and priorities that are articulated by its people in the National Strategy for Sustainable Development - *Te Kakeega II 2005-2015*. These priorities and strategies will enable Tuvalu to pursue growth, development and shared prosperity.

Investments in public services together with the support of development partners have resulted in significant steps towards achieving our national development objectives and the Millennium Development Goals (MDGs). According to the 2013 MDG report, we are on track to achieving universal primary school education, reducing child mortality, and improving maternal health. We have also made significant progress in promoting gender equality and empowering women. Extreme poverty is minimal in Tuvalu given customs of mutual support within communities and remittances have been a traditional safety net that still protects many of Tuvalu's households from extreme poverty. However, as highlighted in the 2010 Household Income and Expenditure Survey, poverty had reversed its declining trend since 2005 – especially in the rural areas – partly explained by the spikes in food and fuel prices and the global economic crisis. To combat this, GoT continues to provide employment opportunities in rural areas – where unemployment is high – through investment in infrastructure. Given the limited opportunities domestically, the GoT is also looking at strengthening employment orientated education to cater for overseas employment opportunities.

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

In recent years, Tuvalu has suffered from a number of economic shocks and natural disasters, placing Tuvalu in a precarious situation and limiting our country's ability to absorb future shocks. The global food and fuel price crisis caused increase in costs to households, especially since all grid electricity is generated from imported fuel. The global economic crisis also had a severe impact on the economy through declining remittances – from seafarers and seasonal laborers, and substantial loss to the capital of the national trust and pension funds, resulting in near exhaustion of buffer assets in the CIF. Tuvalu also suffered a major drought, with a state of emergency declared on September 28, 2011.

Since 2011, the economy has gradually recovered from the impact of these crises and we have prioritized the rebuilding of buffer assets to ensure macroeconomic sustainability. Through fiscal prudence and windfall revenues, we have been able to significantly reduced pre-grant deficit from around 44 percent of GDP in 2009 to a small surplus in 2013. This has enabled the GoT to utilize budget support grants to rebuild the CIF from near depletion after the global economic crisis to around AUD 15 million in 2013. Furthermore, in 2014, budget support from the World Bank, Australia, NZ together with the first distribution from the TTF is expected to enable the GoT to further increase the balance of the CIF from AUD 15 million to around AUD 24 million (above the sustainable target balance).

However, given the tight fiscal situation faced during this period, we have delayed essential spending, leading to increased expenditure pressure and arrears, which were address in 2014. We have increased support to the Outer Islands in 2014, including enhanced infrastructure investment and support to the Tuvalu Corporative Society which is the main wholesaler on the Outer Islands. In 2015, we remain committed to providing a similar level of support to the Outer Islands. We also provided an increase to salaries of civil servants in 2014 to cater for the high food and fuel prices experienced in the country. Although this is an increase to overall wage bill, in actual fact individuals only received a $30 per fortnight cost of living adjustment to their wage. The GoT is however committed to no further increase in wages for 2015 or until such time a public sector review is endorsed. The GoT has also largely settled our outstanding arrears resulting from tight fiscal situation in earlier years, which caused a temporary spike to our total expenditures in 2014. Given Tuvalu's medium term macroeconomic sustainability is contingent on external income sources and the performance of a volatile and uncertain global financial market, we will continue to exert prudence in fiscal management and will also need continued support from development partners to respond, to either real (including economic, environmental and climate change), or financial shocks.

Despite the external challenges we face, we firmly believe that the course we have set is the right one and with the sustained effort and continued advancement in key areas of reform, we will be able to achieve the targets laid out in the national development plan *Te Kakeega II*. To help implement this vision, the GoT developed a Policy Reform Matrix in 2012 which was updated in 2014, in coordination with development partners, to map out the reform agenda in the medium term. The Policy Reform Matrix follows the themes laid out in the *Te Kakeega II* These enabling themes are in turn reflected in the World Bank's budget support operation (the second in a series of two operations). In fact, the reforms selected for the current World Bank budget support operation reflect key activities that would support the achievement of government's priority development objectives – as laid out in the Priority Roadmap.

- More specifically, to improve governance and macroeconomic and fiscal management the government has begun implementing a Public Financial Management Reform Plan with an emphasis on strengthening revenue administration, expenditure controls, procurement policy.

accounting procedures and financial reporting, and budget formulation and planning. Recognizing these priorities the government has strengthened in-year accounting and reporting, prepared corporate strategies for line ministries including Ministry of Finance and Economic Development (MFED), and introduced and begun implementing procurement legislations. More recently, we have introduced centralized commitment control procedures aimed at strengthening internal controls and improving budget execution. As part of this reform, the GoT has introduced a new Purchase Order module in the financial management information system (ACCPAC). The GoT with support from PFTAC is also in the process of revising and updating the financial instructions, which are expected to include theses new commitment control procedures. In the medium term, these reforms are expected to support the overall goal of improving efficiencies and effectiveness of the use of public resources.

- To enhance revenue effort we have increased the Tuvalu Consumption Tax (TCT) rate from 4 percent to 7 percent in 2013 and strengthened tax administration to improve compliance rate. More specifically, in 2013 and 2014, we undertook multiple tax audits of large tax payers and implemented tax recovery measures based on assessments on non-complying tax payers. As a result we achieved 100 percent compliance by public enterprises and remain committed to improving compliance across all sectors going forward. Given fishing license fees are now the biggest source of domestic revenues for Tuvalu, we have begun pursuing reforms to strengthen financial management of fishing revenues. The backlog of financial records in the fisheries management system has been cleared and financial records are now kept up to date. A full reconciliation of 2013 records was also completed between treasury and fisheries departments. An ACCPAC module will also be introduced in the Fisheries department to automate exchange of information from invoicing to receipt of payments between Fisheries and Treasury departments. This will enhance the integrity of the fishing revenue management system and the accuracy of fishing revenue estimates. Strengthening oversight of fisheries revenues will complement other planned medium term reforms in the fisheries sector including the audit and restructuring of NAFICOT (a PE which currently exposes the GoT to substantial contingent liabilities).

- To facilitate outer island development, the government adopted and begun implementing the outer island project management policy to enhance the development impact of outer island projects. More recently the government has brought up to date with the submission of outer islands account from 2000 to 2011 to the Auditor General. We have also piloted a streamlined, context appropriate, financial reporting framework that is expected to help Kaupules better understand their financial position and account for all transactions and monies accurately. Inclusion of project fund accounts as part of the regular reporting efforts will make the progress of projects more transparent and enable better tracking of projects compared to budget. Together, these reforms are expected to result in greater prioritization of the projects by Kaupules to satisfy each island's needs, encourage timely and on budget delivery of projects, and strengthen accountability and governance of Kaupules. In the medium term these reforms are expected to improve the quality and the development impact of outer island expenditure.

- To strengthen social service delivery, reforms in the health sector with the aim of improving the management of the Tuvalu Medical Overseas Medical Treatment Scheme (TMTS) are underway. A number of cost reduction measures were piloted in 2013 including a new referral process for sending cardiac patients to high quality and lower cost facilities outside of the region. These reforms were subsequently institutionalized in the revised TMTS policy in 2014. The government is committed to proving for a healthy Tuvalu, and to complement the above described reforms with increases in budget provisions for primary and preventive health care in accordance with the objectives of *Te Kakeega II*.

• Similarly, education reforms focus on improving the management of the education system, and increasing employment orientated education. In particular, scholarships awards funded by the government have been limited to 30. In addition, extensions and variations regulations have been tightened and are being enforced to limit overspending. Through efficiencies achieved in the tertiary sector, the GoT has continued to prioritize the education sector in its reforms with an emphasis on strengthening basic education, including employment orientated education. Towards this end, the government has endorsed the broadening of the TMTI curriculum to include training for fishing vessel crews, and allow greater access to vocational training for women.

• Finally, we have and remain committed to improving the sustainability of public enterprise (PE). In 2012 and 2013 we completed: (i) an audit of all operating PEs; (ii) the merger of Tuvalu Philatelic Bureau, Tuvalu Travel Office and the Tuvalu Post Office for efficiency savings; and (iii) the removal of public servants from PE boards. In 2014, we developed a PE reform plan to improve their commercial and financial viability. The implementation of this plan will be overseen by our fully staffed Public Enterprise Reform and Monitoring Unit and complemented with ADB technical support. Towards this end, we plan on privatizing the Vaiaku Lagi Hotel. Furthermore, with support from development partners, investments to increase renewable energy in the generation mix and efforts to increase efficiency of the electricity grid is expected to yield large savings and therefore significantly improve the financial sustainability of our only utility. Separately, we are committed to enhancing the soundness of the banking sector (all PEs). In 2014, our Cabinet approved the implementation of the Banking Commission Act and we have requested technical assistance from PFTAC in implementing the Act and advising on the establishment of the new Banking Commission.

Mr. President, coming out of a difficult economic and fiscal situation, we have made significant progress in improving our fiscal sustainability while implementing the reform agenda laid out in the reform roadmap. The government is also committed to continue to deepen this reform agenda, with support and continued dialogue with the World Bank and other development partners. Furthermore, we remain firmly committed to implementing the medium term reform agenda to create a healthy, educated, peaceful and prosperous Tuvalu. I request, that the World Bank take this operation through the lens of our unique challenges as one of the smallest and most geographically isolated member of the World Bank. The Government and the people of Tuvalu, welcome the continued active engagement of the World Bank in Tuvalu in this earnest and important endeavor.

Yours Sincerely,

Honourable Maatia Toafa
Minister of Finance and Economic Development

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