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Report No. 94359 - TV

INTERNATIONAL DEVELOPMENT ASSOCIATION

PROGRAM DOCUMENT

FOR A PROPOSED

DEVELOPMENT POLICY GRANT

IN THE AMOUNT OF SDR 1.1 MILLION
(US$1.5 MILLION EQUIVALENT)

TO

TUVALU

FOR A

SECOND DEVELOPMENT POLICY OPERATION

February 27, 2015

MACROECONOMIC AND FISCAL MANAGEMENT GLOBAL PRACTICE
COUNTRY MANAGEMENT UNIT FOR TIMOR-LESTE, PAPUA NEW GUINEA AND PACIFIC ISLANDS
EAST ASIA AND PACIFIC REGION

GOVERNMENT FISCAL YEAR
January, 1 – December, 31

CURRENCY EQUIVALENTS
(Exchange Rate Effective as of January 31, 2015)

Currency Unit - Australian Dollar (AUD)
(US$1.00 = AUD1.2858)

ABBREVIATIONS AND ACRONYMS

ANS	Assessment of National Systems	LDP	Letter of Development Policy
ADB	Asian Development Bank	MDGs	Millennium Development Goals
AUD	Australian Dollar	MFED	Ministry of Finance and Economic Development
CAS	Country Assistance Strategy	MOHA	Ministry of Home Affairs
CIF	Consolidated Investment Fund	MPs	Members of Parliament
CPI	Consumer Price Index	MTFF	Medium Term Fiscal Framework
CPU	Central Procurement Unit	OAG	Office of Auditor General
DBT	Development Bank of Tuvalu	OIs	Outer Islands
DPO	Development Policy Operation	PE	Public Enterprise
DPO I	Tuvalu First Development Policy Operation (P145488)	PEFA	Public Expenditure and Financial Accountability
DSA	Debt Sustainability Analysis	PFM	Public Financial Management
FTF	Falekaupule Trust Fund	PRM	Policy Reform Matrix
GDP	Gross Domestic Product	SDR	Special Drawing Rights
GFC	Global Financial Crisis	TKII	Te Kakeega II - National Strategy for Sustainable Development 2005-2015
GOT	Government of Tuvalu	TMTI	Tuvalu Maritime Training Institute
HIES	Household Income and Expenditure Survey	TMTS	Tuvalu Medical Treatment Scheme
IBRD	International Bank for Reconstruction and Development	TTF	Tuvalu Trust Fund
IDA	International Development Association	US$/USD	United States Dollar
IMF	International Monetary Fund	VDS	Vessel Day Scheme

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TUVALU

SECOND DEVELOPMENT POLICY GRANT

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SUMMARY OF PROPOSED GRANT AND PROGRAM

TUVALU

SECOND DEVELOPMENT POLICY OPERATION

Recipient	Tuvalu
Implementation Agency	Ministry of Finance and Economic Development
Financing Data	International Development Association (IDA) Grant (standard IDA Grant terms) Special Drawing Rights (SDR) 1.1 million (US$ 1.5 million equivalent)
Operation Type	The proposed operation is the second in a programmatic series of two development policy operations.
Pillars of the Operation And Program Development Objective(s)	The first pillar of the program focuses on strengthening public financial management with the specific development objectives of improved commitment control, enhanced oversight of fishing revenue, and streamlined reporting of local governments (Kapaules). The second pillar focuses on improved social service delivery with the specific objectives of enhancing the efficiency of the tertiary health and education schemes to enable strengthened focus on primary and preventative healthcare and primary and secondary education (including vocational training), with increased access for women.
Result Indicators	**Indicator 1**: Stock and monitoring of arrears ▪ Baseline: 2012 = stock of arrears = 8.9% and no arrears monitoring ▪ Target: 2015 = stock of arrears < 2% of expenditure and annual statement of arrears produced **Indicator 2**: Management of revenue records ▪ Baseline: 2012 = Full reconciliation not available ▪ Target: 2015 = Up to date Treasury records are reconciled at least quarterly and do not deviate by more than 10 percent from those of the revenue and fisheries management systems **Indicator 3**: Local government (Kaupule) accounts are compiled on a timely basis and made public ▪ Baseline: 2012 = Kaupule audited accounts are not compiled / published ▪ Target: 2015 = At least ¾ of annual Kaupule accounts are compiled within the statutory time limit and published on the Auditor's website. **Indicator 4**: Increased rigor of the referral process ▪ Baseline: Number of referral cases scrutinized by a multidisciplinary referral committee in 2012 = none ▪ Target: Number of referral cases scrutinized by a multidisciplinary referral committee in 2015 > 85 percent **Indicator 5**: Increased budget allocation to primary & secondary education (including vocational) ▪ Baseline: 2012 = AUD 3.1 million ▪ Target: 2015 = Increase on average by at least 5 percent per annum **Indicator 6**: Availability of gender disaggregated data on beneficiaries of the broadened TMTI training program ▪ Baseline: 2012 = none ▪ Target: 2015 = Data available
Overall risk rating	Substantial
Operation ID	P150194

IDA PROGRAM DOCUMENT FOR A PROPOSED DEVELOPMENT POLICY GRANT TO TUVALU

I. INTRODUCTION AND COUNTRY CONTEXT

1. **This program document proposes a Development Policy Grant in the amount of SDR 1.1 million (USD 1.5 million equivalent)[1] as the second in a programmatic series of two operations in support of Tuvalu's ongoing reform efforts.** This operation will support reforms to strengthen public financial management and improve social services delivery. Given the importance of the public sector to Tuvalu's economy, an effective system for public financial management (PFM) is critical. The first pillar of the program focuses on strengthening PFM with the specific development objectives of improved commitment control, enhanced oversight of fishing revenue, and streamlined reporting of local governments (Kapaules). The second pillar focuses on improved service delivery with the specific objectives of enhancing the management and efficiency of Tuvalu's essential, but costly, overseas medical treatment scheme and strengthening vocational training, including increased access for women. These services are essential to building and maintaining human capital, a key asset for an undiversified small economy. Together, the supported reforms are designed to help Tuvalu improve its fiscal position both in terms of revenue and expenditure, while maintaining the quality of public services.

2. **Tuvalu, comprised of nine Polynesian islands and atolls, is one of the smallest states in the world with a population of around 11,000 and a land area of only 26km^2.** Tuvalu is the smallest and one of the newest members of the World Bank Group, having joined the World Bank only in 2010. Hence, in addition to supporting and sustaining important policy reforms, this operation will provide an important opportunity to continue developing mutual understanding of Tuvalu's special context, and the role that the Bank can play in Tuvalu's development.

3. **Tuvalu is governed as a parliamentary democracy and the next general election is scheduled for early-2015.** 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 is the head of government. Executive power is exercised by the government. There are 15 Members of Parliament (MPs), includingone female, in the unicameral legislature, each serving a four-year term. There are no formal political parties and floor crossing by MPs is possible, although this has not led to frequent changes in government and Tuvalu ranks in the 90th - 100th percentile on Political Stability under the World Governance Indicators. MPs tend to have very close ties to the island they represent and election campaigns are largely on the basis of personal and family ties and reputation. Traditional chiefs also still play a significant role in influencing island affairs, particularly on the Outer Islands (OIs). This operation provides an opportunity to help sustain critical reforms through the upcoming election scheduled for early-2015.

4. **Tuvalu's economy is highly vulnerable to challenges stemming from its very small size and geographic isolation, structural economic conditions, and relies heavily on grants and buffer assets to absorb shocks.** Tuvalu is one of the smallest and most remote Pacific islands[2]. As is the case in many other small, open and import-dependent economies, Tuvalu is highly vulnerable to global economic shocks and price spikes. With no monetary independence[3], a high level of import dependence and a minimal financial infrastructure, fiscal policy is the main tool available to the Government of Tuvalu (GoT) to manage the

[1] USD 1.5 million equivalent based on SDR/ USD rate on January 31, 2015.
[2] The size of Tuvalu's economy is around AU$39.7 million based on 2013 GDP estimates. Tuvalu is over 3,500 kilometers away from the nearest major market of New Zealand.
[3] Tuvalu does not have a central bank, and uses the Australian dollar as its currency. The 2014 Article IV noted that the use of the Australian dollar is the most appropriate exchange rate arrangement for Tuvalu and there is no significant exchange rate misalignment.

economy. Yet, Tuvalu's fiscal position is extremely tight with insufficient funding for government investments or operations, particularly in times of crisis. The pre-grant deficit averaged 28.1 percent of GDP in the decade to 2014 and grants financed over 80 percent of the deficits. In addition, 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 could significantly alter fiscal outcomes e.g. a drought costing AUD 10 million could result in budget deficits of around 25 percent of GDP. Therefore maintaining adequate buffer assets is critical to Tuvalu's ability to absorb inevitable future shocks.

5. **The public sector dominates the economy, accounting for approximately two-thirds of GDP, as well as the majority of formal sector employment.** The size of the public sector reflects the inability of a very small country to exploit economies of scale in public administration and the provision of services. Domestic private sector plays a limited role in the economy. Agriculture contributed around 23 percent of GDP. Subsistence farming and fishing, the main economic activities in this sector, have suffered more recently from poor soil quality, limited access to fresh water and the high cost of imported fuel. Droughts (the most recent one in September 2011) have also had a further negative effect on crop yields and the contribution of this sector to the economy. The construction sector, largely driven by donor financed projects, has grown unevenly and contributes around 10 percent of GDP. Tuvalu has a long tradition in seafaring on merchant ships, which has been a major source of employment and foreign exchange for Tuvalu. However, employment opportunities have been disappearing as demand for seafarers has declined in the aftermath of the global economic crisis and competition for jobs increased.

6. **A series of shocks including droughts, global economic crises and increasing prices contributed to rising poverty in Tuvalu in recent years, particularly for the OIs.** The most recent poverty estimates, conducted in 2010, show that 3.4 percent of the population experienced food poverty down from 4.9 percent in 2005. On the other hand, 26.3 percent of the population experienced material deprivation up from 21.2 percent in 2005. Poverty is concentrated in the OIs and the gap with the capital Funafuti has increased in recent years. Lack of access to services, employment opportunities (remittances) and vulnerability to shocks (such as food price shocks) are some of the factors underlying the recent increase in poverty, particularly for the OIs. Female headed households have become noticeably less poor in recent years although women's share of paid employment in particular is lower than men's, despite a relatively high level of access to education.

7. **There are limited available data on poverty to assess Tuvalu's performance against the World Bank's twin goal of eradicating extreme poverty and boosting shared prosperity.** While PPP adjusted poverty lines are not available for Tuvalu, the food poverty line would likely be somewhat higher than two dollars. With food poverty estimated to affect 3.4 percent of the population, the World Bank's first goal of eradicating extreme poverty is likely to be already met in Tuvalu. On shared prosperity, 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 the 2010 Household Income Expenditure Survey (HIES) data. This is significantly below the cross-country median of 4.7 based on the Global Income Dynamics Dataset. A HIES is expected to be completed in 2015 and the World Bank is engaged in a coordinated dialogue on this front. See Annex 4 for more details.

8. **Tuvalu's buffer assets in the Consolidated Investment Fund (CIF) supported the GoT in weathering the recent global financial crisis (GFC).** The Tuvalu Trust Fund (TTF) is a capital preserving fund established post-independence to contribute to Tuvalu's fiscal sustainability[4]. Surplus returns on the investment of the TTF are accumulated in the CIF. Funds in the CIF are generally sufficient to provide a regular source of funding for the budget and saved surplus returns have provided a fiscal buffer at times when TTF earnings have been low or when unexpected financing gaps arise[5]. However, the TTF suffered large losses in

[4] See Box 1 for more detail on the TTF.
[5] Since inception, distribution from the CIF provided on average budget support equivalent to15 percent of total revenues.

2008 with the GFC, and Tuvalu's savings in the CIF have been substantially drained since 2009 to finance subsequent budget deficits. During this period, the GoT had to exercise expenditure restraint and including delaying wage adjustments, maintenance spending and OI development spending, which led to increasing expenditure pressure and arrears. Meanwhile, the TTF's capital value has recovered gradually since the GFC, with a surplus return achieved for the first time at the end of 2013. Together with higher grants and revenues, buffer assets in the CIF have been substantially rebuilt.

9. **The GoT has laid out an agenda to address economic challenges and improve macroeconomic sustainability.** As set out in its National Strategy for Sustained Development 2005-2015 or Te Kakeega II (TKII), the GoT has been and will continue to focus on ensuring continued provision of adequate services to Tuvaluans and pursuing both revenue and expenditure efficiencies (as reflected in the policy areas supported by this operation). In line with national development priorities, the GoT has also initiated a series of reforms as documented in the Policy Reform Matrix (PRM), to pursue measures that would reduce economic vulnerabilities, ease fiscal constraints, improve PFM, and enhance the efficiency of key government programs in health and education. The PRM was developed by the GoT, in consultation with the World Bank and other development partners and the process of developing the PRM has enabled the Bank to work with other development partners in a coordinated policy dialogue for the achievement of the priority goals identified in the TKII. The PRM has also proven to be an effective tool for enhancing strategic focus and delivering a practical reform agenda. Nevertheless, fiscal outlook remains fragile and reliant on both grant support and the continued performance of the TTF. The GoT will also need to maintain its focus on fiscal prudence and address vulnerabilities in Public Enterprises (PEs) to maintain a sustainable level of fiscal buffers.

10. **The programmatic series of operations is expected to support the GoT's development objectives and contribute to the improved wellbeing of Tuvaluans in both Funafuti and the OIs, while providing critical financing to enable the maintenance of adequate buffer assets in the CIF.** Drawing from the PRM, reforms to strengthen PFM and improve social service delivery have been identified as critical areas the World Bank can best support. Reforms to strengthening PFM are expected to contribute to improving poverty and social outcomes in Tuvalu indirectly by making the budget a more effective tool for responding to national poverty and social needs. Similarly, the outer island financial and project management reforms are expected to enhance accountability and transparency of outer island Kaupules, in turn improving access to services for some of Tuvalu's poorest and most remote households. Reforms to improve revenue and expenditure efficiencies will enable the maintenance of a sustainable level of fiscal buffers, which in medium term will ensure continued service provision even through periods of shock. Better management of both the overseas scholarship and medical treatment programs is expected to free up scarce resources and allow the GoT to start rebalancing education expenditure towards equitable employment orientated vocational training, and increase expenditure on basic healthcare, which is relied on heavily by poorer households. These reforms are expected to contribute to the government's TKII objective to "provide quality health and education services that are equitable, balanced, cost effective, and meet the needs of Tuvaluans". Financing provided through the operations will support the maintenance of adequate buffer assets in the CIF and ensure Tuvalu's ability to absorb future shocks without impeding the level of service delivery.

11. **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 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. These idiosyncratic risks could counteract one-another and the Bank will continue to work with International Monetary Fund (IMF) staff to monitor macroeconomic risks and provide policy advice as needed. Financial sector risks for example are being

addressed initially with policy advice from IMF. Finally, elections scheduled for early-2015 could distract the GoT from the planned policy reforms or disrupt policy continuity. This risk is, however, largely mitigated through the endorsement of the reforms by both the government and the opposition. Therefore it is unlikely that the scheduled general election would lead to policy reversals.

II. MACROECONOMIC POLICY FRAMEWORK

A. RECENT ECONOMIC DEVELOPMENTS

12. **Tuvalu has experienced uneven economic growth, which has remained low following the GFC.** Although the economy revived briefly in 2011, growing by 8.5 percent due to a pick-up in construction of infrastructure projects and small service sector business activities, growth slowed down to 0.2 percent in 2012 as these activities wound down. In 2013, growth picked up to 1.3 percent, and is projected to grow by a further 2.2 percent in 2014, supported by growth in fish exports. Inflation as measured by the CPI remained moderate, averaging 2.0 percent in 2013, continuing to benefit from benign global food and commodity prices as well as trade diversification and increased retail competition.

13. **The current account of the balance of payments reached a surplus of 26 percent of GDP in 2013, supported by large fishing-related receipts and official aid.** Domestic production is limited in Tuvalu resulting in heavy dependence on imports, all petroleum products, air travel services and a very high proportion of food are imported, which leaves the country extremely vulnerable to international commodity price fluctuations. Boosted by the output of a fishing joint venture, exports doubled in just a few years. With the introduction of a new fishing licensing scheme, license fees more than doubled, reaching 45 percent of GDP in 2013. Foreign aid has been substantial, standing at around 20 percent GDP in 2013. However, declining work opportunities on merchant ships since the global crisis have resulted in remittances falling from around 17 percent of GDP in 2008 to around 10 percent of GDP in 2013[6]. Limited cash earning opportunities domestically, particularly outside of the capital, and the fall in remittance flows led to the deterioration in the population’s access to basic goods and services[7]. Other income sources such as investment income from the TTF and official grants remain variable and dependent on global economic conditions. As current account deficits are largely financed by CIF buffer assets, rebuilding its balance is critical to the macroeconomic stability of Tuvalu.

14. **Tuvalu’s financial assets were severely depleted in the aftermath of the GFC, although the GoT with support from development partners, has rebuilt it to the target level by 2014.** With taxes funding a relatively small proportion of Tuvalu’s budget, the volatile nature of Tuvalu’s other sources of revenues (such as fishing license fees) frequently result in unpredictable fiscal outcomes[8]. Unlike other countries, Tuvalu has limited channels to finance fiscal deficits and relies heavily on buffer assets and grants. The GFC resulted in a 20 percent loss in the capital of the TTF. As a result, the TTF made no distribution to the CIF from 2009 to 2013. In the immediate years after the GFC, despite a significant reduction in expenditures owing to the winding down of capital projects and restraints on recurrent expenditure, CIF assets were drawn down in line with its buffer function and not replenished by TTF distribution. Fishing license fees increased from 2012 onwards due to the implementation of the vessel day scheme[9]. This together with the reduction in expenditures resulted in the decline of pre-grant deficit from around 44 percent of GDP in 2009 to a small surplus in 2013. Together with grants, this has enabled the GoT to rebuild the CIF from near depletion in 2011 to around AUD 15 million

[6] Tuvaluans depend on support from extended families and loss of cash income from 1 person may have a widespread community impact.
[7] Although inflation remained moderate in recent years, households experienced a shock to their real incomes in 2008. Heavy import dependence combined with rising international prices for fuel and food caused annual inflation to spike to 10.4 percent in 2008.
[8] Tuvalu’s tax receipts accounted for around ¼ of revenue over the past five years with non- tax revenues accounting for the remainder. Fisheries income and royalties from the .tv internet domain alone accounted for over half of revenue.
[9] Fishing license fees were particularly high in 2013 due to favourable weather patterns resulting in higher prices for vessel days sold.

in 2013. In 2014, despite the GoT having addressed expenditure pressures and repaid arrears, 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 minimum sustainable target balance.

15. **Total expenditure rose to 96.4 percent of GDP in 2014 due to one-off payment of arrears and cost of living adjustment for civil servants, rising capital expenditures and election related expenditures.** In 2014, with the recovery of TTF's capital value and the replenishment of the CIF, the GoT paid off arrears outstanding with services providers accumulated in the years after the GFC, resulting in a temporary spike in the purchase of goods and services. Separately, the GoT announced a one-off $30 fortnightly cost of living allowance increase aimed at easing cost of living pressures while the GoT considers public sector reform options[10]. The cost of service delivery is increasing with rising maintenance and rental costs[11]. Recognizing the needs of the OI population (where poverty rates are higher), the GoT is also increasing capital spending in the OIs. With increasing absorptive capacity of the OIs through reforms to project preparation and implementation, this is expected to help support the OI economies and in the medium term provide essential infrastructure to improve the living standards of the OIs' population. Together with the normalization of revenues, this is expected to result in the widening of the pre-grant deficit to 26.8 percent of GDP, which is largely met by recurrent grants. Although the 2014 budget marks a departure from the consolidation trend, this was noted as a possible risk in DPO I given scheduled national elections and expected increase to cost of service delivery. The GoT has however laid out a firm plan to unwind this fiscal expansion in 2015 (see paragraph 22).

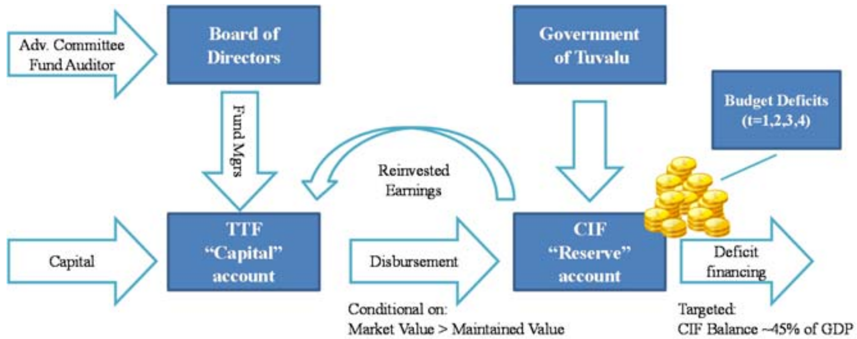
16. **The GoT has implemented reforms to enhance public finance / enterprise management and laid out a plan for future reforms to address economic challenges.** In recent years, Tuvalu has implemented major public finance reforms to ensure revenue and expenditure efficiency as well as adequacy of service delivery. The GoT has also made efforts to strengthen public enterprise management such as through the corporatization of PEs. In line with national development priorities, the GoT has also initiated a series of reforms spanning public enterprise management, PFM, outer island development, public service delivery and infrastructure development. These efforts will reduce vulnerabilities to future shocks, bring Tuvalu to a sustainable fiscal path in the medium term and ensure continued service provision to Tuvaluans even through periods of shocks.

Box 1. THE TUVALU TRUST FUND

As Tuvalu has very limited financing options other than grants to finance fiscal deficits, the TTF and CIF were established to contribute to Tuvalu's fiscal sustainability, although their ability to achieve this is contingent on global financial market conditions. The TTF was established in 1987 to provide an additional source of funding for recurrent expenditures and to set the country on a path towards greater financial autonomy. The TTF initially comprised of a single capital account commonly referred to as the TTF. The TTF was capitalized by donors (Australia, New Zealand, Japan, the Republic of Korea and the United Kingdom), and the GoT in 1988. The TTF is a capital preserving fund and its capital has grown over the years through reinvestment of its own earnings and contributions by the GoT during surplus periods. The TTF is not fully sovereign with development partners represented on its Board. The TTF's capital account aims to generate a real rate of return of 4.5 percent in excess of the Australian Consumer Price Index. An ancillary trust fund was established under full government control to facilitate predictability and regularity of transfers to the budget. In years when the market value of the TTF exceeds it's real maintained value (indexed to the Australian Consumer Price Index (CPI)), the surplus is transferred to the CIF for use in the subsequent years. Transfers accumulate in the CIF until the GoT withdraws for budget financing. The CIF targets a minimum balance equivalent to 16 percent of the TTF's real maintained value (or around 45-50 percent of GDP, which would enable GoT to

[10] Given the cultural context of Tuvalu, those earning cash income are not only expected to support the immediate but also the extended families in the outer islands. The public sector had not received a general wage increase since 2010. With reported large rises in prices for outer islands, those in the public sector are also expected to contribute more, resulting in higher cost of living.
[11] In late-2013, the GoT renegotiated the leases of schools and public buildings at higher cost and increased acreage of land rented for additional school buildings and clinic. Beginning 2014, the GoT brought vessel maintenance cost onto the budget.

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 could occur where no distribution would be made from the TTF. Since the capital of the TTF is invested in international financial markets (approximately 60 percent in defensive and 40 percent in growth assets), annual investment returns have typically shown high levels of volatility. Negative shocks usually mean that no new distributions will be made to the CIF. In 10 out of the past 25 years, the TTF did not make distributions to the CIF (post 1987, 2000 and 2008 crises). The TTF, which suffered losses of around 20 percent during the GFC, achieved returns of around 10 percent in 2012 and 2013, recuperating some of the earlier losses and enabling in 2013 the first distribution to the CIF since 2009.



In parallel to the TTF, the local governments (Kaupules) together with donor partners capitalized the Falekaupule Trust Fund (FTF). The FTF aims to provide a sustainable source of funding for OIs' development. It's fully governed by the Kaupules, invested in parallel to the TTF and makes distribution to the Kaupules when the market value exceeds the maintained value. The market value of the FTF is AUD 27.5 million (70 percent of GDP). Annual distribution in typically averaged around AUD 0.8 million (2 percent of GDP).

B. MACROECONOMIC OUTLOOK AND DEBT SUSTAINABILITY

17. **In the medium term, the Tuvaluan economy is expected to grow moderately and remain dependent on the public sector and donor-funded expenditures.** In the medium term, growth is projected to rise to around 2.5 percent supported by increased investment funded by government and donors. The economy faces challenges in achieving more robust growth over the medium term. Reforms supported by this operation including the broadening of vocational education opportunities will be key to improving employment and competitiveness. Further progress with the structural reform agenda, including stronger risk management in the banking sector and enhancing the sustainability of PEs, may further stimulate growth[12]. However, growth opportunities are constrained by geographical isolation and small size.

18. **Inflation is expected to remain moderate in the medium term.** The CPI, a key measure of inflation, is only produced for the capital Funafuti. OIs' inflation tends to follow the overall trend of Funafuti, however, prices may be higher due to supply shortages and additional transportation costs. Inflation is expected to pick up slightly going forward given the expected higher level of investments (both donor and government funded), but moderate to under 3 percent in the medium term. Prices are expected to remain highly exposed to external price and exchange rate shocks.

19. **The current account is expected to remain in substantial surplus in 2013 and 2014, due to higher fishing license fees and grants.** In the medium term, Tuvalu's current account deficit is expected to narrow from 36 to 12 percent of GDP, with reserves remaining adequate at around 8 - 9 months of imports. However, in the period ahead, global or regional economic downturns could negatively affect income flows, remittances and employment opportunities abroad. With little scope for import substitution or export diversification, the trade balance is expected to remain in deficit and widen slightly, driven by increased imports associated with infrastructure investments. Tuvalu's income account is expected to remain stable in the medium term supported

[12] The GoT, as part of the PRM is working with the ADB and PFTAC to review the banking sector, produce a Public Enterprise Reform Plan - setting out strategies to improve PE's commercial and financial viability, and privatize the Vaiaku Lagi Hotel. The World Bank is providing support to the energy and fisheries sectors including PEs operating in those sectors.

by fishing license fees and returns on the TTF. Current transfers to government (mostly budget support grants) are conservatively estimated to decline from a peak in 2014, but remain substantial in the medium term. Although remittances have declined since the GFC, the employment outlook remains positive given a tentative pick-up in the seasonal labor scheme and the government's focus on employment orientated education.

Figure 1: Projected fiscal trends (in percent of GDP)

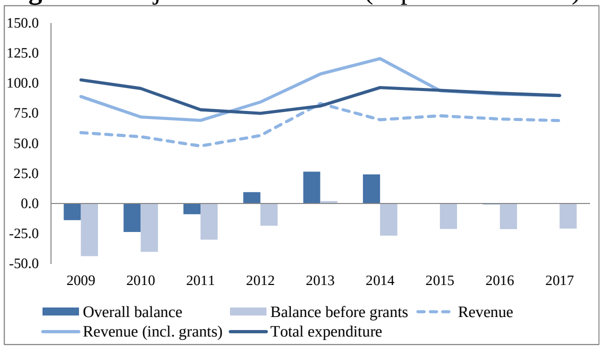
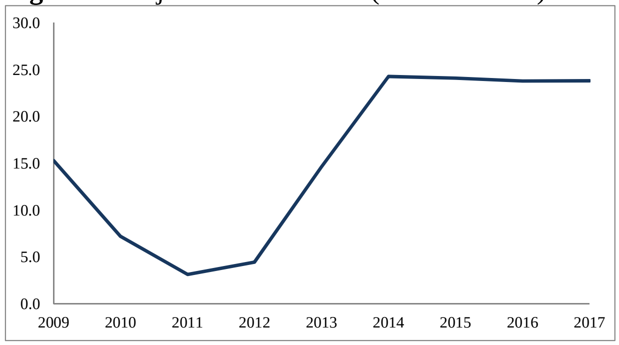


Figure 2: Projected CIF balance (AUD millions)



20. **Fiscal buffer is expected to remain at a sustainable level in the medium term.** Tuvalu's budget deficit is projected to narrow in the medium term compared to 2014, with pre-grant deficits projected at around 21 percent of GDP. This is based on expected steady revenues and the GoT's commitment to prudent fiscal policy going forward – Cabinet commitment to nominal wage capping, reforms of PEs, and normalization of one-off expenditure. Grants are expected to normalize from a peak in 2014 to around 16 percent of GDP in the medium term in line with historical average. Nominal returns on the TTF are conservatively estimated at 4 percent given uncertain outlook of financial markets, resulting in distributions to the CIF (for budget financing) equivalent to 4.5 percent of GDP. Overall, buffer assets in the CIF are expected to remain at around the minimum target level in the medium term (see Figure 1 and 2).

21. **Revenue is projected to remain steady at around 70 percent of GDP, 15 percent higher than historical average, due largely to higher fishing license fees.** Tuvalu is a member of the Parties to the Nauru Agreement which has initiated a more strategic management of tuna resources with higher economic returns for member countries through the Vessel Day Scheme (VDS). Under the scheme member countries can allocate a set number of days to the highest bidding commercial fishing vessels. It is designed to increase the rate of return from fishing activities by limiting the catch of target tuna species and stimulates competition between Distant Water Fishing Nations to purchase fishing days. Since the full implementation of the VDS in 2012, Tuvalu has experienced a structural increase in fishing revenues. Since its full introduction VDS minimum benchmark prices have increased from USD 5,000 per day to USD 6,000 per day in 2014 and will increase further to USD 8,000 per day in 2015. In addition, Tuvalu saw the value of the Multilateral Treaty on Fisheries for US purse seiners to fish in the waters triple from US$21 to US$63 million in 2013[13], and according to the agreement reached in October 2014, will increase further to US$90 million from 2015. The GoT anticipates that with the VDS, the renewal of the US Treaty and planed reforms in the sector, revenue from fisheries will increase in the medium term. In the projection period, revenue is expected to average around 70 percent of GDP, compared to an average of 55 percent between 2009 and 2012. Grants are expected to normalize from a peak in 2014[14].

22. **In the medium term, the GoT is expected to unwind the 2014 fiscal expansion through nominal expenditure capping, structural reforms and normalization of one-off expenditure.** The fiscal framework is largely consistent with the latest IMF framework (see Fund Relations Annex). The GoT through Cabinet

[13] The renegotiated interim contract applies from Jun-13 to Dec-14. Tuvalu's share under this agreement is typically over 10 percent.
[14] Grants increased in 2014 due to one off increase in recurrent grants from Taiwan, China, aggregation of budget support grants and higher return on the TTF in 2013, which was made available for the 2014 budget.

decision has committed to no further general wage rises in 2015 until the endorsement of the Public Sector Review. Towards this end, an advisor has been recruited to support the reforms in the public sector. Maintaining the nominal wage bill in the medium term through public sector reform is expected to result in its decline as a share of GDP. In the medium term, although the Japan fuel grant is expected to be terminated, with the introduction of renewable energy sources through investments currently underway at the utility[15], significant savings from fuel purchase are expected to be achieved, substantively increasing the utility's commercial viability. Structural reforms supported by this operation to improve the efficiency of the tertiary schemes are also yielding fruit and their full implementation could lead to additional savings in the future (see Tables 5, 6). Finally, one-off expenditure increase such as arrears payment is expected to normalize thereafter. Beyond fiscal consolidation, a new CIF regulation is being put in place to support fiscal sustainability through strengthened management of the CIF. Furthermore, PFM reforms supported by this operation to strengthen the management of fishing license fees, commitment controls and OI financial reporting are critical steps to safeguard fiscal resources and improve their management, ensuring adequate service delivery.

23. **Vulnerabilities in the public sector and the banking sector create contingent liabilities for the government.** The deterioration of the Development Bank of Tuvalu's (DBT) financial position points to potential solvency issues; with public sector exposure related to deposit guarantees estimated at around AUD 0.6 million. Recent Cabinet endorsement to establish a Banking Commission and to develop a resolution framework is an important first step to understanding and resolving banking sector vulnerabilities (see LDP). IMF technical assistance is planned for March 2015 to review and consider options forward, this is the critical next step. Non-bank PEs accumulated losses of around 3.5 percent of GDP in 2013, revealing vulnerability in their financial position, which may result in additional potential liabilities for the GoT. Although impediments to PE operations such as the inability to explore economies of scale will remain, reforms to regularize the relationship between GoT and PEs such as those to resolve cross-arrears and planned structural reforms should partly mitigate this risk. Development of a PE reform plan and privatization of the Vaiaku Lagi Hotel in 2015 will further reduce vulnerability stemming from PEs. Overall, the macroeconomic framework incorporates an additional fiscal cost equivalent to over 3 percent of GDP per annum in the medium term associated with potential PE restructuring and related costs in line with the IMF framework[16].

24. **In the longer term, given Tuvalu's domestic and external vulnerabilities and an uncertain outlook for TTF performance, continued grant flows will help sustain fiscal buffers.** In the Tuvalu context, fiscal sustainability is measured by the ability of financial assets in the TTF and CIF to continuously finance post-grant deficits, including through periods of shock. Based on historical information (length of shock and average deficit), a sustainable level assets in the CIF is numerically expressed as 16 percent of the maintained value of the TTF. This level could be sustained when GoT achieves pre-grant deficits of around 21 percent of GDP going forward. With grants expected at around 16 percent of GDP, the remaining deficit (around 5 percent of GDP) could be sustainably financed by drawdowns from CIF assets, which is fully replenished by distributions from the TTF even at the assumed lower rate of return. Figure 3 depicts the projected evolution of CIF assets when the medium term projections in Table 2 are applied to a long term fiscal sustainability analysis. In this scenario,

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[15] The Japan fuel grant, equivalent to US$1.0 million as anticipated is expected to be terminated by end-2014. We differ from the IMF in our assumptions on fuel subsidies required going forward. Investment funded by NZ and UAE are expected to be completed in 2015 resulting in near 100 percent renewable energy generation for all the inhabited OIs. This is expected to save around 0.3 million liters of diesel fuel per year, which applying the current price equates to potential savings of around AUD 0.5 million per year from 2016 onwards. The IDA financed Tuvalu Energy Sector Development Project (P144573) will support further renewable energy penetration and increased energy efficiency. Based on the financial and economic analysis, renewable energy investment will further reduce diesel generation leading to additional savings of AUD 0.9 million per annum from 2017 onwards while energy efficiency investments will help in reducing energy demand and postponing the need for more costly future investments in generation leading to further savings of around AUD 0.6 million from 2020 onwards. Overall, these investments could considerably improve the utility's revenue collection, reduce cost of generation and strengthen its financial sustainability.

[16] This includes potential costs related to the refloating of Tuvalu Corporative Society and potential capital injection for the DBT and PEs.

fiscal buffers in the CIF will remain at around the sustainable level[17]. Sustaining Tuvalu's fiscal buffer assets will however require continued expenditure restraint, strong TTF performance and sustained level of grant flows. Although the TTF has achieved double digit returns in recent years, the outlook in the coming years is subject to a high level of uncertainty and vulnerable to downside risk. Therefore, expenditure restraint and continued grant flows would be needed to support the maintenance of the CIF at around the minimum target level. At the minimum sustainable level, the CIF could ensure continued service delivery through future shocks and safeguard fiscal sustainability.

Figure 3: Projected long term CIF balance

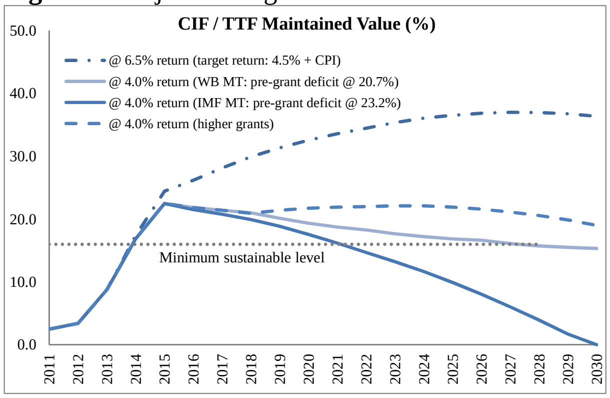
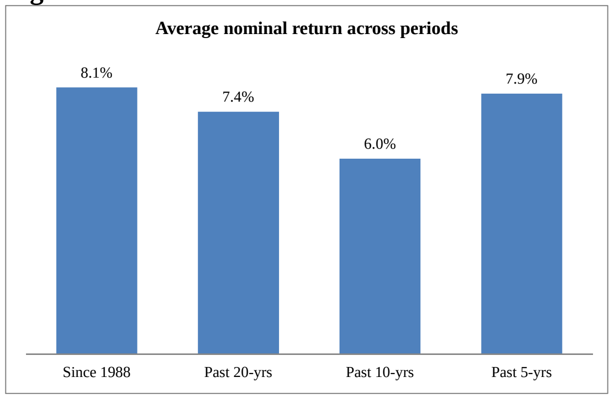


Figure 4: Historical TTF return



25. **The 2014 joint IMF - World Bank Debt Sustainability Analysis (DSA) concluded that Tuvalu is at a high risk of debt distress although the government does not face debt servicing risks.** The latest (2014) DSA assumes significant disbursement of borrowings on concessional terms for critical infrastructure going forward. On the assumption of such borrowing, the external debt stock breaches indicative thresholds for a sustained period in the long term under the baseline assumptions, although the government does not face debt servicing risks[18]. Stress tests confirmed that Tuvalu's debt burden was highly vulnerable to deteriorating macroeconomic conditions or a weaker financing outlook. Concessional loans provided by the Asian Development Bank (ADB) constitute the majority of external debt stock. Loans contracted by joint ventures in the fisheries sector (around 34.5 percent of GDP) are included in the DSA as they constitute a substantial contingent liability. Known loans contracted by PEs, guaranteed by GoT are also included in the baseline of the DSA[19]. The public and publically guaranteed debt stock stands at around 57 percent of GDP, while debt servicing requirements was equivalent to 12.5 percent of revenue. Ensuring debt risks remain contained while the country's development needs are addressed will require continued donor assistance in the form of grants.

26. **The GoT is committed to returning its debt to sustainable levels, through prudent fiscal policy and effective debt management.** The GoT through fiscal prudence and with donor support rebuilt the fiscal buffers post the GFC. Going forward the GoT will maintain prudent fiscal policy through its commitment to nominal wage capping, structural reforms to PEs, and normalization of one-off expenditure. The 2014 DSA analyzed the debt dynamics under an alternative scenario, and concluded that the implementation of the reform agenda could support the achievement of a structurally balanced budget and therefore debt sustainability. In terms of improved debt management, the Debt Risk Management and Mitigation Policy was introduced and approved by the Cabinet in 2009, providing clear guidelines on the contracting of debt. Furthermore, since 2012, the GoT has completed and published (as part of the government financial accounts) a stock-take of bank

[17] 2014 Tuvalu Long Term Fiscal Sustainability Analysis, the World Bank. A counterfactual scenario assumes long term pre-grant deficit of 23.2 percent of GDP per IMF framework. This is expected to result in the CIF balance falling below the minimum target level and be substantially depleted in the long term.

[18] Due to Tuvalu's high risk of debt distress rating, major World Bank and ADB supported infrastructure projects will now be financed on grant terms, substantially reducing the pace of debt acquisition relative to the pace reflected in the DSA baseline scenario.

[19] Other public sector exposure not included in the DSA comprise of DBT deposit guarantees amounting to 1.5 percent of GDP and PE overdrafts estimated at 3 percent of GDP. Full incorporation of these debts will not substantially alter the outcome of the DSA.

accounts and government debt and guarantees, obtaining a comprehensive position of its net liabilities. With recent surpluses, the GoT has largely paid down arrears (estimated at around AUD 2.0 million) and expensive overdrafts. Going forward, reforms supported by this operation to improve expenditure control will help contain any buildup of arrears. The GoT also plans to complete an audit of the joint ventures and assign institutional responsibility for debt policy, ensuring that all loans (including those contracted by PEs) adhere to the restrictions of the debt management policy.

Figure 5: PV of debt-to-GDP ratio

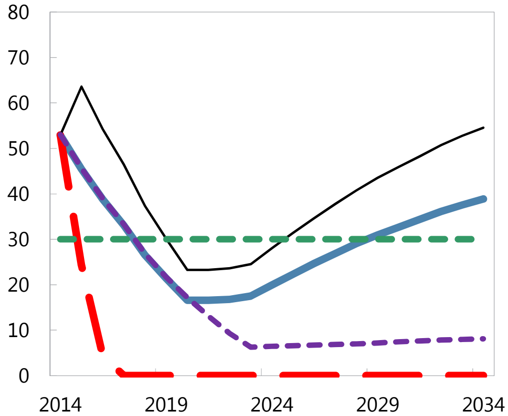
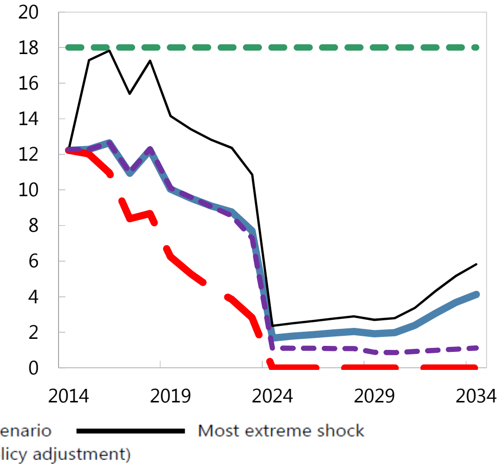


Figure 6: Debt service-to-revenue ratio



Source: 2014 joint IMF - World Bank Debt Sustainability Analysis (DSA)

27. **The macroeconomic policy framework in place is adequate, but is subject to domestic and external risks.** In the longer term, continued grant flows will help Tuvalu maintain a sustainable level of fiscal buffers. The GoT will, however, need to continue to focus on controlling expenditure and enhancing revenue to overcome budgetary constraints and maintain adequate fiscal buffers to buttress against shocks. In terms of the broader economic outlook, stability could be hampered by vulnerabilities in the state-owned banks and PEs, and the GoT needs to maintain its focus on related structural reforms. To address these, the GoT is committed to nominal expenditure capping, structural reforms to key PEs and strengthening oversight of the banking sector. The incipient economic recovery in Tuvalu could be threatened by a sharper than expected rise in global commodity prices. A renewed shock to global growth would further dent overseas employment opportunities, hurting growth, while financial market turmoil would depress Tuvalu's asset holdings. A depreciation of the Australian dollar (AUD) could also cause inflation to spike and the trade deficit to widen[20]. The macroeconomic policy framework also depends on the continued availability of grants from development partners over the long term. This is especially important at present given Tuvalu's high risk of debt distress and limited scope to borrow to cover fiscal deficits. Finally, Tuvalu like other Pacific islands remains vulnerable to adverse natural events that may also place considerable stress on the macroeconomic policy framework.

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

Table 1. Tuvalu: Selected Social and Economic Indicators, 2009 - 2017

I. Social and Demographic Indicators

GDP (2013):		Poverty rate (2010)	26.3
U.S. dollars (millions)	39.7	Life expectancy at birth (years, 2012)	65.0
GDP Per capita (U.S. dollars, 2013)	3,575	Total fertility rate (births per woman, 2008)	3.2
Population		Infant mortality rate (per 1,000 live births, 2008)	30
Total (thousands, 2013)	10.8	Primary school enrollment (2011)	100
Urban population (percent of total, 2008)	57.1	Unemployment rate (2004)	16.3

II. Economic Indicators 1/

	2009	2010	2011	2012	2013 Est.	2014 Proj.	2015 Proj.	2016 Proj.	2017 Proj.
	(Percent change, unless otherwise indicated)								
Real sector									
Real GDP growth	-1.7	-2.7	8.5	0.2	1.3	2.2	2.5	2.5	1.9
Consumer prices (period average)	-0.1	-1.9	0.5	1.4	2.0	3.3	3.1	3.0	2.9
	(Percent change, unless otherwise indicated)								
Money and credit									
Deposits	-8.1	-8.3	8.6	9.7	29.3	9.5	…	…	…
Credit	…	0.9	15.1	-11.4	-7.7	0.8	…	…	…
Lending interst rate (in percent)	11.1	10.6	10.6	10.6	10.6	10.6	…	…	…
	(In millions of Australian dollars, unless otherwise indicated)								
Balance of payments									
Current account balance 2/	-1.2	-4.1	-13.9	9.8	10.4	11.1	-15.7	-10.0	-5.8
(In percent of GDP)	-3.3	-11.9	-36.5	25.3	26.1	26.6	-35.9	-21.9	-12.1
Trade balance	-13.0	-6.4	-7.4	3.2	1.4	-0.9	-13.6	-6.0	-3.7
Exports	3.3	10.9	10.2	19.9	20.5	21.1	21.9	22.5	23.4
of which: fish	2.8	10.4	9.4	19.5	20.1	20.7	21.4	22.1	22.9
Imports	16.3	17.3	17.6	16.7	19.1	22.0	35.5	28.5	27.1
Services balance	-22.4	-24.0	-30.2	-23.1	-26.6	-29.5	-32.8	-35.2	-33.6
Credit	3.8	4.4	4.2	4.3	4.4	4.6	4.9	5.1	5.3
Debit	26.2	28.4	34.4	27.4	31.0	34.1	37.7	40.3	38.9
Income balance	18.8	11.0	9.4	9.4	17.6	18.4	16.1	16.3	16.2
of which: Overseas workers income	5.5	4.3	4.4	3.7	3.8	4.0	4.1	4.2	4.4
Current transfers (net)	15.5	15.2	14.3	20.3	18.0	23.1	14.6	14.9	15.3
of which: government	16.4	16.7	16.2	22.0	19.7	25.4	16.6	16.9	17.3
Gross official reserves 3/	29.9	26.6	24.1	27.5	36.7	48.7	47.6	46.3	44.3
(In months of imports of goods and services)	7.7	6.1	6.6	6.5	7.8	8.0	8.3	8.4	8.7
Debt indicators									
Gross public debt (incl. guarantees)	22.0	19.3	17.3	16.6	16.3	23.7	21.3	18.9	15.9
(In percent of GDP)	63.2	55.6	45.3	43.0	41.1	56.9	48.6	41.2	33.4
of which: publicly guaranteed debt	2.2	2.2	2.1	3.8	3.8	3.5	3.3	3.1	2.2
of which: contingent liabilities 4/	11.1	9.8	8.2	6.4	5.6	14.4	12.7	11.1	9.4
Debt service	1.4	1.2	2.8	2.9	3.3	3.7	3.9	3.9	4.1
(In percent of GDP)	4.1	3.5	7.3	7.6	8.3	8.9	9.0	8.4	8.6
(In percent of revenue)	6.9	6.2	15.4	13.5	10.0	12.8	12.3	12.0	12.5
Exchange rates									
AUD per U.S. dollar (period average)	1.3	1.1	1.0	1.0	1.0	…	…	…	…
Real effective exchange rate (2005=100)	110.7	108.3	111.0	112.4	110.6	…	…	…	…
Nominal GDP	34.7	34.7	38.1	38.5	39.7	41.7	43.8	45.9	47.8

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

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

2/ The current account deficit widens from 2015 due to large grant financed infrastructure projects such as the World Bank Aviation Project and are largely expected to be financed through increased capital transfers.

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

4/ Contingent liabitlities associated with fishing joint venture 50 percent owned by the GoT. The joint venture limited took out a loan in 2009 to finance the building of a fishing vessel and had subsequently paid down this loan through profits. In 2014, the joint venture limited took out a further loan to build a second fishing vessel.

Table 2. Tuvalu: Government Budget, 2009-17

	2009	2010	2011	2012	2013 Est.	2014 Proj.	2015 Proj.	2016 Proj.	2017 Proj.
	(In percent of GDP, unless otherwise indicated)								
Revenue	58.9	55.5	47.8	56.6	83.1	69.6	72.9	70.2	68.9
Taxes	14.7	16.5	16.9	15.0	19.0	14.4	15.8	15.0	14.5
Direct 1/	6.6	9.1	9.9	8.3	11.2	7.3	7.3	7.3	7.2
Indirect	8.1	7.4	7.0	6.7	7.7	7.1	8.5	7.8	7.2
Nontax revenue	44.2	39.1	30.9	41.5	64.1	55.2	57.1	55.1	54.4
Of which: Fishing license fees	26.3	20.6	14.9	21.8	45.5	31.9	34.7	33.6	32.4
Total expenditure	102.7	95.7	77.9	75.0	81.1	96.4	94.1	91.6	89.7
Recurrent expenditure	80.9	75.5	65.9	68.7	73.5	85.3	84.3	82.2	80.7
Wages and salaries	32.5	33.8	31.3	31.9	32.2	35.6	34.2	33.1	32.9
Purchase of goods and services 2/	21.9	23.2	19.8	20.1	21.2	27.3	21.9	22.0	22.0
Purchase of fuel in lieu of Japan fuel grant	…	…	…	…	…	…	2.5	1.3	0.0
Subsidies and transfers 3/	23.5	15.0	11.7	16.3	19.9	22.1	21.8	22.1	22.3
Potential PE restructuring and related costs	…	…	…	…	…	…	3.3	3.2	3.1
Interest payments	0.7	0.8	0.8	0.3	0.3	0.3	0.5	0.5	0.5
Other expense	2.3	2.7	2.3	0.2	0.0	0.0	0.0	0.0	0.0
Net acquisition of nonfinancial assets (capital) 4/	21.8	20.2	12.0	6.3	7.6	11.0	9.8	9.4	9.0
Balance before grants	**-43.8**	**-40.2**	**-30.1**	**-18.4**	**2.0**	**-26.8**	**-21.2**	**-21.4**	**-20.8**
Grants 5/	29.9	16.4	21.2	27.7	24.6	50.9	20.8	20.7	20.9
Recurrent	22.6	15.8	16.4	12.4	16.5	21.3	12.7	11.8	11.9
Non-recurrent	7.3	0.6	4.8	15.3	8.1	14.4	3.4	4.4	4.4
TTF distributions to CIF	…	…	…	…	…	15.2	4.7	4.6	4.5
Overall balance (net lending / borrowing) 6/	-13.9	-23.8	-8.9	9.3	26.5	24.2	-0.4	-0.7	0.0
(in millions of Australian dollars)	-4.8	-8.3	-3.4	3.6	10.5	10.1	-0.2	-0.3	0.0
Extra-budgetary grants 7/	28.6	31.8	21.2	29.3	25.2	25.7	31.4	34.3	26.7
Memorandum Items (in millions of Australian dollars)									
Tuvalu Trust Fund (TTF) balance	95.5	108.0	118.7	130.6	140.6	144.1	147.7	151.4	155.2
(In percent of GDP)	274.8	311.2	311.4	339.1	339.4	345.6	337.3	330.0	324.9
Consolidated Investment Fund (CIF) balance	15.3	7.2	3.2	4.5	14.6	24.3	24.1	23.8	23.8
(In percent of GDP)	44.1	20.8	8.3	11.6	36.9	58.2	55.1	51.9	49.9
Nominal GDP	34.7	34.7	38.1	38.5	39.7	41.7	43.8	45.9	47.8

Sources: Tuvalu authorities and IMF staff estimates.

1/ Fisheries joint venture companies are among the largest tax payers in Tuvalu.
2/ Includes payment of arrears in 2014.
3/ Includes medical treatment scheme and scholarships, as well as Community Service Obligations (CSO)
4/ Includes capital expenditure and in-kind and technical assistance largely for OIs. Classified as other expenditure in the 2014 Article IV report.
5/ Includes recurrent grant from Taiwan, China; non-recurrent grants including the proposed World Bank Budget Support Operation; and transfers from TTF to CIF.
6/ Given the limited financing channel, this is indicative of the net asset accumulation (+ve) / drawdown (-ve) requirements from the CIF.
7/ Estimated based on balance of payment and fiscal data.

III. GOVERNMENT'S PROGRAM

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

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

consideration the problems and challenges that were faced in the implementation of the TKII. The review resulted in a more strategic focus. It accordingly identifies and proposes new and revised strategies to ensure that TKII targets for 2015 will be met. The TKII mid-term Review Action Plan 2015 will guide the government's development policies as well as Tuvalu's development partners' assistance to Tuvalu for the remaining life of the TKII. The areas of focus identified by the review are presented in Box 2.

Box 2: TKII Areas of Focus

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

30. **The GoT developed the PRM in 2012, in consultation with development partners, to map out a clear and selective path to achieving priority goals identified in the review of TKII.** The preparation of the PRM helped to foster a shared strategic focus and policy dialogue around a limited set of reform priorities among government and development partners. The PRM also adopted a phased approach with annual priorities set through a consultative process to best meet the priority goals while being cognizant of the capacity constraints faced by the GoT.

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

32. **The PRM has proven to be an effective tool for delivering a practical reform agenda; the proposed operation will support and sustain the momentum of key reforms mobilized by the PRM.** The PRM has enhanced mobilization of government initiative in tackling difficult areas of reform. Since 2012, the GoT has demonstrated good progress in pursuing the objectives of the PRM and this is reflected in the progression of development partner support. The ADB, Australia, New Zealand and the World Bank have each provided policy-based grants to the GoT reflecting their achievements against the PRM. In March 2014, the GoT endorsed the third phase of PRM (PRM III). PRM III maintains the main areas of focus identified above, and presents a consolidated set of reform measures for 2014 and 2015. The policy focus for this operation was developed through the process of dialogue and policy analysis that accompanied the PRM III.

IV. THE PROPOSED OPERATION

A. OPERATION DESCRIPTION

33. **The first budget support operation in the programmatic series supported reforms to strengthen public financial management and improve social service delivery.** The regular production of quarterly fiscal reports has enhanced the tracking of key budget information, strengthening budget execution and decision making. The offsetting of tax liabilities with the Tuvalu Maritime Training Institute (TMTI) and Vaiaku Lagi Hotel have improved the integrity of the tax system and ensured the continued service provision by these PEs. The outer island project management policy has unblocked funding to the OIs and increased the number of projects delivered, resulting in enhanced service delivery to some of Tuvalu's poorest households. Reforms to the scholarship and medical treatment schemes have helped to enhance the efficiency of these key programs, enabling the GoT to re-orient much needed expenditure in these sectors towards basic services, which will benefit the broader population including the poor.

34. **Continuing on these themes, this program document proposes a Development Policy Grant for SDR 1.1 million (USD 1.5 million equivalent) as the second in a programmatic series of two operations in support of Tuvalu's ongoing reform efforts.** This operation will provide financing to support Tuvalu's fiscal buffers and help sustain reform efforts through an election. It will also continue to support complementary reforms to strengthen PFM, and improve social service delivery. Given the importance of the public sector to Tuvalu's economy, an effective system for PFM is critical. The first pillar of the program focuses on strengthening PFM with the specific development objectives of improved commitment control, enhanced oversight of fishing revenue, and streamlined reporting of local governments (Kapaules). The second pillar focuses on improved service delivery with the specific objectives of enhancing the management and efficiency of Tuvalu's essential, but costly, overseas medical treatment scheme and strengthening vocational training, including increased access for women. These services are essential to building and maintaining human capital, a key asset for an undiversified small economy. Together, the supported reforms are designed to help Tuvalu improve its fiscal position both in terms of revenue and expenditure, while maintaining the quality of public services.

35. **The prior actions identified in the operation are consistent with indicative triggers proposed as part of the first operation of the series.** The program continues to be anchored in a broad two year reform strategy supported by multiple donors, each drawing on their areas of expertise (PRM III). The prior actions have been slightly reworded to provide more specificity and reflect more recent information where available. The program as originally conceptualized remains appropriate given its focus on ensuring macroeconomic sustainability and adequate service delivery. More specifically, PFM reforms supported by this operation to strengthen the management of fishing revenue, commitment controls and OI financial reporting are critical steps to safeguard fiscal resources and improve their management. Reforms to social service delivery will contribute to better health outcomes for Tuvaluans, enhance employment opportunities and competitiveness. To return to a consolidating path, the GoT has also committed to withhold wage increases for 2015 or until a public sector review is completed and endorsed. A broader structural reform agenda, including stronger banking sector risk management and enhancing PE sustainability is also underway, supported by the IMF and ADB. Given capacity constraints and the upcoming general election, the GoT is expected to make further progress on these reforms in 2015.

36. **The programmatic series of operations supports the GoT's development objectives and contributes to the improved wellbeing of Tuvaluans in both Funafuti and the OIs.** Drawing from the PRM, reforms to strengthen PFM and improve social service delivery have been identified as areas the World Bank can best support. Better management of both the overseas scholarship and medical treatment programs will improve the quality of these services while reducing the cost of their provision. These savings have freed up

scarce resources and allow the GoT to start rebalancing education expenditure towards employment orientated vocational training, and increase expenditure on basic healthcare, which is relied on heavily particularly by poorer households. Together, the reforms are expected to contribute to the government's TKII objective to "provide quality health and education services that are equitable, balanced, cost effective, and meet the needs of Tuvaluans". Similarly, the outer island financial and project management reforms are expected to enhance accountability and transparency of outer island Kaupules, in turn improving access to services for some of Tuvalu's poorest and most remote households. The other reforms supported by this operation for strengthening PFM are also expected to contribute to improving poverty and social outcomes in Tuvalu indirectly by making the budget a more effective tool for responding to national poverty and social needs. The outcome indicators 1, 3 and 4 have been changed to better reflect the objective of the reforms in improving expenditure commitment controls, PFM of the OIs, and achieving efficiency gains in the health sector. Data will also be collected on beneficiaries of the broadened TMTI training program which will be gender disaggregated[21].

37. **Possible subsequent operations would continue to focus on improving the wellbeing of Tuvaluans, including through PFM reforms, social sector reforms as well as other structural reforms.** The existing national development strategy ends in 2015. Possible subsequent operations would likely be developed together with the next national development strategy. Selected reforms have already been identified by the GoT as part of the broader reform agenda, including the wider fisheries sector reforms, PE reforms, and public sector reforms aimed at improving the efficiency and effectiveness of the public sector. The GoT has also held early discussions on options to enhancing the budget linkage and management of the CIF (anchored through a medium term fiscal framework) to enhance its ability as a tool to help the GoT weather future shocks. Possible subsequent operations will also aim to support reforms on the broader social service delivery front, including those aimed at strengthening primary and preventative healthcare service provision and NCD outcomes.

38. **The design of this operation was informed by lessons learned from the implementation of other operations in Tuvalu.** The proposed operation draws lessons from the First Development Policy Operation (DPO I) and the Pacific Regional Aviation Project on the importance of recognizing capacity constraints, selectivity, and continuous engagement. Tuvalu is a new member of the World Bank with limited capacity and familiarity with the World Bank program and processes. The approach taken by this operation, was to engage with government on a broad reform program drawn from the medium term reform agenda, and then to identify a few critical actions (in consultation with the authorities and jointly with other development partners) as conditions for disbursement. This made it possible to identify actions with a significant potential impact on achieving the program's development objectives without overloading the government's implementation capacity. Separately, the Bank's continued engagement has helped maintain momentum at times when the reform agenda could have gone off-track during DPO I, such as through the by-election which resulted in a change of government. For the proposed operation, both the incumbent government and the opposition are strongly committed to a medium-term reform agenda. Furthermore, development partner engagement has assisted the GoT to clarify and sequence reforms, and will provide momentum to implement them through continued engagement.

B. PRIOR ACTIONS, RESULTS AND ANALYTICAL UNDERPINNING

39. **The policy actions for this operation are described both in terms of content and rationale below.** The design of the operation has been informed by a number of analytical studies. In selecting these reforms, priority is given to areas where the World Bank can add value in coordination with development partners. These

[21] A gender specific target has not been set due to the intensive nature of the training program which could result in high attrition rates, particularly during the first years. Times of intake can also affect uptake, particularly when culture and community commitments have not been taken into consideration. It is also important for the government to assess markets available for employment before establishing gender targets; access to markets such as cruise liners could result in substantially higher female intake compared to shipping companies.

reform areas are consistent with Country Assistance Strategy (CAS) objectives and have been selected because of their importance to the government's core reform priorities as expressed in the TKII and the PRM. They also reflect demonstrated government commitment whilst being cognizant of thin capacity which limits the pace of reforms.

Table 3: DPO Prior Actions and Analytical Underpinnings

Prior Actions	**Analytical Underpinnings**
Strengthening Public Financial Management	
The Recipient, through its Ministry of Finance and Economic Development, has introduced centralized commitment control procedures to strengthen treasury commitment and expenditure control. The Recipient, through its Ministry of Natural Resources has: (i) updated all financial records in its fisheries management system; and (ii) concluded a full reconciliation of fishing revenues generated through its Fisheries Department for 2013 with records of the Recipient's Treasury to strengthen oversight of fishing revenues.	The Public Expenditure and Financial Accountability Report (2011) – highlighted among others weaknesses in commitment controls, accounts reconciliation, and Kaupule reporting; a PFM roadmap (2012 – 2015) was developed in response. Reports of the Auditor General (2009 - 2012) – in addition to the annual audit report, the Auditor General also prepared a performance audit on managing sustainable fisheries which highlighted key gaps in the management of fishing revenues. The Household Income Expenditure Survey Poverty Analysis Report (2010) – highlighted that people in OIs are increasingly facing greater hardship than in the capital city.
The Recipient, through its Office of the Auditor General, has implemented a pilot streamlined Outer Island financial reporting framework to reduce administrative burden on the Kaupules and enable better tracking of funds.	
Improving Social Service Delivery	
The Recipient, through its Ministry of Health, has revised the TMTS Policy to strengthen the patient referral process and institute efficiency measures.	The Tuvalu Medium Term Expenditure Framework Report for Education and Health (2010) – found that the efficiency of the Tuvalu scholarship program and Tuvalu Medical Treatment Scheme (TMTS) could be enhanced and that equity of school financing is a concern. Health and education expenditure review (2013) – found that the reorientation of expenditure in these sectors towards primary services is critical to ensuring the achievements of targeted development outcomes.
The Recipient, through its Ministry of Education and the Tuvalu Maritime Training Institute, has broadened vocational training programs to increase post-primary education opportunities, particularly for Tuvaluan women.	

Table 4: Indicative Triggers and Prior Actions for the Second Operation		
DPO II – Proposed Trigger	DPO II – Prior Action	Explanation
Strengthening Public Financial Management		
The Recipient introduces centralized commitment control procedures to strengthen treasury commitment and expenditure control.	The Recipient, through its Ministry of Finance and Economic Development, has introduced centralized commitment control procedures to strengthen treasury commitment and expenditure control.	Unchanged
The Recipient updates all financial records in the fisheries management system, and concludes a full reconciliation of fishing revenues for 2013 with Treasury records to strengthen oversight of fishing revenues.	The Recipient, through its Ministry of Natural Resources has: (i) updated all financial records in its fisheries management system; and (ii) concluded a full reconciliation of fishing revenues generated through its Fisheries Department for 2013 with records of the Recipient's Treasury to strengthen oversight of fishing revenues.	Unchanged
The Recipient pilots a streamlined Outer Island financial reporting framework to reduce administrative burden on the Kaupules and enable better tracking of funds.	The Recipient, through its Office of the Auditor General, has implemented a pilot streamlined Outer Island financial reporting framework to reduce administrative burden on the Kaupules and enable better tracking of funds.	Unchanged
Improving Social Service Delivery		
The Recipient revises the TMTS Policy to strengthen the patient referral process and institute efficiency measures piloted in 2013.	The Recipient, through its Ministry of Health, has revised the TMTS Policy to strengthen the patient referral process and institute efficiency measures.	Unchanged
The Recipient broadens vocational training programs, to increase post-primary education opportunities, particularly for Tuvaluan women.	The Recipient, through its Ministry of Education and the Tuvalu Maritime Training Institute, has broadened vocational training programs to increase post-primary education opportunities, particularly for Tuvaluan women.	Unchanged

Prior Action 1: The Recipient, through its Ministry of Finance and Economic Development, has introduced centralized commitment control procedures to strengthen treasury commitment and expenditure control.

40. **The GoT has taken steps to strengthen its PFM system as prioritized in the PFM roadmap.** A good PFM system will support the implementation of policies and the achievement of developmental objectives by supporting aggregate fiscal discipline, strategic allocation of resources and efficient service delivery. The PFM reform roadmap, developed to address weaknesses identified in the 2011 Public Expenditure and Financial Accountability (PEFA) assessment and the Assessment of National Systems (ANS), laid out priority measures in the areas of revenue administration, expenditure controls, procurement policy, accounting procedures and financial reporting, and budget formulation and planning. Recognizing these priorities while being cognizant of its capacity limitations, the GoT has undertaken significant steps (supported by technical assistance selectively mapped by bilateral, multilateral and regional partners) to strengthen its PFM system, including strengthening in-year accounting and reporting, preparing corporate strategies for line ministries including Ministry of Finance and Economic Development (MFED), and introducing procurement legislation. These reforms have addressed significant weaknesses identified and improved the PFM environment.

41. **The critical next step of the PFM reform plan is to address weaknesses associated with internal controls.** Tuvalu has a relatively realistic budget which is an important condition for the effectiveness of commitment controls, however there are no commitment control tools or procedures currently in place. The MFED has started to strengthen cash planning but has not effectively used cash ceilings as commitment controls on spending units. Without appropriate commitment controls, the GoT runs the potential risk of over-committing or inappropriately committing funds. In the past several years, this led to the creation of expenditure arrears - estimated at around AUD 2.0 million in 2013 (equivalent to 5 percent of GDP)[22], although data on the stock of arrears is limited. With arrears largely being settled in 2014, introducing a basic centralized commitment control process using existing systems, as appropriate for Tuvalu's context (where limited skills and capacity would make it more difficult to implement a de-centralized process) will help GoT match its financial obligations to its resources and control future arrears build-up. This is particularly important given Tuvalu's tight fiscal context.

42. **The GoT through, its Ministry of Finance and Economic Development, has introduced centralized commitment control procedures to strengthen treasury commitment and expenditure control (prior action).** As part of this reform, the GoT has introduced a new Purchase Order module in the FMIS system (ACCPAC) which gives Treasury the tool to centrally track purchase orders issued and prevent line ministries from committing more than their quarterly warrants. The new Purchase Order system was trialed with the Ministries of Finance and Education in 2014. The Ministry of Finance and Economic Development subsequently revised the Financial Instructions, which now include detailed centralized commitment control procedures to be used by all ministries from January 1, 2015. The centralized commitment control procedures require that once the line ministry completes the relevant procurement procedures, it will submit the request for a purchase order together with the draft contract to the Central Procurement Unit (CPU) [23]. The CPU will check that sufficient budget is available before issuing a purchase order and in parallel entering the item into ACCPAC. The line ministry will then issue a purchase order which the vendor could claim against. Implementation of the centralized commitment control procedures will strengthen internal controls going forward and in turn improve budget execution. This is critical given Tuvalu's tight fiscal context. The treasury department created three additional full time positions as part of the CPU dedicated to implementing the procurement and the centralized

[22] Expenditure arrears are largely associated with vessel maintenance costs and does not include accounts payable.
[23] With support from Australia and ADB, the GoT introduced a Procurement Act in 2013, and established the CPU housed in treasury. The CPU plays a central role in all government procurement and the implementation of purchase orders and associated procedures.

commitment control procedures. The next steps in its implementation include awareness campaigns and training for GoT staff.

43. **The introduction of commitment control procedures will help to control overspending by line ministries by ensuring expenditures are accounted for as they occur.** This will also help reduce the need for re-allocations and improve cash management. Quarterly reporting is also expected to help strengthen monitoring of budget implementation and may lead to fewer re-allocations stemming from weak monitoring and controls. Taken together, these reforms are expected to lead to improvements in budget execution, reduce arrears and are likely to improve effectiveness in the use of public resources.

Prior Action 2: The Recipient, through its Ministry of Natural Resources has: (i) updated all financial records in its fisheries management system; and (ii) concluded a full reconciliation of fishing revenues generated through its Fisheries Department for 2013 with records of the Recipient's Treasury to strengthen oversight of fishing revenues.

44. **Fishing license fees are the biggest source of revenue for Tuvalu followed by tax revenues**[24]. Effective management of these two sources of revenue is critical to the fiscal sustainability of Tuvalu and therefore the government's ability to provide adequate services to its citizens, especially the poor. Recognizing the importance of the fisheries sector, the GoT is also pursuing a comprehensive range of medium term reforms to maximize the return on this critical natural resource while being cognizant of the sustainability of fishing stocks. Guided by the national development strategy, the GoT signed the VDS aimed at increasing the rate of return from fishing activities while limiting the catch of target tuna species[25]. To enhance revenue efforts and strengthen vessel compliance monitoring, the GoT approved the reorganization and institutional strengthening of the fisheries department in September 2013 to focus on oceanic activities. Tuvalu will also be one of the pilot countries for the World Bank Pacific Regional Oceanscape Program which aims to enable participating countries to capture greater economic benefits from sustainable management of the region's oceanic and coastal fisheries, and the critical habitats that sustain them[26]. Given capacity constraints, the GoT has adopted a phased approach to these reforms, which are expected to be completed over the medium term.

45. **The whole of government audit identified weaknesses in record keeping and lack of reconciliation between the Fisheries Department and Treasury, which could put at risk the integrity of the management of this key revenue source.** All vessels granted permission to fish in Tuvalu's exclusive economic zone must pay vessel day fees or license fees. A recent audit found that the fisheries management system[27], which records revenue from licenses issued and vessel day fees, had not been updated with all financial data, including information on payments and receivables due partly to staff shortages. The information which is entered into the fisheries management system is also not reconciled with Treasury information. The current practice is for the Fisheries Department to issue a license upon receipt of a copy of the telegraphic transfer of funds from the purchaser, however, as these records are not reconciled with Treasury receipts, the GoT is unable to tell which fishing vessels have paid their fees and whether payment received is accounted for in the correct year[28]. The

[24] The GoT had taken steps to improve the management of tax revenues, which was supported as part of DPO I.
[25] It creates competition between Distant Water Fishing Nations to purchase fishing days. A fixed allocation of fishing days for countries under the Parties to the Nauru Agreement is set under the scheme based on the most recent stock assessment information on the target species tuna and economic information.
[26] The program will support strengthened collaboration among PICS, and between PICs and other states, to reduce the open access conditions and management inefficiencies that have led to overexploitation of fishery resources, and to build on the experience and knowledge being generated in the region to strengthen institutional capacity and improve management effectiveness.
[27] Tuvalu's Fisheries Department records financial data related to tuna fishing using two regional databases called TUFMAN and FIMS. TUFMAN's primary purpose is to allow regional bodies to estimate fishery catch and effort by species at regional and national levels, although there is a module which records fishing licenses issued and the amount of license fee paid. FIMS is used by national fisheries agencies to manage the Vessel Day Scheme including monitoring fishing in PNA waters and records vessel day fees paid. The information from TUFMAN and FIMS are used within Tuvalu for the purpose of revenue reconciliation.
[28] Often the purchaser of licenses will negotiate the terms of the license to be purchased a quarter in advance and payment may be received in the earlier calendar year.

integrity of revenues collected from this key resource is therefore at risk (a 5 percent leakage of fishing revenues is equivalent to around 2 percent of GDP). Given the importance of fishing license revenues, accurate record keeping, to minimize revenue leakage is critical. Furthermore, given the lump-sum nature of these fees, weakness in record keeping could also complicate cash flow management.

46. **The GoT is pursuing reforms to strengthen financial management of fishing revenues, which will not only ensure its integrity, but complement the planned medium term reforms.** Towards this end, the GoT, through its Ministry of Natural Resources, updated all financial records in its fisheries management system and concluded a full reconciliation of fishing revenues generated through its Fisheries Department for 2013 with records of its Treasury to strengthen oversight of fishing revenues (**prior action**). Since the approval to reorganize the Fisheries Department, a new full time fisheries economist was recruited to enhance the maintenance of fisheries records and establish arrangements for systematic information exchange and regular reconciliation between the Fisheries and Treasury Departments. Since then, the backlog of records in the fisheries management system has been cleared and a full reconciliation of fishing revenues for 2013 was concluded with Treasury records. Going forward, an ACCPAC module will be extended to the Fisheries department to automate the exchange of information from invoicing to receipt of payments between Fisheries and Treasury ensuring automated and timely reconciliation of records. This will equip the Fisheries department with updated and comprehensive knowledge on foreign fishing vessels which have paid their licensing fees and facilitate penalizing those illegally fishing in Tuvalu's waters, and enable the production of quarterly reports to inform policy decisions. In turn, 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.

47. **The reforms supported by the programmatic DPO series are expected to strengthen revenue management and support fiscal sustainability.** In conjunction with the broader set of reforms underway to strengthen the fisheries sector, these reforms are expected to lead to improvements in revenue management. Given the significance of fisheries receipts, regular updating of all financial records in the fisheries management system and regular reconciliation of fishing revenues with Treasury records and reporting are expected to improve Tuvalu's oversight of fees received from fisheries. This, in addition to efforts to ensure the integrity of tax systems, will minimize any revenue leakage and improve revenue management. Taken together, these reforms are also expected to lead to improvements in in-year cash management through more accurate revenue estimation. In the medium term, these reforms are expected to minimize disruptions to service delivery as a result of revenue volatility and support fiscal sustainability.

Prior Action 3: The Recipient, through its Office of the Auditor General, has implemented a pilot streamlined Outer Island financial reporting framework to reduce administrative burden on the Kaupules and enable better tracking of funds.

48. **Kaupules play a key role in providing basic services to the OIs' citizens; strong governance and accountability of Kaupules will support service delivery and subsequently development outcomes.** Around half of Tuvalu's population lives on the OIs, where the incidence of poverty is higher. *Kaupules*[29] play a key role in providing basic services to the OIs' citizens, although their capacity is very thin. OIs receive both recurrent and capital transfers from the national government, as well as distributions from the Falekaupule Trust Fund (FTF)[30]. These transfers (equivalent to around 10 percent of GDP) are used to finance the operations of

[29] Other than the national government, Tuvalu has eight Kaupules (traditional island councils, one for each OI) established under the Falekaupule Act. The Act provides for significant level of autonomy from the national government for the Falekaupule. Kaupules govern local affairs and manages the implementation of local development projects. They also play a key role in providing services such as schools, clinics, water and sanitation facilities and local roads.
[30] FTF is the OIs' trust fund and invests and operates in a similar manner to the TTF. Correspondingly, FTF suffered losses post the GFC, which has resulted in lower distributions to the OIs placing a strain on OI financing.

Kaupules, public service delivery and OI development projects[31], although transfers through the Ministry of Home Affairs (MoHA) and FTF distributions are largely used to finance development projects. A large portion of these transfers are used in accordance with the rules of the Kaupules. Kaupules are required to separately report to the MoHA, the FTF, the Treasury, and the Auditor General. From a financial reporting perspective, the accounts of the Kaupules are required to be compiled and reconciled[32], with the Auditor General's office responsible for auditing the Kaupule annual accounts. Strong financial reporting supports accountability of transactions and monies going through the Kaupules, and contributes to project reporting. Strong project reporting supports on-time and on-budget delivery of OI development projects. These projects are important as they develop core infrastructure which enables service delivery and when well-managed, are the main source of employment opportunities and economic activities in most of the OIs. Therefore, a strong reporting framework plays a key role in ensuring accountability, while supporting service delivery and subsequently development outcomes.

49. **Transparency and accountability of Kaupules have been limited due to weak reporting stemming from thin capacity and the lack of a streamlined and context appropriate financial reporting framework.** Capacity limitations, multiple reporting requirements and the lack of a clear guideline on reporting and accounting standards have resulted in significant delays in bank reconciliation, financial reporting, and in turn the production of Kaupule annual accounts (Kaupule audits have not been produced since 1999). This limits the ability of Kaupules to fully understand their financial position, and account for all transactions and monies accurately. Lack of regular financial reporting has also hindered the development of project reporting frameworks, which track the progress and expenditure of each project against plan. As a result, community members and stakeholders have inadequate insight into the progress of a project and how a project is doing compared to budget.

50. **The GoT has taken steps to strengthen OIs reporting, aimed at improving accountability of outer island Kaupules.** Towards this end, the GoT, through its Office of the Auditor General, has implemented a pilot streamlined Outer Island financial reporting framework to reduce the administrative burden on the Kaupules and enable better tracking of funds (**prior action**). Towards this end, the OAG held extensive consultations with the Kaupules to design and introduce clear and concise guidelines on reporting and accounting standards. This includes the piloting of a streamlined monthly reporting template (an electronic cash-book and vote-ledger) with the Kaupules[33], which were implemented in 2014. The electronic cash-book makes it much easier for Kaupules to compile the accounts in soft copy, which eliminates the need for manual addition of all the entries, saves time, reduces the risk of keystroke errors and can be submitted via email rather than face long delays through the mail. The electronic vote-ledger will help Kaupules to monitor actual spending versus budget availability. This in turn strengthens the effectiveness of budget controls by preventing overspending. This monthly reporting template also tracks spending for development projects including those financed by the FTF. Establishing a simple, unified mechanism for financial reporting enhances tracking of funds while reducing the administrative burden on the Kaupules. After a long delay in the compilation of Kaupule accounts up to 2013, 2014 audited Kaupule accounts are expected to be tabled in the first parliament session in 2015[34].

[31] Recurrent fiscal transfers are administered by Treasury while capital transfers are administered by the MoHA. Transfers from the national government through Treasury and MoHA are made to the Kaupule general account. Transfers from the FTF are made to the Kaupule FTF account. In addition, Kaupules will typically have 1 or 2 other accounts to keep deposits, etc.

[32] In accordance with the Falekaupule Act and the Financial Instructions, at the close of the financial year, the Kaupule shall bring its accounts to a balance. Statements of actual revenue and actual expenditures measured against budget shall be prepared. A balance sheet to show the balances of assets and liabilities shall also be prepared. The annual accounts of the Kaupules are required to be submitted to the MoHA and to the Auditor General for audit and submission to parliament.

[33] The purpose of the cash-book is to record all of the payments and receipts of the Kaupule and to reconcile to the actual cash balances at the bank (and cash on hand) at the end of each month and to ensure that the cashbook is a complete record of the Kaupules operations. The electronic vote-ledger will help Kaupules to monitor how much money they have left in their budget. Previously, the Kaupules were not monitoring whether the payments they were making exceeded the budget allocation. Through updating the vote-ledger, the Kaupules will be able to tell if they have sufficient budget in place to make a payment, before they make the payment.

[34] Financial year end for Kaupules is March-31.

51. **In the medium term these reforms are expected to improve the quality and the development impact of outer island expenditure.** The implementation of the outer island project management policy (supported under DPO I) is expected to result in greater prioritization of the projects by Kaupules to satisfy each island's needs and encourage timely and on budget delivery of projects. The adoption of a streamlined, context appropriate, financial reporting framework is expected to strengthen OI governance through increased transparency and accountability. These reforms have already resulted in the unblocking of financial flows to the OIs (number of projects and development expenditure to OIs have increased by over 25 percent compared to 2012). These projects are important as they develop core infrastructure which enables service delivery and helps communities to invest in assets to support income generating activities such as communal farming and fishing especially impacting on the livelihoods of the poor. In the medium term, these reforms are also expected to improve the quality and the development impact of OI expenditure.

Prior Action 4: The Recipient, through its Ministry of Health, has revised the TMTS Policy to strengthen the patient referral process and institute efficiency measures.

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

53. **In recent years, the TMTS has expanded rapidly while the quality of care provided to Tuvaluan patients have been declining, resulting in increased recognition of the need to improve the efficiency of the program.** The initial annual budget of the TMTS was under AUD 0.5 million in 2005. However, since then, spending under the scheme escalated rapidly to consuming around 45 percent of the national health budget. The growing costs of the TMTS are largely attributable to the rising number of patients (99 patients participated under the scheme in 2013) and increases in treatment and subsistence costs[36]. As is the case for other Pacific island countries, a large proportion of the patients under the TMTS are normally referred to medical facilities in Fiji[37]. Recently, the capacity of Fiji's medical system has been strained with growing demand for services from domestic and international patients, and for some procedures such as cardiac surgery, waiting times for treatment or onward referrals have been increasing. At the same time, the GoT has been increasingly aware that hospitals and medical centers in other parts of the world have been delivering a full suite of sophisticated and high quality services at more competitive prices. As a result there is increasing recognition of significant scope for improving the overall value for money of the program.

Table 5: Relative TMTS expenditure 2009-2013

	2009	2010	2011	2012	2013
Tuvalu Medical Treatment Scheme (AUD million)	2.5	2.2	2.1	2.3	2.1
As % of health budget	56.8%	49.0%	40.6%	48.5%	44.5%
As % of recurrent budget	8.9%	8.4%	8.5%	8.9%	7.3%

Note: 2013 number sourced from the 2013 TMTS annual report.

[35] As expressed in TKII and the Strategic Health Plan 2009 – 2019.
[36] Tuvalu Medium Term Expenditure Review, 2010; TMTS Annual Report, 2012.
[37] Patients are also referred to regional hospitals in New Zealand and Australia.

54. **The GoT has, after careful consideration, instituted measures to improve the quality of care provided through the TMTS and to reduce the cost of the program.** The GoT, through its Ministry of Health, has revised the TMTS policy to strengthen the patient referral process and instituted efficiency measures (**prior action**). Taking into account the recommendations made in the TMTS annual report[38], the revised TMTS policy instituted a strengthened patient referral committee to oversee the patient selection process. The current referral process where treatment decisions are based on the advice of only two doctors, will be strengthened with the institution of a Medical Board comprised of the Permanent Secretary of Health (Chairperson) Director of Health (Secretariat), Medical superintendent, medical doctors, matron, and civil society representative (with medical background). The Committee shall meet weekly and only request the referral of patients, who, based on the best clinical analysis available to the Committee, meet the requirements of the TMTS policy. This will ensure that the policy objectives of the scheme are met and curb ineffective use of public resources. Additional changes to the scheme include the institutionalization of a new referral system for complex treatments such as cardiac surgery to accredited high quality hospitals in India to reduce the cost and timeline for referrals[39], reduce accommodation costs by requiring patients to be affordably accommodated in GoT leased houses or private homes instead of hotels. The GoT has inserted patient responsibility clauses to encourage timely and successful completion of treatment. Separately, the GoT signed a Memorandum of Understanding with Suva Private Hospital with a three week limit on non-dialysis patient care, to ensure timely turnaround of patients.

55. **Savings from the TMTS are expected to enable increased investment in primary and preventative care, benefiting the broader population in line with the national development strategy.** TMTS savings have contributed to an increase in budget allocations to primary and preventative healthcare by 5 percent in 2012, and 2013. The Ministry of Health has also been able to recruit a surgeon for Funafuti hospital in 2013 to treat relevant surgery cases domestically on a timely basis. Looking ahead, continued implementation of these reforms could result in significant savings. Preliminary health sector expenditure analysis estimates that by referring cardiac cases to India for treatment, per patient savings of around AUD 15,000 could be achieved. Reducing treatment time of non-dialysis patients from around 70 to 60 days could results in savings of around AUD 1,900 per patient, and introducing shared long-term accommodation could result in savings of around AUD 1,750 per patient. Fully implemented, these reforms could result in potential cost savings of around AUD 0.5 million (equivalent to around 1.2 percent of GDP). Given this potential for savings, TMTS reforms are a priority for enabling increased investment in primary health services, including those offered in the OIs. In the longer term, increasing investments in the primary and preventative programs would benefit the broader population and improve healthcare outcomes (including NCD), reducing the need for specialized tertiary care in future.

Prior Action 5: The Recipient, through its Ministry of Education and the Tuvalu Maritime Training Institute, has broadened vocational training programs to increase post-primary education opportunities, particularly for Tuvaluan women.

56. **The Tuvalu Maritime Training Institute (TMTI) offers a key vocational training program for Tuvaluan men, skilling them for employment on foreign merchant ships.** Seasonal labour schemes in Australia and New Zealand together with seafaring makeup the majority of foreign income earning opportunities in Tuvalu. Tuvalu sent around 70 workers in 2013 for seasonal labour schemes in neighboring countries (around 40 percent of which are female). On the other hand, Tuvalu sent over 100 people to work as seafarers, none of which are women. The TMTI is a PE, established under the TMTI Act, and is Tuvalu's only training institution

[38] During 2013, the Ministry of Health piloted measures to improve the quality, timeliness, and cost effectiveness of care. The first annual report for the TMTS documented the outcomes of the piloted reforms and made recommendations to further strengthen the TMTS. The findings of this report was endorsed by the Cabinet and presented to Parliament the (action supported by DPO I). The annual report was also made public to increase transparency of the scheme. This paved the way for the revision of the TMTS policy.
[39] The costs of the new referral system to India are significantly lower than for comparable interventions in Fiji or New Zealand.

for seafarers. The TMTI provides 18-month training for 40 young Tuvaluan men each year to enable them to seek employment aboard foreign merchant vessels. Courses offered by the TMTI are accredited by the International Maritime Organization. With limited domestic employment opportunities, seafaring on merchant ships has traditionally been a major source of employment and income for Tuvaluans. In its peak, the industry employed around 400 men (around 20 percent of the working population). Remittances from seafarers comprise a major part of household income, financing house construction, school fees, business investment, and consumption. Moreover, seafarer income is distributed to all the OIs where cash earning opportunities are low and poverty rates are higher. In some islands, overseas remittances comprise as much as half of the family income, especially in areas dominated by subsistence activity.

57. **Employment opportunities on foreign merchant ships have declined in recent years, and the curriculum offered at the TMTI limits the students' ability to exploit emerging opportunities.** The number of Tuvaluan seafarers employed has declined dramatically in recent years from a peak of around 400 in 2005 to around 100 in 2013. Factors that explain this include, declining demand from labour receiving countries due to global economic shocks, and increased competition from other countries which are geographically closer to the recruiting companies. On the other hand, Tuvalu has the opportunity to increase employment on fishing vessels and cruise ships. For fishing vessels operating in Tuvalu waters, through joint ventures as well as other licensing mechanisms, there is an opportunity to use or take up licensing conditions which can leverage employment[40]. The cruise ship industry in the South Pacific has also seen a large expansion in recent years. Pacific islanders have a natural advantage in their language skills, knowledge of the region, and proximity to the employer. Some Pacific island countries have taken this opportunity and began training and sending their labour force for employment in this sector. Tuvalu is well placed to expand its labour force into these industries if appropriate training and certification is provided. However, the TMTI's curriculum limits the ability of students, particularly female students, to exploit these emerging opportunities.

Table 6: Tuvalu education sector expenditure and temporary overseas workers 2009-2013

	2009	2010	2011	2012	2013
Tuvalu Education Expenditure (AUD million)	5.8	5.6	5.0	5.6	6.0
Tertiary scheme expenditure	2.4	2.2	2.1	1.9	1.8
Tertiary scheme as % of education budget	41.2%	39.4%	43.2%	33.8%	30.0%
Number of temporary overseas workers	368	309	348	240	184
Seasonal employer schemes	61	60	118	61	72
Seafarers	307	249	230	179	112

Note: 2012 and 2013 seafarers numbers are estimates based on information provided by industry employers

58. **The government is broadening the curriculum of the TMTI to facilitate employment opportunities and allow greater access for women.** The GoT is focused on providing employment oriented education in line with the national development strategy. As efficiency gains achieved through reforms to the tertiary scholarship scheme are gradually realized, this has enabled a reorientation of resources towards employment orientated basic education. The GoT, through its Ministry of Education and the TMTI has broadened vocational training programs to increase post-primary education opportunities, particularly for Tuvaluan women (**prior action**). The TMTI in consultation with the Ministry of Education has broadened the TMTI curriculum to include training for fishing vessel crews and female students. As a first step, the TMTI adopted a new curriculum for training of seafarers for fishing vessels. This curriculum was developed by the Secretariat of South Pacific, currently used in Kiribati and Papua New Guinea, and provides an additional accreditation for seafarers. Beginning in the 1st quarter of calendar year 2015, the TMTI will be regularly in-taking 25 students for fishing vessel crew training. TMTI has also opened its enrolment to female students. The

[40] In 2010 Parties of Nauru Agreement countries adopted a resolution to target a minimum of 10 percent domestic crew on all fishing vessels operating in its waters and to gradually increase this to 20 percent. Any vessel that does not comply would need to pay a premium on their fishing license fees.

GoT is also in the process of developing a memorandum of understanding with the Auckland Institute of Studies to franchise their hospitality training. This will enable female cadets in particular to work in service orientated industries such as on cruise ships. Broadening the TMTI training program will increase employment opportunities for both men (mainly seafaring on fishing vessels) and women (mainly for service industries such as cruise ships) and allow the continued flow of overseas remittances, upon which the social and economic welfare of Tuvalu, including the OIs, depends.

59. **Ensuring that Tuvaluans will continue to be employed overseas will contribute to the goal of reducing poverty and promoting shared prosperity, particularly for the OIs.** The GoT is increasing efforts to rebalance expenditure across the education sector, to enhance education outcomes and employment opportunities. The GoT has taken steps to enhance the performance and value for money of its tertiary scholarship programs. Broadening vocational education opportunities through the main vocational training facility, TMTI, will benefit those excluded from the education system and expand economic opportunities. Similar programs in other Pacific Island countries have shown that participants trained in seafaring are more employable in local markets in a broad range of sectors including hospitality, building and labor and, office and administration. Moreover, as seen in other Pacific Island countries, broadening of the vocational training programs, with specific opportunities for women could improve female education and employment opportunities[41]. This in the medium term will contribute to the goals of reducing poverty and enhancing shared prosperity.

C. LINK TO CAS AND OTHER BANK OPERATIONS

60. **The proposed DPO contributes to the second CAS theme by supporting Tuvalu's capacity to increase fiscal resilience against external shocks.** The first World Bank CAS for Tuvalu FY2012 - FY2015 is focused around the two themes of: (i) mitigating economic isolation by encouraging regional and global integration; and (ii) building resilience against exogenous shocks. The CAS noted that budget support grants from the World Bank and other development partners will help Tuvalu rebuild its fiscal buffers in the medium term, especially in the CIF, in turn building resilience against exogenous shocks. In addition, the reforms proposed in this operation are expected to strengthen Tuvalu's capacity to manage its budget and public financial system, thereby also improving the ability to respond to shocks from a fiscal perspective. The proposed operation will also complement the Bank's regional Pacific aviation and fisheries engagements, and together contribute to a more sustainable macroeconomic environment. In turn, this will support the achievement of the CAS outcomes.

D. CONSULTATION AND COLLABORATION WITH DEVELOPMENT PARTNERS

61. **The design of this proposed programmatic series is based on the PRM, developed by the GoT in consultation with development partners and reflects broader stakeholder consultation.** The authorities have requested development partners to provide coordinated budget support in light of the country's capacity limitations. The PRM was developed through a series of consultations between the GoT and development partners, with the participation of the World Bank at an early stage. It draws heavily on the TKII, which was developed and updated through a series of extensive consultations with Parliament, island chiefs, island presidents, government officials, businessmen, Non-Government Organization representatives, religious leaders, and women, youth and the community in general. The proposed programmatic series also reflects broader stakeholder consultation including NGOs and community groups. Discussion with women's group / 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.

[41] A Norwegian Cruise Company has entered into an agreement with the Kiribati government to employ 500 locally trained seafarers, of which 75 percent are women.

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.

62. **The Bank is working in coordination with other development partners to provide budget support to Tuvalu.** In 2011, the Bank began a dialogue with the GoT and development partners on the policy actions (proposed by GoT in the PRM) that might be associated with budget support going forward, culminating in agreement on the multi-year policy matrix. The ADB, Australia, and New Zealand are all supporting the implementation of the PRM - through varying combinations of budget support and technical assistance – and have arranged for joint missions when possible[42]. The World Bank and the IMF also maintain a close working relationship in Tuvalu, with the Bank participating in all Article IV missions since Tuvalu became a member, facilitating the discussions on structural reforms. In addition, the Bank and the IMF jointly prepared the 2014 DSA for Tuvalu. Based on this cooperation, the Bank and the IMF teams share a common view about Tuvalu's macroeconomic and structural reform priorities.

V. OTHER DESIGN AND APPRAISAL ISSUES

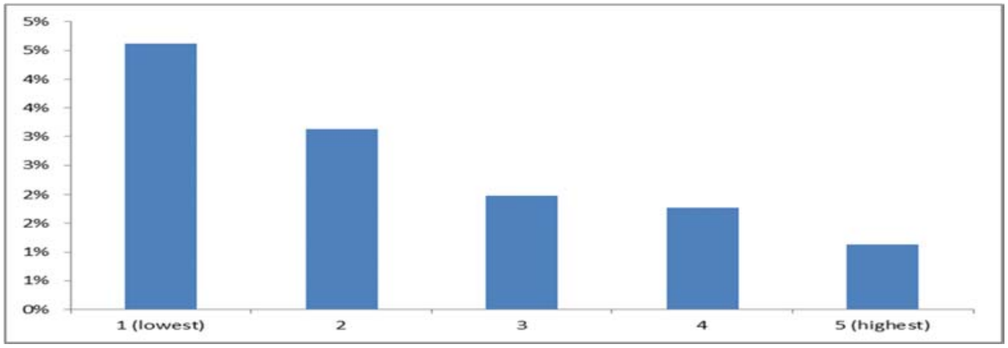
A. POVERTY AND SOCIAL IMPACT

Service delivery

63. **Rebalancing education expenditure towards the non-tertiary levels through improved management of the scholarship programs will contribute to better education outcomes for Tuvaluans, including the poor.** Whilst primary education is provided free of charge with universal access, schools ask parents to pay a "school contribution" and parents provide children with school uniforms and purchase stationary as well as textbooks. Secondary schooling is on a fee basis and enrollment rates at the secondary level are much lower[43]. In recent years, limited non-salary recurrent expenditure has resulted in schools becoming reliant on contributions from communities (parents and Kaupules), implying additional costs to the household. These factors, together with the recent under investment in post-primary education and training have presented both a financial burden and obstacle to secondary education for the poorest households. By supporting cost saving measures that will help to rebalance the focus of the education sector towards non-tertiary education, especially secondary and post-primary vocational training, this operation will contribute to improving education outcomes and potentially reducing costs, especially for the poor households that rely solely on the public provision of services. Increased investment in non-salary recurrent expenditure (to reduce the need for user fees such as textbooks, food, and uniforms) may reduce education expenditure burden on poorer families (see Figure 5) and reduce disadvantage to women[44] from education expenditures making education expenditure more progressive.

Figure 7: Expenditure on secondary education as percent of household expenditure (by expenditure quintile)

[42] Tuvalu's principal budget support development partners are Australia, New Zealand and the ADB. Taiwan, China also provides regular budget support. Other non-budget support partners include the European Union, Japan International Cooperation Agency, and several agencies of the United Nations.
[43] Tuvalu's gross primary enrollment rate was 101 percent, compared with a secondary enrollment rate of 52 percent in 2011.
[44] International evidence indicates that women are more likely to meet children's school costs, which increase when there is insufficient government expenditure on recurrent primary education beyond teacher salaries. Similarly therefore, women are financially more advantaged by expenditure allocation choices more orientated to primary education over tertiary education.



Source: GoT and World Bank estimates

64. **Enhancing employment orientated vocational training will contribute to greater employment opportunities for Tuvaluans, including the poor.** The TMTI is the main vocational training institute in Tuvalu, which offers potential income earning opportunities for boys who do not complete higher education. Remittances from seafarers comprise a major part of household income, financing house construction, school fees, business investment, and consumption. Moreover, seafarer income is distributed to all the OIs where few cash earning opportunities exist and incidence of poverty is higher. In some islands, overseas remittances comprise as much as half of the family income, especially in areas dominated by subsistence activity. However, the courses offered at the TMTI restrict employment to merchant ships, and with the decline in demand for Tuvaluan seafarers this has resulted in a decline in income earning opportunities for TMTI graduates. By supporting the rebalancing of education sector towards non-tertiary education, especially employment orientated vocational training, the proposed series of operations will contribute to improving education outcomes and employment opportunities for Tuvaluans, including the poor[45]. The broadening of the TMTI program to allow female participation will not only reduce disadvantage to women in education opportunities, but enhance the employment prospects of Tuvaluan women.

65. **The TMTS reforms are designed to be efficiency enhancing, by improving the management of the scheme, which will contribute to better health outcomes for Tuvaluans, including the poor.** The TMTS reforms are designed to be efficiency enhancing rather than rationing measures. They aim to achieve higher value for money, through enhanced management of the scheme. Improving the management of the overseas medical treatment program could in turn improve the quality of tertiary health services whilst reduce the costs of the program. This will help the GoT address the expenditure imbalance in the health sector and to invest more in primary, preventative and maternal care, benefiting a greater proportion of the population. This rebalancing could also improve overall health outcomes. In particular, improving access to medical services and drugs in the OIs would make health expenditure more progressive given their higher poverty levels.

Public finance management

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

[45] Tuvalu has high levels of primary and secondary enrollment (near universal enrollment at the primary level). A small proportion of the population progresses past primary and secondary education, particularly so for the OI population where incidence of poverty is higher. Tertiary scholarships are expensive and anecdotal evidence in the regional suggests that the relative well off benefit more from these tertiary schemes. Therefore, the reallocation of public spending from tertiary to primary and secondary social expenditures would likely make the spending more progressive and pro-poor.

67. **Reforms to strengthen governance and accountability of outer island Kaupules are expected to support improved service delivery to some of Tuvalu's poorest and most remote households.** Kaupules play a key role in providing services such as schools, clinics, water and sanitation facilities and local roads in the OIs. OI projects are the main source of investment in basic services and infrastructure are also an important source of employment and economic activity. Reforms to strengthen the financial and project reporting framework of Kaupules will enhance the governance of these Kaupules through increased transparency and accountability. In the medium term these reforms are expected to improve the quality and the development impact of OI expenditure. Given that hardship in Tuvalu is concentrated in the OIs, these reforms are expected to support enhanced service delivery to many of Tuvalu's poorest households.

B. ENVIRONMENTAL ASPECTS

68. **The policy reforms supported by this operation are not likely to have any negative effects on Tuvalu's environment or natural resources.** The Environment Protection Act (2008) provides the overarching legislative framework for environmental protection and management in Tuvalu including environmental impact assessment for larger projects. However a framework for costing and compliance is not yet fully in place and capacity in the Department of Environment is thin, thus the capacity and resources to effectively undertake this role are limited. Tuvalu will continue to be heavily reliant on outside expertise provided by regional organizations such as the Secretariat of the Pacific Regional Environment Program. The actions supported by the proposed operation for improving PFM and service delivery do not have any direct links to environmental factors.

C. PFM, DISBURSEMENT AND AUDITING ASPECTS

Public Financial Management Environment

69. **Tuvalu's public financial management environment is improving.** Key documents relating to PFM include the PEFA assessments, the PFM reform roadmap and the ANS. Annual Financial Statements of the GoT are audited by the Auditor General applying international auditing standards. The most recent audit report was for 2013 and issued in September 2014. The GoT had improved its accounting policy in 2013 to include fixed assets in its Annual Financial Statements however a qualified opinion was issued, mainly due to issues with the fixed asset valuations and inventory accounting. The Auditor General's report for 2013 noted a number of improvements in the Annual Financial Statements from the previous year, including the supporting documentation and internal controls.

70. **The GoT is leading a coordinated reform program to address weaknesses identified in its PFM system.** The 2011 ANS concluded that the country fiduciary risk for Tuvalu is in the range of Moderate to High, with the higher risk rating referring to Procurement and Reporting. This has been addressed through the implementation of Procurement regulations. The 2011 PEFA identified weaknesses particularly in the area of 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 integrity of the revenue management systems and in year expenditure management. Prior actions supported by this operation will further address the need for regular reconciliation of fisheries and treasury records and strengthen the effectiveness of commitment controls and the reporting of subnational fiscal data. The sequence of reforms is as laid out in the PFM reform roadmap. This was endorsed by Cabinet in 2012 and sets out a sequenced medium term reform program to address the key areas of weakness identified in the PEFA and ANS.

Foreign Exchange Environment

71. **An IMF Safeguards Assessment is not available as Tuvalu does not have a central bank and uses the Australian dollar as its currency.** In addition, Tuvalu has not accessed IMF funds. There is no indication of major issues within the foreign exchange environment, especially given that Tuvalu uses the Australian dollar. However without a safeguards assessment, and limited previous experience in DPOs, 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

72. **The proposed USD 1.5 million equivalent operation is the second in a two-year programmatic operation with funds to be made available upon effectiveness.** The proposed operation will follow IDA's disbursement procedures for development policy grants. Once the operation becomes effective, and at the request of the Recipient, the proceeds will be deposited by IDA into a deposit account in a separate government account at the National Bank of Tuvalu. The National Bank's 2012 annual financial statements received an unqualified audit opinion, and it has previously been used for the designated account for DPO I 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 Agreement. If, after being deposited in a government deposit account, the proceeds of the operation are used for ineligible expenditure as defined in the Financing Agreement, IDA will require the Recipient to refund the amount directly to IDA. Any such amounts refunded to IDA shall be cancelled.

73. **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) that this account was only used for the purposes of the operation and that no other amounts were deposited into this account, including confirmation from corresponding bank(s) involved in the funds flow; and (iii) that an equivalent amount was accounted for in the Recipient's budget management system. This will enable IDA to review compliance with the Financing Agreement and achievement of the objectives of the operation.

D. MONITORING AND EVALUATION

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

VI. SUMMARY OF RISKS

External and Domestic Shocks

75. **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 2014, with global fuel prices halving, this resulted in an approximately 6 percent reduction in wholesale fuel price in Tuvalu. Global or regional economic downturns could yield a shock to Tuvalu's remittance flows, diminish employment opportunities abroad, and create an uncertain aid environment[46]. Similarly, the returns on the trust fund 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 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.

76. **The GoT has taken a conservative approach in estimating revenues and grants to provide a cushion against external uncertainties, while continued donor engagement will support reform momentum.** The main buffer at Tuvalu's disposal against macroeconomic shocks is the CIF. As described above, this program will help the GoT to maintain this fiscal buffer at a more sustainable level and support measures that will contribute to improved revenues and prudent expenditure management in the medium term while enhancing employment opportunities abroad. Continued donor engagement will also support the continuation of the reform momentum. 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.

Institutional capacity

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

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

Ownership

79. **Dialogue supporting this program builds on a continuing engagement by development partners with the GoT that has demonstrated bipartisan ownership and that reforms can be sustained through political transition.** Dialogue and endorsement has typically been sought from both the Development Coordination Committee [47]and the Tuvalu cabinet, which provides a level of continuity, particularly since senior officials tend to remain in position even when political mandates change. Therefore it is unlikely that the general election scheduled for early-2015 would lead to significant deviation in policy. Furthermore, the programmatic operation is in itself considered to be critical for sustaining the progress made in policy dialogue over the last 18 months and the momentum of reform through political transition.

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[46] Announced cuts to Australian aid is not expected to impact on the medium term macroeconomic framework presented.

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

ANNEX 1: POLICY AND RESULTS MATRIX

DPO I – Prior Actions	DPO II – Prior Actions	Results Indicators by June 2016
The Recipient has strengthened its budget execution and transparency through the preparation and publication of quarterly fiscal reports.	The Recipient, through its Ministry of Finance and Economic Development, has introduced centralized commitment control procedures to strengthen treasury commitment and expenditure control.	**Indicator 1**: Stock and monitoring of arrears ▪ Baseline: 2012 = stock of arrears = 8.9% and no arrears monitoring[48] ▪ Target: 2015 = stock of arrears < 2% of expenditure and annual statement of arrears produced
The Recipient has resolved to offset the tax related cross liabilities that have hindered the operations of the Tuvalu Maritime Training Institute and the Vaiaku Lagi Hotel.	The Recipient, through its Ministry of Natural Resources has: (i) updated all financial records in its fisheries management system; and (ii) concluded a full reconciliation of fishing revenues generated through its Fisheries Department for 2013 with records of the Recipient's Treasury to strengthen oversight of fishing revenues.	**Indicator 2**: Management of revenue records ▪ Baseline: 2012 = Full reconciliation not available ▪ Target: 2015 = Updated treasury records are compiled at least quarterly and do not deviate by more than 10 percent from those of the revenue and fisheries management systems[49]
The Recipient has approved the outer islands project management policy aimed at strengthening project selection, implementation and monitoring in its outer islands.	The Recipient, through its Office of the Auditor General, has implemented a pilot streamlined Outer Island financial reporting framework to reduce administrative burden on the Kaupules and enable better tracking of funds.	**Indicator 3**: Local government (Kaupule) accounts are compiled on a timely basis and made public ▪ Baseline: 2012 n/a ▪ Target: 2015 = At least ¾ of annual Kaupule accounts are compiled within the statutory time limit and published on the Auditor's website.
The Recipient has: (a) on a pilot basis, implemented measures, designed to reduce health care costs and improve the quality of care provided through the Tuvalu Medical Treatment Scheme; and (b) submitted to its Parliament the report and recommendations from the TMTS pilot.	The Recipient, through its Ministry of Health, has revised the TMTS Policy to strengthen the patient referral process and institute efficiency measures.	**Indicator 4**: Increased rigor of the referral process[50] ▪ Baseline: Number of referral cases scrutinized by a multidisciplinary referral committee in 2012 = none ▪ Target: Number of referral cases scrutinized by a multidisciplinary referral committee in 2015 > 85 percent
The Recipient has approved the revised pre-service and in-service training and scholarship policies in order to tighten the criteria for extension of scholarships	The Recipient, through its Ministry of Education and the Tuvalu Maritime Training Institute, has broadened vocational training programs to increase post-primary education opportunities, particularly for Tuvaluan women.	**Indicator 5**: Increased budget allocation to primary & secondary education (including vocational)[51] ▪ Baseline: 2012 = AUD 3.1 m ▪ Target: 2015 = Increase on average by at least 5% p.a. **Indicator 6**: Availability of gender disaggregated data on beneficiaries of the broadened TMTI training program ▪ Baseline: 2012 = none ▪ Target: 2015 = Data available

[48] Baseline estimated based on 2012 whole of government accounts payable (it is unknown what proportion of this is in arrears, the team has included the full amount but will confirm) and the estimated AUD 2 million arrears not recorded in government accounts.
[49] The revenue management system is updated by the Inland Revenue Department and the fisheries management system is updated by the Fisheries Department.
[50] Indicator 4 was chosen as data associated with the TMTS, including inputs and outputs, is limited and highly variable depending on the number of patients.
[51] Indicator 5 was chosen as data on the education sector, including outputs, is very limited and variable and to reflect the GoT's planned outcome of improving resourcing and delivery of primary, secondary and vocational education services. Baseline data sourced from Tuvalu MTEF expenditure estimates – 2012.

ANNEX 2: LETTER OF DEVELOPMENT POLICY

TUVALU GOVERNMENT

OFFICE OF THE MINISTER OF FINANCE AND ECONOMIC DEVELOPMENT

PRIVATE MAIL BAG, VAIAKU, FUNAFUTI, TUVALU

Phone (688) 20201 – Ext: 3074, Fax: (688) 20210

Email: maatia_t@yahoo.com; mtoafa@gov.tv

09 January 2015

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 fortright 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

MINISTRY OF FINANCE
TUVALU GOVERNMENT

4

ANNEX 3: FUND RELATIONS ANNEX

Tuvalu—Assessment Letter for the World Bank

December 18, 2014

Economic outlook is generally stable. Owing to large donor-financed infrastructure projects that are planned to be implemented in the next few years, real GDP growth is projected to rise to 2½ percent in 2015. Inflation has been moderate thanks to benign food and oil prices, but the rapidly growing government expenditure and weakening Australian dollar would exert upward pressure on prices. Balance of payments is strong, reflecting large inflows of fishing license fees and foreign aid as well as transfers from the Tuvalu Trust Fund.

Nevertheless, macro-financial stability is clouded by substantial vulnerabilities in state-owned banks and public enterprises. In the unsupervised state-owned dual-bank system, asset quality remains poor as half of the loan portfolio is nonperforming. The Development Bank of Tuvalu (DBT)—accounting for about10 percent of banking sector assets—has made substantial losses in the past few years, and more recently, experienced a sharp outflow of deposits, giving rise to liquidity pressure and solvency concerns. The authorities have recently requested technical assistance from PFTAC to deal with DBT and set up a regulatory framework for the banks. Meanwhile, non-bank public enterprises, with some being insolvent already, have made large losses as a whole, reflecting weak governance and the cost of taking on social responsibilities.

Fiscal buffers have been built up to historical high, and fiscal risks have diminished since the Board discussed the Article IV report last August. The budget will likely achieve a large surplus this year thanks to a temporary increase in foreign aid, higher-than-expected revenue and some expenditure restraints. The Consolidated Investment Fund—the fiscal buffer account controlled by the authorities—has reached more than 50 percent of GDP and could grow further in the near term because of robust investment return on Tuvalu's foreign assets. With these developments, fiscal deficit would narrow by more than 10 percent of GDP cumulatively in the next three years compared to staff projection during the Article IV visit. Nevertheless, budgetary foreign grants are set to revert towards its historical average over the medium term, and fishing license fees may have peaked and are likely to decline. In this connection, a 20 percent (y/y) increase in the 2014 budget expenditure, mostly current spending, is a significant risk to long-term fiscal sustainability, and the fiscal buffer would erode over the medium to long run. The volatile spending pattern points to a deficient budgeting process and weak governance, which should be improved via donors' technical assistance. More importantly, the fiscal position needs to provide for substantial contingent liabilities stemming from vulnerabilities in state-owned banks and public enterprises.

The authorities are cognizant of the challenges, and have actively implemented reforms. A policy reform matrix (PRM), formulated in consultation with development partners, has been fleshed out in an effort to enhance governance and social development, facilitate private sector growth, and safeguard macroeconomic stability—the first two phases of PRM have been completed and the third phase has just commenced. Significant progress has been made to enhance public financial management, but efforts to strengthen public enterprises have seen limited success. Clearly, more needs to be done to enhance the economy's resilience.

Going forward, policies should be geared towards controlling fiscal risks and addressing structural weaknesses in banks and public enterprises. To maintain fiscal sustainability, fiscal consolidation efforts are needed with a focus on expenditure restraints, and a well anchored medium-term fiscal framework would help improve budget performance and maintain buffers to deal with potential large shocks such as climate change. A sound banking regulation and resolution framework should be established as soon as possible, and the potential need for recapitalization should be assessed urgently on the basis of prudential standards. A comprehensive reform package for the public enterprise sector should be developed and implemented with the priority on a clear definition of their social responsibilities, which, together with strengthened accounting and auditing practices, would enhance transparency and accountability.

The 2014 Article IV consultation was discussed by the Executive Board in August 2014.

Table 1. Tuvalu: Selected Social and Economic Indicators, 2010–2015 1/

Population (2013): 10,753	Poverty rate (2010): 26.3 percent
Per capita GDP (2013 est.): US$3,575	Life expectancy (2012): 65 years
Main export: Fish	Primary school enrollment (2006): 100 percent
Key export markets: Fiji, Australia, Japan	Secondary school enrollment (2001): 79.5 percent

	2010	2011	2012	2013	2014	2015
				Est.	Proj.	
			(Percent change)			
Real sector						
Real GDP growth	-2.7	8.5	0.2	1.3	2.2	2.5
Consumer price inflation (period average)	-1.9	0.5	1.4	2.0	3.3	3.1
			(In percent of GDP)			
Government finance						
Revenue and grants	71.9	69.0	84.3	107.5	120.5	93.8
Revenue	55.5	47.8	56.6	82.9	69.6	70.9
of which: Tax revenue	16.5	16.9	15.0	19.0	14.4	15.9
Fishing license fees	20.6	14.9	21.8	45.4	31.8	34.8
Grants 2/	16.4	21.2	27.8	24.6	50.9	23.0
Total expenditure	95.7	77.9	75.0	81.1	96.7	94.2
Current expenditure	92.5	76.1	75.0	81.0	96.5	94.1
of which: Wages and salaries	33.6	31.3	31.9	32.2	36.8	35.1
Capital expenditure and net lending	3.2	1.8	0.0	0.2	0.2	0.2
Overall balance	-23.8	-8.9	9.3	26.3	23.8	-0.4
Extra budgetary grants 3/	31.8	21.2	29.3	25.2	25.7	31.4
Tuvalu Trust Fund (stock, $A million)	108	119	131	141	146	148
Consolidated Investment Fund (stock, $A million)	7.2	3.2	4.5	14.5	23.9	23.3
			(Percent change, unless otherwise indicated)			
Money and credit						
Deposits	-8.3	8.6	9.7	29.3	9.5	...
Credit	0.9	15.1	-11.4	-7.7	0.8	...
Lending interest rate (in percent) 4/	10.6	10.6	10.6	10.6	10.6	...
			(In millions of Australian dollars, unless otherwise indicated)			
Balance of payments						
Current account balance	-4.1	-13.9	9.8	10.5	10.9	-14.8
(In percent of GDP)	-11.9	-36.5	25.3	26.4	26.3	-33.7
of which:						
Exports of goods	10.9	10.2	19.9	20.5	21.1	21.9
ow/ Fish	10.4	9.4	19.5	20.1	20.7	21.4
Imports of goods	-17.3	-17.6	-16.7	-19.1	-22.0	-35.6
Fishing license fees	7.2	5.7	8.4	18.0	13.3	15.2
Current transfers (net)	15.2	14.3	20.3	18.0	22.9	16.1
ow /Remittances	4.3	4.4	3.7	3.8	4.0	4.1
Capital and financial account balance	10.0	12.3	0.8	1.2	1.8	13.3
of which: .TV domain license fees	2.0	1.9	3.7	4.4	4.5	4.5
Capital transfers (net)	7.5	12.3	4.7	5.1	5.8	9.1
Gross official reserves 5/	26.6	24.1	27.5	36.5	49.2	47.6
(In months of next year's imports)	6.1	6.6	6.6	7.8	8.1	8.4
			(In percent of GDP, unless otherwise indicated)			
Debt indicators						
Gross public debt	55.6	45.3	43.0	41.1	56.9	48.6
External	50.6	40.7	36.4	35.3	52.0	44.6
Domestic	5.1	4.6	6.7	5.8	4.9	4.1
Exchange rates						
Australian dollars per U.S. dollar (period average)	1.1	1.0	1.0	1.0	...	...
Nominal effective exchange rate (2005=100)	111.2	119.1	122.7	123.7	...	...
Real effective exchange rate (2005=100)	108.3	111.0	112.4	110.6	...	...
Nominal GDP (In millions of Australian dollars)	34.7	38.1	38.5	39.7	41.7	43.8

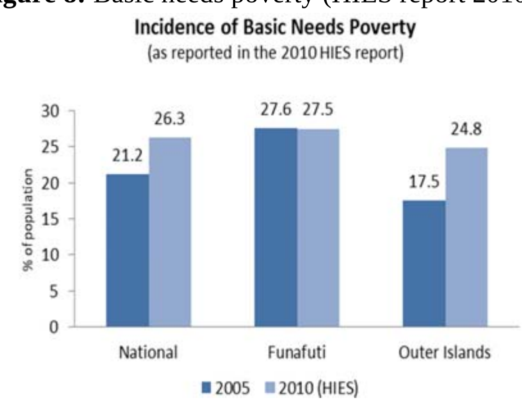
Sources: Tuvalu authorities; PFTAC; SPC; ADB; World Bank; and IMF staff estimates and projections.

Severe hardship, as measured by the food poverty line, is low in Tuvalu and has declined between 2005 and 2010. In Funafuti, where almost half of Tuvalu's population resides, food poverty (the ability of the household to meet its basic food needs) fell to just 0.6 percent in 2010. In contrast, food poverty increased amongst the outer island populations from 3.7 percent in 2005 to 6.6 percent in 2010 (see Figure 10). A series of shocks including water shortages, deteriorating soil quality and increasing prices contributed to these trends particularly in the OIs. The decline in remittance flows would also have negatively impacted households. The next HIES is scheduled for 2015.

Basic needs poverty is more widespread and is estimated to affect over a fifth of the population in both Funafuti and the OIs in 2010. Tuvalu's basic needs poverty line is based on a relative measure that makes it difficult to compare basic needs poverty rates between periods[52]. Figure 8 presents the incidence of poverty based on this measure, whereby similar levels of poverty were recorded in both 2005 and 2010 for Funafuti, and a higher basic needs poverty rate was reported for the OIs. Figure 9 presents an adjusted set of poverty estimates for 2010. These adjusted estimates differ from relative measure presented in the HIES report in that the 2005 non-food poverty line (adjusted for prices) is used as the point of reference. This adjustment is made in order to enhance comparability between the survey periods[53]. In addition, the adjusted estimates use one national poverty line for both Funafuti and the OIs. The adjusted estimates indicate that the basic needs poverty rate in the OIs is almost twice as high as that of the rate in Funafuti. Overall, these poverty estimates indicate that poverty is concentrated in the OIs and that the gap with Funafuti has increased in recent years[54].

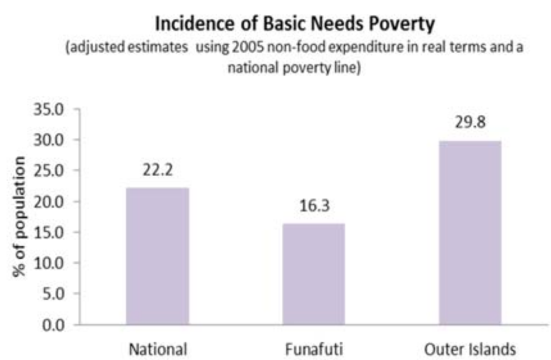
Lack of access to services, employment opportunities and vulnerability to shocks are some of the factors underlying these trends. Poverty in the Tuvalu context more frequently refers to lack of access to basic services such as potable water as well as lack of income earning and higher education opportunities, particularly in the OIs. Poverty dynamics also demonstrate vulnerability to price changes, particularly for imported goods such as food and fuel[55] that constitute a large share of the consumption basket. Customs of mutual support within communities and extended families and remittances have been a traditional safety net that still protects many of Tuvalu's households from extreme poverty. Investments in public services have also been sufficient to bring Tuvalu's health and education indicators on track to meeting the MDGs.

Figure 8: Basic needs poverty (HIES report 2010)



Source: GoT

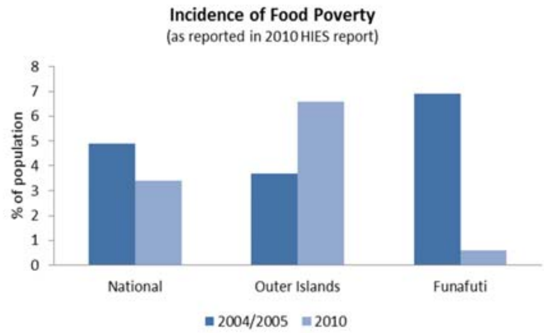
Figure 9: Basic needs poverty (adj. measure 2010)



Source: GoT and World Bank estimates

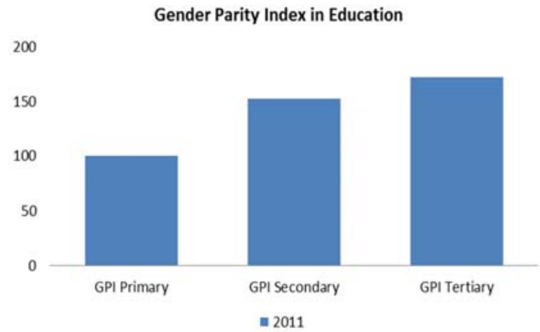
52 In contrast, the food poverty measure is based on individual calorific intake requirements and is therefore broadly comparable.
53 The adjusted basic needs poverty line is composed of the food poverty line as reported in the HIES 2010 report and the non-food poverty line for 2005 which was adjusted upwards (using the non-food CPI) to bring it to 2010 prices.
54 Like several other Pacific Islands, Tuvalu has not been part of the surveys conducted by the International Comparison Project, which computes Purchasing Power Parities). Hence, a reliable estimate of the conversion factor is not available for Tuvalu.
55 Growing fuel prices inflate electricity costs as power is generated through diesel generators.

Figure 10: Food Poverty



Source: GoT

Figure 11: Gender parity in education



Source: Secretariat of the Pacific Community

Tuvalu is well-placed to support shared prosperity, with inequality low by global standards. 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 the 2010 HIES data. This is significantly below the cross-country median of 4.7 based the Global Income Dynamics Dataset.

Tuvalu has made significant progress towards the achievements of gender equality in education and in improving health outcomes for mothers. Almost all Tuvaluan girls and boys are enrolled in primary schools, and there are more girls than boys enrolled in secondary and tertiary education (see Figure 11). Tuvalu is also one of the few Pacific island countries on track to achieve the MDGs for maternal mortality by 2015. Despite these achievements, there is much progress to be made in gender based violence and in terms of female participation in employment and leadership. The Demographic and Health Survey 2007 reported that 4 in 10 women have been subjected to some type of physical violence, and a large proportion of these incidents remain unreported. As part of its response to this issue, the GoT has prepared a domestic violence bill that is currently under consultation in the OIs. In terms of political power, Tuvalu's Constitution and electoral laws provide equal opportunities for women and men to contest in elections. Nevertheless, it is rare for women to compete in the political arena and there have been only two females in Parliament since 1986. At the local level, the *Falekaupule* (local government) Act provides for the appointment of a 'Women's Community Worker' as a permanent office in the local council, and women constituted 8.3 percent of elected members at the council level[56].

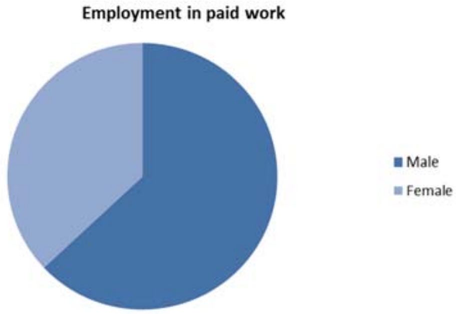
Although girls have a relatively high level of access to education, women's share of paid employment is lower than men. Figure 12 presents women's share of employment in the non-agricultural sector, which is relatively low and is estimated to be 36 percent in 2010[57]. This reflects the general scarcity of paid employment opportunities outside of the public sector and the male dominated nature of the traditional occupations such as seafaring, fishing and construction. This trend differs however in terms of own business employment, where women are equally active as men (see Figure 13). This suggests that small scale entrepreneurial activities may be an area with fewer traditional barriers to entry for women. It also highlights the potential for stimulating women's employment through vocational training in targeted business related skills.

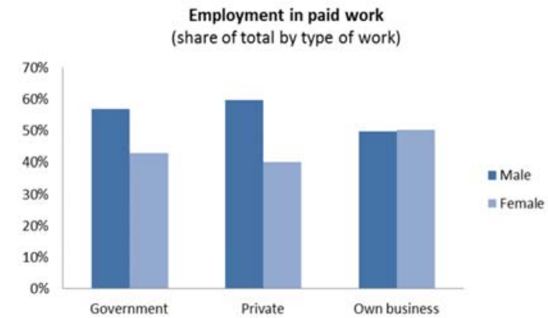
Figure 12: Employment in paid work by gender

Figure 13: Employment in paid work by type / gender

[56] Beijing + 15: Review of progress in implementing the Beijing Platform for Action in Pacific Island countries and territories. Secretariat of the Pacific Community, 2010.

[57] Pacific regional MDGs tracking report, 2013. Additional gender disaggregated data is not available.





Source: Pacific MDGs tracking report, 2013.

Source: HIES, 2010.

The GoT has undertaken further steps to strengthen the gender environment through the endorsement of a Gender policy and the tabling to parliament of a gender based violence bill. The National Gender Policy was endorsed by Cabinet in January 2014. It aims to provide the guiding framework to operationalize GoT's commitments to gender equality and women's empowerment in Tuvalu. The policy was developed recognizing the benefits of the initial National Women's policy of 1999 and takes note of the continued gender inequalities in some areas of society. The policy outlines specific areas (Institutional Strengthening and Capacity Building, Women's Economic Empowerment, Women in Decision Making and Ending Violence against Women) that the GoT will focus on within the next five years and provides the basis for multi-sectorial engagement and partnerships towards the overarching goal of gender equality and the empowerment of women. These areas of focus were identified through several consultations that were conducted as part of a gender stock-take in Tuvalu in 2013, which took stock of the existing supporting mechanisms and constraints for gender mainstreaming across all of government, as well as a desk review of the work on gender equality and women's development in Tuvalu since 1999. A five-year corporate plan as well as annual work plan was also developed as part of the process for developing and operationalizing this policy. As a next step, the family protection bill has been drafted and is expected to be tabled to parliament in the July session.

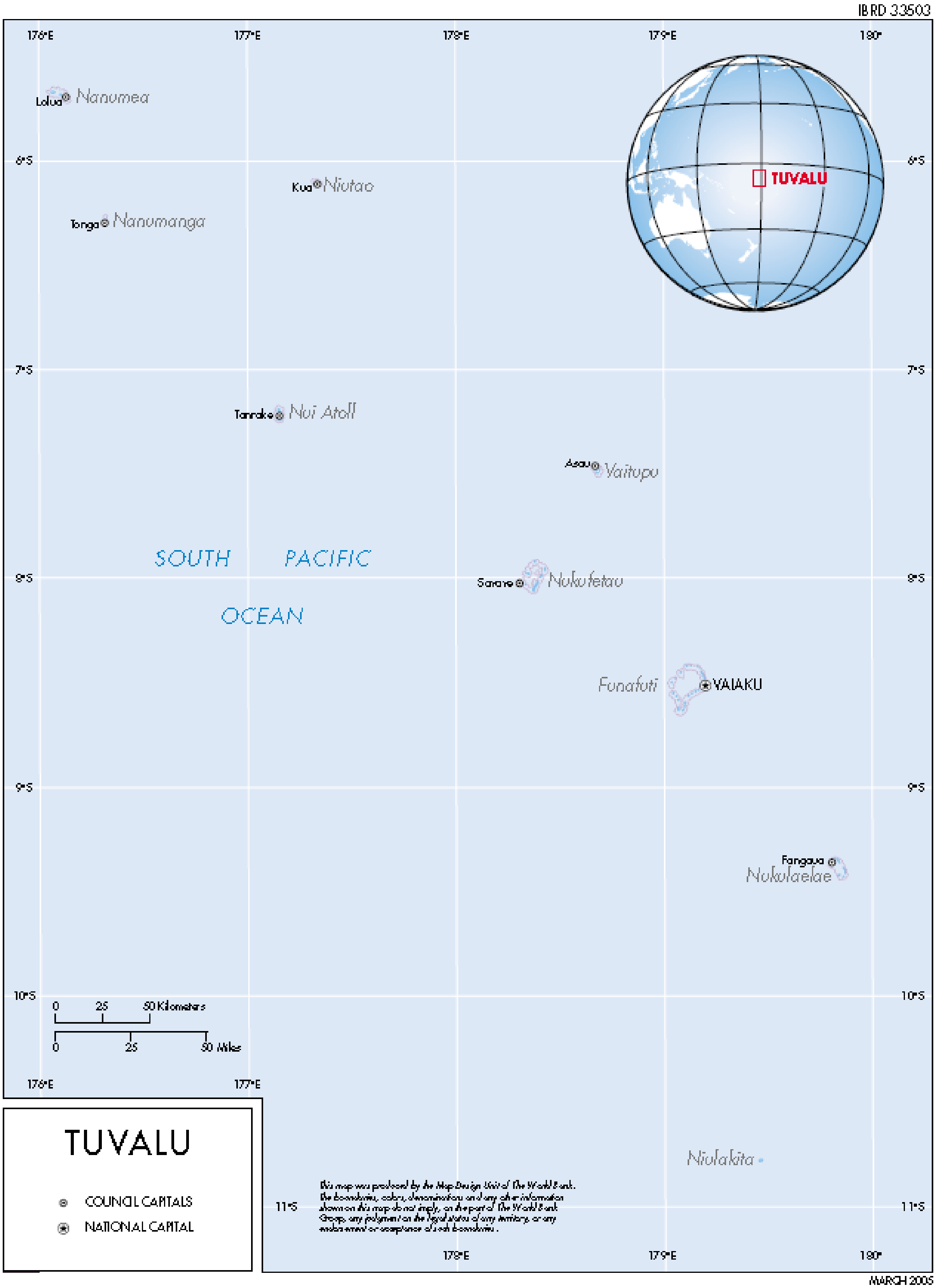
ANNEX 5: POLICY REFORM MATRIX

Roadmap-PRM Integrated Phase III matrix

Donor	Roadmap Activity	Roadmap-PRM Integrated Action	Verification Measure	Timeline	
				Tier 1 Actions Sept2014-Mar2015	Tier 2 Actions Apr 2015-Dec2015
TKII Strategic Area: Good Governance Macroeconomic Growth and Stability					
ADB, DFAT, NZ	10. Procurement legislation for transparency and accountability	1. Increase transparency and value for money of public procurement through the implementation of the procurement policy and the information is available publicly	1.1. Cabinet approval of 2014 procurement policy report detailing implementation of CPU activities. Report to include (i) procurement tenders completed, (ii) Number and value of contracts issued, (iii) Staff training conducted (iv) 2015 workplan. 1.2. GoT Procurement website developed 1.3. Procurement manual and public procurement information published on website	1st quarter 2015	2nd quarter 2015 2nd quarter 2015
NZ, DFAT, WB	42. Rationalise TMTS costs to achieve sustainable costs	2. Increase the efficiency and transparency of the TMTS to enable a greater focus on Primary and Preventative Health [PPH] Care[1]	2.1. Cabinet decision memorandum(s) approving the revised TMTS policy instituting piloted cost saving measures and strengthening the patient referral process; 2.1. 2014 Annual Report submitted to Cabinet and made public, reporting on revisions to the TMTS, number of people treated, average cost of treatments, cost saving measures and strategies to strengthen the referral process.	4th quarter 2014	2nd quarter 2015
ADB	72. Privatise VLH & Travel Office to increase private sector activities	3. Privatization of the Vaiaku Lagi Hotel	3.1. Government preparation towards the sale of the Vaiaku Lagi Hotel undertaken, including (i) formal issue of the sub-lease of the land to the hotel, (ii) settlement of all debts and taxes owed between Government and VLH, (iii) VLH 2013 financial results and details updated, (iv) sale and tender documents prepared,		2nd quarter 2015

			and (v) tendering process undertaken.		
Donor	**Roadmap Activity**	**Roadmap-PRM Integrated Action**	**Verification Measure**	**Timeline**	
				Tier 1 Actions Aug 2014-Mar2015	**Tier 2 Actions Apr 2015-Dec2015**
NZ, DFAT, ADB	87. Institutional Strengthening Programme (ISP) To restructure, new org. structure, focused direction, new complex, new corporation plan, reform NAFICOT	4. Comprehensive review of NAFICOT with a view to restructuring and strengthening management and operations including independent review on the joint venture agreements and bring its operation under the PE Accountability Act.	4.1. Audit report[2] of NAFICOT and associated JVs tabled to parliament 4.2. Cabinet decision to implement key recommendations following independent review of NAFICOT and JVs	1st quarter 2015	2nd quarter 2015
ADB	155. Privatise PWD activities as appropriately to reduce the size of PWD activities	5. Privatise Public Works Department functions as identified in the rationalization strategy *(**rationalization options could include contracting out activities to private sector, PWD staff becoming self-employed contractors, corporatizing PWD, direct sale)*	5.1. PWD functions reviewed with the aim of identifying which operational aspects might be best provided by the private sector and which should remain with GoT. 5.2.Cabinet decision memorandum approving the rationalization strategy for selected PWD functions.	1st quarter 2015	2rd quarter 2015
WB	172. Ensure medium term fiscal sustainability	6. Strengthen treasury commitment and expenditure control by introducing centralized commitment control procedures.	6.1. Commitment Control Paper approved by Cabinet and a demonstration of a functioning purchase order module within ACCPAC	4th quarter 2014	
WB ADB, NZ?		7. Strengthen oversight of revenues by: - Updating all financial records in the fisheries management system, and concluding a full reconciliation of fishing revenues for 2013 with Treasury records. - Updating all financial records in the customs database and concluding a full reconciliation of customs revenues	7.1. Fisheries Department updates all backlog of financial records in TUFMAN Subsequently, - Fisheries Department & Treasury reconcile 2013 fishing revenue records from TUFMAN and ACCPAC 7.2. Cabinet endorsement or tabling to parliament of the Fisheries Corporate Plan. This Corporate plan should detail GoT's commitment to: (i) keep up to date financial records in TUFMAN; (ii) conduct regular reconciliation of fishing revenues collected by TUFMAN with Treasury records (in ACCPAC); and (iii) production of quarterly fisheries reports going forward.	4th quarter 2014 4th quarter 2014	

			7.3. Ministry of Finance letter on the establishment of a Customs revenue database that is reconciled with Treasury 2014 records.		3rd quarter 2015
Donor	**Roadmap Activity**	**Roadmap-PRM Integrated Action**	**Verification Measure**	**Timeline**	
				Tier 1 Actions Aug 2014-Mar2015	**Tier 2 Actions Apr 2015-Dec2015**
DFAT, NZ, ADB		8. The review of the Financial Instructions to look at the management of the CIF and establish a set of management rules to guide, replenish and regulate the use of the CIF as a long-term fiscal buffer	8.1. The revised Financial Instructions is approved by Cabinet and include details on rules to manage, replenish, guide and regulate the use of the CIF as a long-term fiscal buffer.	1st quarter 2015	
ADB		9. Public Enterprise Reform plan[5] developed to enhance PEs' commercial orientation and financial viability	9.1. Cabinet approval of Public Enterprise Reform Plan setting out strategies to improve PE's commercial and financial viability.	1st quarter 2015	
TKII Strategic Area: Good Governance and Outer Islands Development					
WB	88 & 166. Kaupule audit scrutiny increased (report to Parliament Dec 2013) Update Kaupule accounts	10. Piloting of a streamlined Outer Island financial reporting framework to reduce administrative burden on the Kaupules and enabled better tracking of funds.	10.1. Audit Report of the Auditor General of Kaupule accounts for 2012, 2013 and 2014. 10.2. Pilot 2014 Kaupule accounts submitted to Auditor General for audit using the new streamlined financial reporting framework	4th Quarter 2014 4th Quarter 2014	
TKII Strategic Area: Education and Human Resources					
DFAT, NZ? DFAT, WB, NZ? WB	75,76,80,85,86. Rationalize pre-service training and increase overseas employment opportunities	11. GoT continues to improve the efficiency of the tertiary education scheme, enabling government to increase spending on basic and vocational education.	11.1. SELF Annual Report tabled in Parliament covering: regulations and implementation of the Student Education Loan Fund (SELF) program, including repayments 11.2. TTFAC report verifies that GoT met its fiscal ratios of at least 5% increase in primary non-salary education expenditure in 2014 11.3. Letter from Minister of Education or Cabinet Decision to broaden the curriculum of TMTI to (i) include training for fishing vessel crews, with specific date for first intake; and (ii) open TMTI to female participation with a view to training them for service oriented activities.	1 quarter 2015 1st quarter 2015 4th quarter 2014	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TUVALU
COUNCIL CAPITALS
NATIONAL CAPITAL
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MARCH 2005