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IDA/R2016-0270/1

November 16, 2016

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<p><b>Closing Date: Friday, December 9, 2016 at 6 p.m.</b></p>
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FROM: Vice President and Corporate Secretary

**Tuvalu - Third Development Policy Operation**

**Program Document**

Attached is the Program Document regarding a proposed development policy grant to Tuvalu for a Third Development Policy Operation (IDA/R2016-0270), which is being processed on an absence-of-objection basis.

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Report No. 108535-TV

INTERNATIONAL DEVELOPMENT ASSOCIATION

PROGRAM DOCUMENT

FOR A

PROPOSED DEVELOPMENT POLICY GRANT

IN THE AMOUNT OF EQUIVALENT TO US\$3.3 MILLION TO

TUVALU

FOR THE

THIRD DEVELOPMENT POLICY OPERATION

November 10, 2016

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

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## TUVALU - GOVERNMENT FISCAL YEAR

*January, 1 – December, 31*

### CURRENCY EQUIVALENTS

(Exchange Rate Effective as of October 31, 2016)

Currency Unit – Australian Dollar (\$A)

(US\$1.00 = \$A 1.3154)

### ABBREVIATIONS AND ACRONYMS

ACCPAC	Financial Management Information System Name
ADB	Asian Development Bank
CAS	Country Assistance Strategy
CIF	Consolidated Investment Fund
DBT	Development Bank of Tuvalu
DPO	Development Policy Operation
DSA	Debt Sustainability Analysis
GDP	Gross Domestic Product
GFC	Global Financial Crisis
GoT	Government of Tuvalu
HIES	Household Income Expenditure Survey
IMF	International Monetary Fund
IRD	Inland Revenue Department
MP	Member of Parliament
NCD	Noncommunicable Disease
OI	Outer Island
PE	Public Enterprise
PEFA	Public Expenditure and Financial Accountability
PFM	Public Financial Management
PPH	Primary and Preventative Health Care
PRM	Policy Reform Matrix
SCD	Systematic Country Diagnostic
SOP	Standard Operating Procedure
TC	Tropical Cyclone
TIN	Tax Identification Number
TKIII	National Strategy for Sustained Development 2016-2020 or Te Kakeega III
TSF	Tuvalu Survival Fund
TTF	Tuvalu Trust Fund
WHO	World Health Organization

Vice President: Victoria Kwakwa  
Country Director: Michel Kerf  
Senior Practice Director: Carlos Felipe Jaramillo  
Practice Manager: Ndiame Diop  
Program Leader: Robert Utz  
Task Team Leader: Lucy Pan

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The Third Development Policy Operation to Tuvalu was prepared by an IDA team consisting of Lucy Pan (TTL), Economist, GMF02; Robert Utz, Program Leader, EACNF; Virginia Horscroft, Senior Economist, GMF02; Duangrat Laohapakakul, Senior Counsel, LEGES; Loren Atkins, Associate Counsel, LEGES; Stephen Hartung, Financial Management Specialist, GGODR; and Samantha Evans, Program Assistant, EACNF. The team received valuable contributions from Imogen Halstead, Senior Economist, GPV02, and Binh Thanh Vu, Senior Education Specialist, GED02. The team was supervised by Robert Utz, Program Leader, EACNF. Overall guidance was provided by Mathew Verghis and Ndiame Diop, Practice Manager, GMFDR; and Michel Kerf, Country Director, EACNF. Peer reviewers are Tobias Haque, Senior Economist, GMF13, and Hans Anand Beck, Senior Economist, GMF06.



**SUMMARY OF PROPOSED GRANT AND PROGRAM**  
**TUVALU**  
**THIRD DEVELOPMENT POLICY OPERATION**

Borrower	Tuvalu
Implementation Agency	Ministry of Finance and Economic Development
Financing Data	IDA Grant; IDA terms; Amount: SDR 2.5 (US\$3.3 million equivalent)
Operation Type	First in a programmatic series of two development policy operations
Pillars of the Operation And Program Development Objective(s)	<p>The <i>first pillar</i> of the program focuses on improving social service delivery through (a) enhancing inclusiveness and equity of secondary education and (b) reducing risk factors for noncommunicable diseases (NCDs).</p> <p>The <i>second pillar</i> of the program focuses on improving macroeconomic sustainability through (a) strengthening investment management of reserve assets; (b) improving effectiveness of payroll controls; and (c) enhancing banking sector oversight and sustainability.</p>
Result Indicators	<p><b>Indicator 1:</b> Increased enrollment in secondary education</p> <ul style="list-style-type: none"> <li>▪ Baseline: 2012 gross secondary enrollment rate = 55 percent</li> <li>▪ Target: 2019 gross secondary enrollment rate &gt; 60 percent</li> </ul> <p><b>Indicator 2:</b> Reduce adult smoking prevalence</p> <ul style="list-style-type: none"> <li>▪ Baseline: 2015 = 37.9 percent</li> <li>▪ Target: 2019 &lt; 34 percent</li> </ul> <p><b>Indicator 3:</b> International best practice applied to Tuvalu Trust Fund investment management</p> <ul style="list-style-type: none"> <li>▪ Baseline: 2015 = Investment managers not selected on competitive basis and annual management fee average 63 basis points</li> <li>▪ Target: 2019 = Investment managers are selected on competitive basis and annual management fee reduced by 20 basis points</li> </ul> <p><b>Indicator 4:</b> Reduce variance between budget and actual wage spending</p> <ul style="list-style-type: none"> <li>▪ Baseline: 2014 = 12.7 percent</li> <li>▪ Target: 2019 &lt; 7 percent</li> </ul> <p><b>Indicator 5:</b> Increased oversight of banking sector</p> <ul style="list-style-type: none"> <li>▪ Baseline: 2015 = No regular monitoring reports</li> <li>▪ Target: 2019 = Monitoring reports are produced regularly, including information on nonperforming loans, and tabled to the Cabinet for information.</li> </ul>
Overall risk rating	Substantial
Climate and disaster risks	Short- and long-term climate and disaster risks are relevant to the operation (as identified as part of the SORT environmental and social risk rating).
Operation ID	P155066



## IDA PROGRAM DOCUMENT FOR A PROPOSED GRANT TO TUVALU

### 1. INTRODUCTION AND COUNTRY CONTEXT (INCLUDING POVERTY DEVELOPMENTS)

**1. The proposed Development Policy Operation (DPO) of US\$3.3 million equivalent is expected to be the first in a series of two programmatic DPOs.** The proposed operation is aimed at supporting the reform agenda of the Government of Tuvalu (GoT) in the critical areas of (a) improving social service delivery and (b) building macroeconomic sustainability. Building human capital is a key pillar to the national development strategy and fostering access to economic opportunities and public services has been identified by the Systematic Country Diagnostic (SCD) as an area of priority action for reducing poverty and boosting shared prosperity. The reforms in this area are in turn focused on enhancing inclusiveness and equity of secondary education and supporting improved health sector outcomes and its financing sustainability. The national development strategy and SCD also reiterated that exogenous shocks create poverty traps, which are amplified by weaknesses in macroeconomic management. Building resilience to shocks and sustainability is particularly important to Tuvalu, in light of the Global Financial Crisis (GFC) and the recent Tropical Cyclone (TC) Pam, which resulted in losses exceeding 15 percent of gross domestic product (GDP) in the Tuvalu Trust Fund (TTF) and damage and losses exceeding 30 percent of GDP. To mitigate against this, the reforms under the second pillar of the operation are focused on improving macroeconomic sustainability by strengthening investment management of reserve assets, which will be complemented by reforms to improve the effectiveness of payroll controls, and increasing oversight on the banking sector. Financing provided through this proposed operation will not only support the maintenance of buffers and meet long-term financing needs,<sup>1</sup> but more importantly focus on the reform agenda while sustaining the reform momentum built through the previous operations.

**2. In the 2015 election, the then incumbent Government as well as a majority of the Cabinet was returned, providing a stable political landscape.** The next general election is not scheduled until 2019. The politics of Tuvalu take place in a framework of a parliamentary representative democratic monarchy, whereby the British monarch is the head of state, represented by the governor-general, while the prime minister is the head of Government. Executive power is exercised by the Government. There are 15 members of parliament (MPs), including one female MP, 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 the Government. Traditional chiefs also still play a significant role in influencing island affairs, particularly on the Outer Islands (OIs).

**3. 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, comprised of nine Polynesian islands and atolls, is one of the smallest and most remote states in the world<sup>2</sup> with a population of around 11,000 and a land area of only 26 km<sup>2</sup>. 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

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<sup>1</sup> In the Letter of Development Policy, the GoT has noted its plans on saving a portion of the funds provided under the proposed series of budget support operations in the TTF.

<sup>2</sup> Tuvalu is over 3,500 km away from the nearest major market of New Zealand.

monetary independence,<sup>3</sup> a high level of import dependence, and a minimal financial infrastructure, fiscal policy is the main tool available to the GoT to manage the economy. Yet, Tuvalu's fiscal position is extremely tight with regular fiscal deficits providing limited space for government investments or operations, particularly in times of crisis. The pre-grant deficit averaged 28 percent of GDP in the decade till 2014 and grants financed over 80 percent of the deficits. Given the small size of the economy in nominal terms, exogenous shocks can significantly alter fiscal outcomes. The 2015 TC Pam, for example, resulted in damages of around 30 percent of GDP. Losses of this magnitude are very difficult to absorb for a very small country with limited resources—the size of Tuvalu's economy is estimated at around \$A 43.5 million based on 2015 GDP estimates. Therefore, maintaining adequate buffer assets is critical to Tuvalu's ability to absorb inevitable future shocks.

**4. These extreme physical challenges in turn limit growth prospects.** The private sector remains small, mostly consisting of small firms in the wholesale and retail sectors. The private sector has struggled to grow partly because of the inherent lack of economies of scale due to remoteness and dispersion of population across nine islands. The public sector dominates the economy, accounting for approximately two-thirds of GDP, as well as the majority of formal sector employment. The large size of the public sector reflects the inability of a very small country to exploit economies of scale in public administration and the provision of services. Agriculture contributed around 26 percent of GDP. Subsistence farming and fishing, the main economic activities in this sector, have suffered from poor soil quality, limited access to fresh water, and the high cost of imported fuel. Droughts and cyclones 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 6 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. Overseas employment opportunities have remained stable with declining demand for seafarers partly offset by increased temporary labor scheme opportunities offered by regional partners.

**5. The TTF and its auxiliary fund, the Consolidated Investment Fund (CIF), are the main stabilizing tools for volatile fiscal outcomes, and building adequate buffers in these funds to meet long-term financing needs is critical to the sustainability of Tuvalu.** The TTF is a capital-preserving fund established post-independence to contribute to Tuvalu's long-term fiscal sustainability (see Box 1 for details). Surplus returns on the investment of the TTF are accumulated in the CIF to provide a regular source of budget finance and mitigate against short- to medium-term shocks. 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.<sup>4</sup>

**6. 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.<sup>5</sup>** On the other hand, 26.3 percent of the population experienced material deprivation, up from 21.2 percent in 2005. The

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<sup>3</sup> Tuvalu does not have a central bank and uses the Australian dollar as its currency.

<sup>4</sup> Since inception, average distribution from the CIF provided budget support equivalent to 15 percent of total revenues.

<sup>5</sup> While purchasing power parity-adjusted poverty lines are not available for Tuvalu, the food poverty line would likely be somewhat higher than US\$ 2. 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.

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. 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. An HIES is expected to be completed in 2016 and the World Bank is engaged in a coordinated dialogue on this front.

**7. The GoT has laid out an agenda to address these challenges and improve macroeconomic sustainability.** As set out in its National Strategy for Sustained Development 2016–2020 or Te Kakeega III (TKIII), 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). As part of the TKIII, the GoT has put together a medium-term development matrix, including reforms in each of the areas of focus. These measures are in turn aimed at reducing vulnerabilities, easing fiscal constraints, and enhancing the effectiveness of key government programs, including in health and education, which are further articulated in the Policy Reform Matrix (PRM).

**8. The programmatic series of operations is expected to support the GoT's development objectives and contribute to the improved well-being of Tuvaluans, while supporting the maintenance of buffers to meet long-term financing needs.** Drawing from the TKIII development matrix, reforms to improve social service delivery and build macroeconomic sustainability have been identified as critical areas the World Bank can best support. Reforms to improve social service delivery, including the removal of school fees for secondary education to broaden access and reforms to tobacco legislations to enhance tobacco control strategies, will disproportionately benefit the poor. Reforms to build macroeconomic sustainability are expected to contribute to improving poverty and social outcomes in Tuvalu indirectly by making the public service more effective in responding to national poverty and social needs and through sustained service delivery to all Tuvaluans, including the poor. In addition, reforms to enhance the management of reserve assets and disaster preparedness will support all Tuvaluans in times of crises, particularly those living on the OIs, where some of Tuvalu's poorest households reside and where disasters have had the most negative impact. These reforms are expected to contribute to the Government's TKIII mission to achieve a greater level of security and prosperity for all Tuvaluans, including through achievement of higher standards of quality health and education. Financing provided through the operations will support the maintenance of buffers to meet long-term financing needs. Maintenance of adequate buffer assets will in turn ensure Tuvalu's ability to absorb future shocks without disrupting the level of service delivery, which is relied on heavily by the poor.

**9. The proposed operation carries risks stemming from thin institutional capacity in the GoT and an uncertain external and domestic environment.** First, 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 mapping technical assistance from development partners where gaps arise.

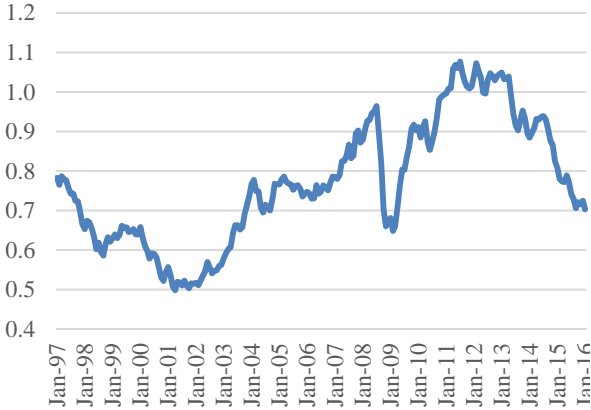
Second, external and domestic risks stemming from financial market volatility, commodity price volatility, uncertain external aid environment, and slower domestic policy reform could place a strain on Tuvalu’s fiscal situation. These idiosyncratic risks could counteract one another and the World Bank 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, Tuvalu’s high degree of vulnerability to external shocks, including from natural disasters, poses a risk to the operation. If it experiences another major natural disaster over the medium term, Tuvalu’s macroeconomic stability will be threatened and large parts of the bureaucracy will have to shift their attention to disaster recovery and reconstruction efforts. This is partly mitigated by reforms under way to increase disaster preparedness.

**2. MACROECONOMIC POLICY FRAMEWORK**

**2.1 RECENT ECONOMIC DEVELOPMENTS**

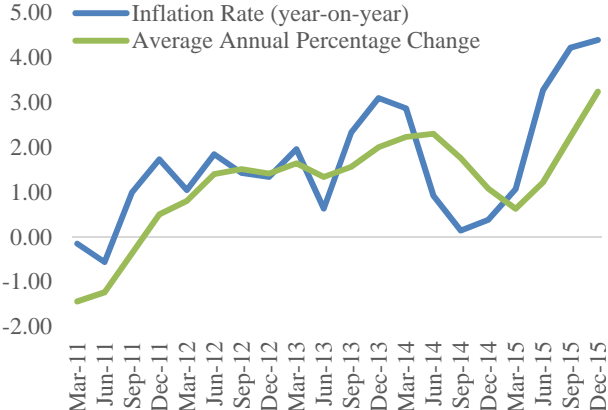
**10. The pace of Tuvalu’s economic growth has picked up in recent years, while inflation remains moderate.** GDP growth rose to 2.6 percent in 2015, and is estimated to rise to around 4.0 percent in 2016 partly on account of recovery spending following TC Pam. Government- and donor-funded investments, including OI school and clinic projects, have also supported the increase in growth. Credit growth remained moderate at 2 percent, on account of modest retail and wholesale activities. While inflation remained steady in 2015 at 3.2 percent,<sup>6</sup> it is expected to rise slightly in 2016 to 3.5 percent as economic activity picks up. Inflation trends in 2015 and 2016 also partly reflect growing government expenditure and a shortage of essential items due to TC Pam-related disruptions in transportation and in the domestic supply of agricultural products, partly offset by falling fuel prices. Monetary policy is constrained by the use of the Australian dollar as the national currency.

**Figure 1. \$A-US\$ Exchange Rate (monthly average)**



Source: World Bank, Reuters

**Figure 2. Funafuti Inflation Trends**



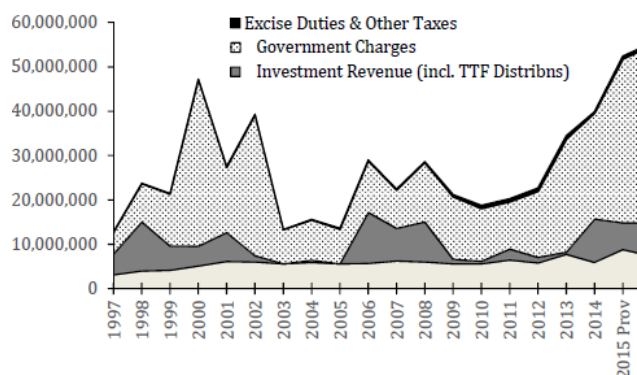
Source: World Bank, GoT

**11. The balance of payment position remains in net surplus despite large trade deficits.** The country’s goods and services deficit (which averaged 84 percent of GDP between 2010 and 2014) has worsened to 97 percent of GDP in 2015 and is expected to widen further in 2016 on the

<sup>6</sup> The Consumer Price Index, 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.

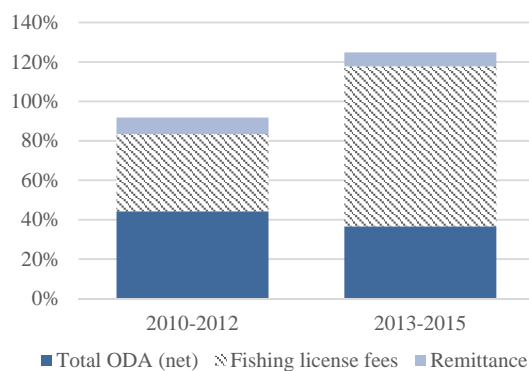
back of increased imports related to aforementioned infrastructure projects, partly funded through grants. Remittances, which are dominated by transfers from seafarers, have declined over the long term, with slowing world shipping activities and increased competition, to slightly under 10 percent of GDP. On the other hand, steady performance on the assets invested in the TTF have resulted in higher income flows. The record fishing license revenues in 2015 and 2016, almost doubling from 2014, resulted in substantially higher income flows and supported continued current account surpluses in 2015 and 2016. Similarly, gross reserves are expected to remain adequate, covering around seven months of imports in 2015 and 2016.

**Figure 3. Key Sources of Revenue in Nominal \$A**



Source: TTF Advisory Committee Report, May 2016

**Figure 4. Key Sources of Foreign Exchange as Percent of Imports**



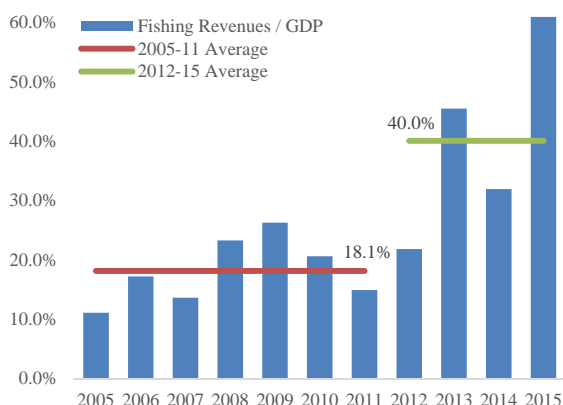
Source: OECD Statistics, World Bank estimates

**12. The fiscal deficit of 5 percent of GDP in 2015 was largely due to TC Pam recovery and reconstruction expenditures.** Given the narrow economic base, tax revenues finance a relatively small proportion of the budget, although tax effort at 19 percent of GDP is moderate compared to regional peers. Nontax revenues such as fishing license fees and .tv Internet domain leases finance the bulk of spending needs and have increased dramatically in recent years largely on the back of higher fishing license fees (at \$A 26.5 million collected in 2015 and \$A 28.7 million collected from January to July 2016). Favorable El Niño weather patterns, the full implementation of Vessel Day Scheme from 2012 to increase the economic return on fisheries to Pacific nations, and, more recently, the appreciation of the U.S. dollar against the Australian dollar have contributed to the increase. However, these revenues have demonstrated a high level of volatility in the past and potential downside risks exist. The movement from El Niño to La Niña in 2016 could, for example, mean less favorable fishing conditions in Tuvaluan waters and result in lower fees. With these fees denominated in U.S. dollar, exchange rate movements could similarly affect this revenue in local currency terms. The substantively higher revenues in 2015 are largely offset by increased TC Pam-related spending. The GoT made transfers of \$A 4.2 million (or 9.7 percent of GDP) for TC Pam, including transfers to the OIs for cleanup, rebuilding, and replanting. There were also additional recurrent costs which resulted from TC Pam, such as fuel for extra ship runs to the OIs for delivery of goods and labor. Capital expenditure increased on the back of TC Pam-related projects; it also reflected higher planned capital spending which had been delayed in the aftermath of the GFC given the tight fiscal situation.<sup>7</sup> Grants fell short of expectation in 2015 due

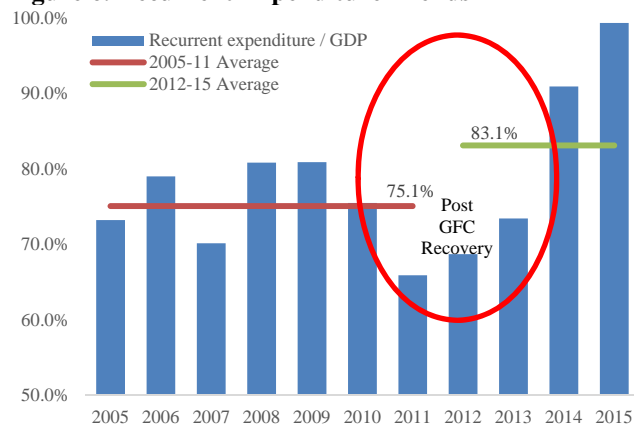
<sup>7</sup> Out of the \$A 10 million plus spent on capital projects in 2015, \$A 2.8 million was spent on OI development projects, \$A 2.3 million on coastal protection, and around \$A 2.5 million and \$A 1 million on delayed school improvement projects and vessel maintenance, respectively. Some of this expenditure was transferred to the Tuvalu Development Fund, which the 2016 IMF Article IV classified as below the line transactions resulting in a fiscal surplus.

to the December quarter budget support payment from Taiwan, China arriving in January 2016.<sup>8</sup>

**Figure 5. Fishing Revenue Trends**



**Figure 6. Recurrent Expenditure Trends**



Source: World Bank staff estimates based on government and IMF data

**13. A surplus of around 12 percent of GDP is expected in 2016, although expenditures are expected to remain elevated.** On the revenue side, fishing license fees are expected to remain strong in 2016, projected at around \$A 27.8 million (or 62.3 percent of GDP). At the same time, with increased fiscal space, spending remains elevated.<sup>9</sup> On the capital side, this is partly driven by one-off expenses such as the establishment and transfer of \$A 5 million to the Tuvalu Survival Fund (TSF), continued recovery spending following TC Pam, pipeline of delayed infrastructure projects for priority areas such as health and education, as well as increased maintenance. Recurrent expenditure has also risen in recent years on the back of higher wages,<sup>10</sup> subsidies, and transfers for education, health care, and public enterprises. In 2016, the arrival of an additional transportation vessel donated by Japan is expected to add to the GoT's operational costs, including wages to crew the vessel, additional fuel, and maintenance costs. However, the GoT is in the process of divesting an old vessel, which should result in some normalization of the costs. Despite this, a surplus of around 12 percent of GDP is expected in 2016 on the back of high fishing license fees and lumpy grant inflows. While the rise in expenditures has been more than offset by structural upshift in fishing revenues in the recent past, over the medium term, expenditure growth needs to be contained, including in the areas of public sector wages and subsidies and transfers to ensure sustainability of service delivery and create room for inevitable shocks and occasional large-scale climate-related expenditures.

<sup>8</sup> Tuvalu's accounts are prepared on a cash basis.

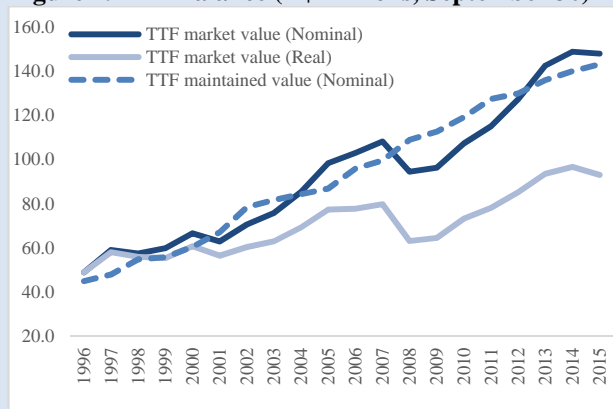
<sup>9</sup> The TTF suffered large losses in 2008 with the GFC, and Tuvalu's savings in the CIF have been substantially drained since 2009 to finance subsequent budget deficits. During this period, the GoT had to exercise expenditure restraint, including delaying wage adjustments, maintenance spending, and infrastructure spending, which led to increasing expenditure pressure and arrears.

<sup>10</sup> In 2014, the GoT announced a one-off \$A 30 fortnightly cost of living allowance increase, the first in five years, aimed at easing cost of living pressures while the GoT considers public sector reform options. Following this, the GoT made no wage adjustment in 2015 and announced a wage increase of 2.5 percent in 2016. Spending on wages for the first seven months of the year totaled \$A 10.5 million, annualizing to an estimated total spending of \$A 18.0 million. Similar to previous years, this is below the budget estimate, which is based on the full staff registry and does not consider unfilled posts. Spending for health and education have broadly increased in line with TKIII, as detailed in section 3. The cost of service delivery is also increasing with rising maintenance and rental costs, including bringing maintenance costs onto budget and increasing land rent costs.

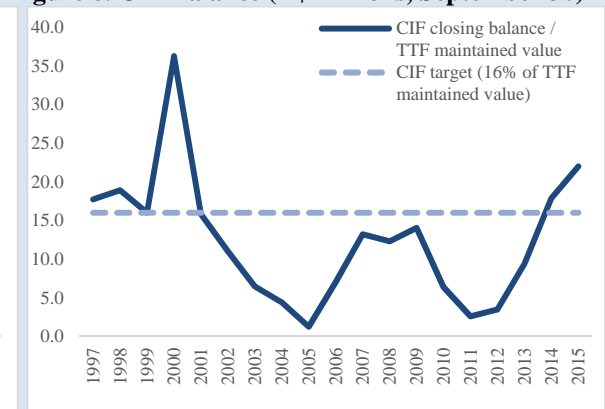
### Box 1. The TTF

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 long-term source of funding for recurrent expenditures and to set the country on a path toward greater financial autonomy. The TTF was capitalized by donors (Australia, New Zealand, the United Kingdom, and so on) and the GoT in 1988. The TTF is a capital-preserving fund distributing only real returns. This, together with contributions by the GoT during surplus periods, has resulted in capital growth over the years. The TTF is not fully sovereign with development partners represented on its Board. In years when the market value of the TTF exceeds its real maintained value (indexed to the Australian Consumer Price Index), the surplus is transferred to the CIF for use in the subsequent years. Since the capital of the TTF is invested in international financial markets, 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 the 1987, 2000, and 2008 crises).

**Figure 7. TTF Balance (A\$ millions, September 30)**



**Figure 8. CIF Balance (A\$ millions, September 30)**



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

Transfers accumulate in the CIF until the GoT withdraws for budget financing, including to meet short-term financing needs resulting from shocks. 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 the GoT to continuously finance post-grant deficits of around 11 percent of GDP for four years). This is based on the assumption that a ‘dry spell’ up to four years could occur where no distribution would be made from the TTF. The ancillary fund, CIF, was established under full Government control to facilitate predictability and regularity of transfers to the budget.

Falekaupule Trust Fund and the TSF run in parallel to the TTF. The local governments (*Kaupules*), together with donor partners, capitalized the Falekaupule Trust Fund, which 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 TSF was established in 2016 to finance recovery from climate change impacts and investments in climate mitigation projects. The current balance of the TSF is estimated at 11 percent of GDP.

**14. Higher revenues and grants have allowed the GoT to replenish the reserve assets from near depletion in the post GFC era and build the capital base of the TTF.** The GFC resulted in accumulated losses estimated at around 15 percent of the value of the assets in the TTF and Tuvalu’s savings in the CIF were substantially drained since 2009 to finance subsequent budget deficits. In the ensuing years, the TTF’s capital value has recovered gradually with disbursements to the CIF resuming from 2014. Despite the recent increase in spending, the sustained fiscal surpluses over the past several years, supported by higher grants and revenues, have substantially rebuilt the fiscal buffer. Assets in the CIF are currently well above the sustainable target of 16 percent of the maintained value of the TTF. The GoT has in the past two years also reinvested earnings of the TTF to increase the asset base and long-term distributions (targeted at \$A 200

million, to provide long-term fiscal space for climate-related investments and mitigate any upward pressure on future cost of service delivery). In parallel, the public debt stock including contingent liabilities is estimated at 58.2 percent of GDP in 2015 while debt service remains moderate at 6.2 percent of revenues.

**Table 1. Tuvalu: Selected Economic Indicators, 2014–19 1/**

	2014	2015	2016	2017	2018	2019
	Actual	Prelim.	Est.	Proj.	Proj.	Proj.
	(Percent change, unless otherwise indicated)					
<b>Real sector</b>						
Real GDP growth	2.2	2.6	4.0	2.3	2.3	2.2
Consumer prices (period average)	1.1	3.2	3.5	2.9	2.8	2.8
	(Percent change, unless otherwise indicated)					
<b>Money and credit</b>						
Deposits	10.6	2.0	...	...	...	...
Credit	-32.0	2.0	...	...	...	...
Lending interest rate (in percent)	10.6	9.1	...	...	...	...
	(In millions of Australian dollars, unless otherwise indicated)					
<b>Balance of payments</b>						
Current account balance 2/	8.4	3.3	2.7	-2.3	-2.4	-2.1
(In percent of GDP)	20.2	7.6	5.8	-4.9	-4.8	-4.1
Goods and services balance	-31.4	-42.2	-53.3	-53.2	-53.3	-53.3
Income balance	14.1	30.6	32.8	24.8	24.9	25.1
<i>of which: Overseas workers income</i>	4.1	4.1	4.3	5.0	4.6	4.3
Current transfers (net)	25.6	14.9	23.1	26.0	26.0	26.1
<i>of which: government</i>	25.5	14.9	23.1	26.0	26.0	26.1
Gross official reserves 3/	41.1	43.1	48.5	45.7	42.0	37.3
(In months of imports of goods and services)	7.4	6.6	7.4	6.7	6.1	6.1
<b>Debt indicators</b>						
Gross public debt (incl. guarantees)	26.6	25.3	24.7	21.3	18.4	15.8
(In percent of GDP)	64.4	58.2	53.8	44.6	36.9	30.7
<i>of which: contingent liabilities 4/</i>	16.5	15.3	13.4	11.5	9.5	7.6
Public Debt service	1.1	3.4	3.8	4.0	3.4	2.9
(In percent of revenues)	2.1	6.3	6.2	7.8	6.6	5.5
<b>Exchange rates</b>						
AUD per U.S. dollar (period average)	1.1	1.3	...	...	...	...
Real effective exchange rate (2005=100)	97.3	91.9	...	...	...	...
<b>Nominal GDP</b>	41.3	43.5	45.9	47.9	49.8	51.6

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 2017 due to expected moderation of grant flows. Capital projects such as the World Bank Aviation Project are largely expected to be financed through increased capital transfers.

3/ Defined as sum of foreign assets of the National Bank of Tuvalu, the balance in the CIF, and SDR holdings.

4/ Contingent liabilities 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, 2014–19**

	2014	2015	2016	2017	2018	2019
	Audited	Prel.	Est.	Proj.	Proj.	Proj.
	(In percent of GDP, unless otherwise indicated)					
Revenue	75.8	105.5	100.8	80.3	79.0	78.1
Taxes	18.0	19.3	17.3	16.7	16.8	16.9
Direct 1/	10.7	11.5	9.5	9.1	9.2	9.3
Indirect	7.3	7.8	7.7	7.6	7.6	7.6
Nontax revenue	57.8	86.1	83.6	63.6	62.2	61.2
<i>Of which: Fishing license fees</i>	32.9	60.9	62.3	43.0	42.2	41.8
Total expenditure	100.4	128.4	122.5	112.0	111.5	111.2
Recurrent expenditure	91.0	104.0	98.5	98.4	97.9	97.6
Wages and salaries	36.8	37.5	39.1	38.8	38.5	38.4
Purchase of goods and services 2/	22.7	27.1	24.5	24.7	24.7	24.7
Subsidies and transfers 3/	28.0	36.9	31.7	31.6	31.4	31.2
Interest payments	0.2	0.1	0.1	0.1	0.1	0.1
Other expense	3.2	2.3	3.1	3.1	3.1	3.1
<b>Recurrent / structural balance</b>	<b>-15.1</b>	<b>1.5</b>	<b>2.4</b>	<b>-18.0</b>	<b>-18.8</b>	<b>-19.5</b>
Capital spending 4/	9.4	24.4	24.0	13.7	13.7	13.7
<b>Balance before grants</b>	<b>-24.5</b>	<b>-22.9</b>	<b>-21.6</b>	<b>-31.7</b>	<b>-32.5</b>	<b>-33.2</b>
Grants 5/	27.9	18.0	33.3	19.2	18.5	17.8
Net TTF distributions to CIF	25.9	0.0	0.0	6.7	6.6	6.5
<b>Overall balance (net lending / borrowing) 6/</b>	<b>29.3</b>	<b>-5.0</b>	<b>11.7</b>	<b>-5.8</b>	<b>-7.4</b>	<b>-8.9</b>
<i>(in millions of Australian dollars)</i>	12.1	-2.2	5.4	-2.8	-3.7	-4.6
Extra-budgetary grants 7/	25.9	31.6	34.2	26.5	25.1	24.8
<b>Memorandum Items (in millions of Australian dollars)</b>						
Tuvalu Trust Fund (TTF) balance	144.1	151.5	160.1	164.8	168.9	173.1
<i>(In percent of GDP)</i>	348.6	348.3	347.3	342.3	336.3	331.3
Consolidated Investment Fund (CIF) balance 8/	24.6	27.6	33.0	30.2	26.5	21.8
<i>(In percent of TTF Maintained Value)</i>	17.0	18.2	20.6	18.3	15.7	12.6
Nominal GDP	41.3	43.5	46.1	48.1	50.2	52.3

Sources: Tuvalu authorities and IMF and World Bank staff estimates. Tuvalu government account is presented on cash basis.

1/ Fisheries joint venture companies are among the largest taxpayers in Tuvalu.

2/ Includes TC Pam related expenditure such as fuel and oil for boats to visit OIs in 2015.

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

The one-off increase in 2015 results from TC Pam related transfers. Includes the newly introduced deferred maintenance funds.

4/ Includes capital expenditure and special development expenditure. Elevated levels for 2015 and 2016 relate to the recovery and reconstruction post TC Pam most for OIs as well as a one-off transfer to the Tuvalud Development and Tuvalu Survival Fund in the aftermath of TC Pam.

5/ Includes recurrent grant from Taiwan, China; non-recurrent grants from World Bank (DPO II Supplemental) and budget support from other donors in response to TC Pam. Does not include the proposed operation or pledged in-kind/capital grants in response to TC Pam.

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, including donor funded projects which is not captured on budget.

8/ Includes GoT reserves in the CIF and general account, does not include assets in the Tuvalu Survival Fund (A\$5 million).

Movement in this line item reflects asset de/replenishment as a result of budget financing requirements.

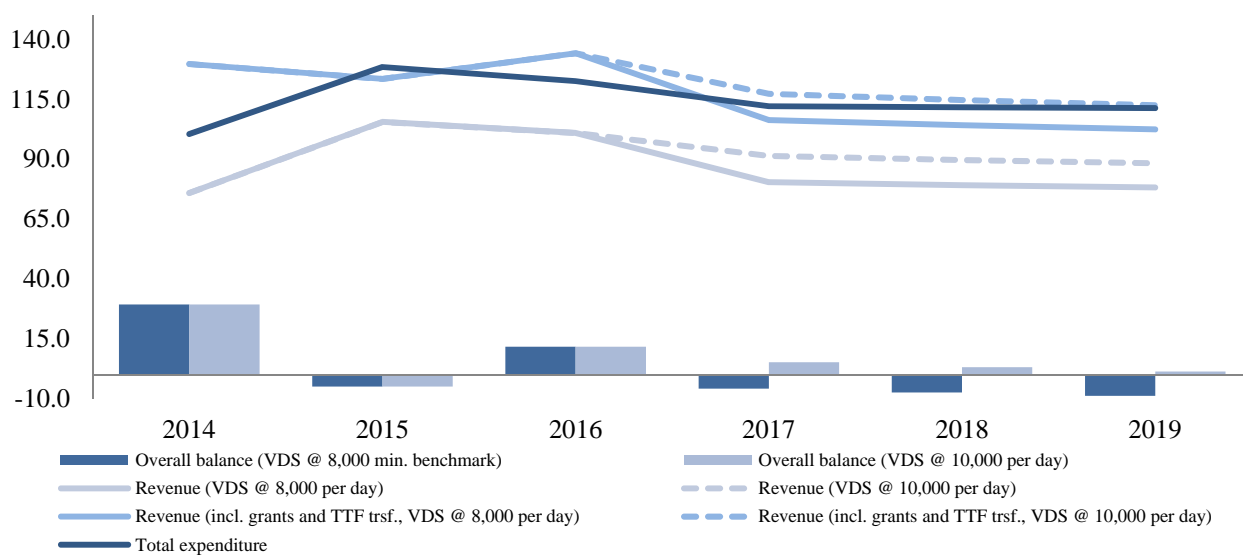
## 2.2 MACROECONOMIC OUTLOOK AND DEBT SUSTAINABILITY

**15. 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 expected to moderate toward 2.2 percent as work on infrastructure projects are completed. The economy faces challenges in achieving more robust growth over the medium term. Reforms supported by this operation, including improving human development outcomes, together with progress on improving public sector effectiveness and building resilience to external shocks, may support longer-term growth. However, growth opportunities are constrained by geographical isolation and small size. Inflation is similarly expected to moderate to under 3 percent in the medium term, normalizing from the TC Pam effects. Inflation should also benefit from the

continued softness in international food and commodity prices, but remain highly exposed to external price and exchange rate shocks.

**16. The current account balance will likely return to deficits in the medium term.** With little scope for import substitution or export diversification, the trade balance is expected to remain in deficit. Imports associated with the recently approved Green Climate Fund Project (over 100 percent of GDP over seven years) and other projects involving improvement of seawalls are expected to support high imports and trade deficits over the medium term. Tuvalu’s income account is conservatively expected to decline in the medium term as fishing license fees and returns on the TTF normalize. Current transfers to the Government (mostly budget support grants) are estimated to decline from elevated levels in 2016 as donors rallied to support the GoT in post-disaster efforts, but remain substantial in the medium term. Although remittances have declined since the GFC, the employment outlook remains positive given the opening of the Australian seasonal labor scheme for the service industry. In the medium term, Tuvalu’s current account deficit is expected to stabilize at under 5 percent of GDP, with reserves remaining adequate at around six months of imports. However, in the period ahead, global or regional economic downturns could negatively affect income flows, remittances, and employment opportunities abroad.

**Figure 9. Projected Fiscal Trends (in % of GDP)**



Source: World Bank staff estimates, baseline assumes Vessel Day Scheme sold at minimum benchmark price of US\$8,000 per day.

**17. The fiscal buffer is expected to remain at around the sustainable level in the medium term, although the country faces pre-grant deficits.** With a narrow domestic tax base and high costs associated with delivering services—partly resulting from the small size of the economy, remoteness, as well as geographic dispersion—Tuvalu has in the decade till 2014 experienced pre-grant fiscal deficits averaging 28 percent of GDP, which is expected to continue into the future. This has been financed by a mixture of grants and TTF income accumulated in the CIF buffer account. Accumulated buffer assets amounted to \$A 27.6 million (over 18 percent of the maintained value of the TTF) at the end of 2015, above the sustainable target. Going forward, nominal returns on the TTF are conservatively estimated at 4.5 percent given the uncertain outlook of financial markets. This would result in distributions to the CIF (for budget financing) equivalent

to around 6.5 percent of GDP per year. Grants are expected to taper from the 2015 level, to around 18 percent of GDP in the medium term, broadly in line with historical averages. Over the medium term, with projected average deficit of 7.4 percent (\$A 3.7 million equivalent), buffer assets in the CIF are expected to remain at around the minimum target level, but deplete over the long run.

**18. Revenue is projected to fall from 101 percent to around 80 percent of GDP, due largely to normalizing fishing revenues.** While fishing revenues have experienced a structural upshift in recent years due to the implementation of Vessel Day Scheme, it remains a supply and demand-driven market where prices are determined by market factors, many of which are outside the control of the GoT, including weather factors, regional treaty negotiation success, and so on. The recent renegotiation of the U.S. South Pacific Tuna Treaty, while is not expected to significantly affect Tuvalu's fishing license income in the short term, may be signaling more limited revenue growth potential in the medium term. Tax revenues are conservatively expected to remain steady at around 17 percent of GDP. The recent changes to the tax bracket for public sector employees may reduce income taxes collected, but are expected to increase consumption and related taxes.

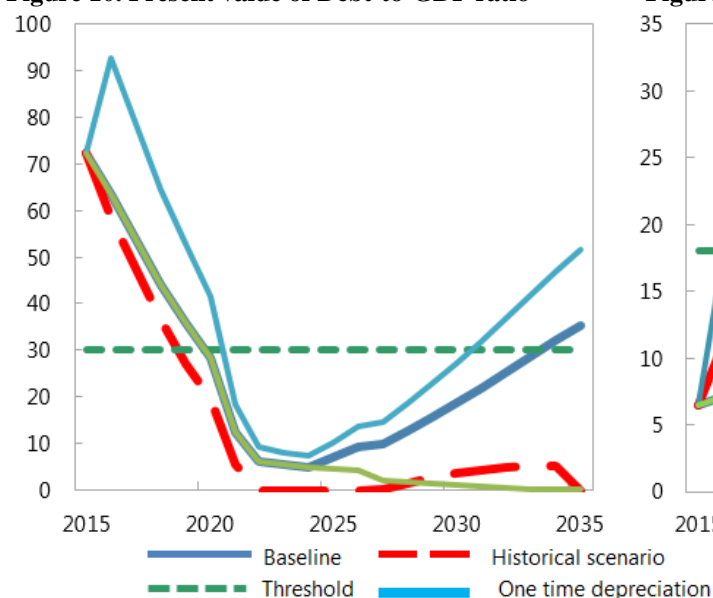
**19. Expenditure is expected to remain elevated, but gradually fall as a share of GDP.** The medium-term fiscal framework is aligned with the TKIII to achieve a greater level of security and prosperity for all Tuvaluans, including higher quality health and education outcomes. However, this will translate to continued spending pressures. On the recurrent side, improving service delivery to address the burgeoning noncommunicable disease (NCD) crisis and gearing education toward migration could be costly. Therefore, expenditure efficacy and restraint as well as 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, including through future shocks, and safeguard short to medium-term fiscal sustainability. To this end, the GoT has initiated efforts to strengthen wage bill, contingent liability, and reserve asset management, as well as enhance basic education and encourage healthy lifestyles and health sector financing sustainability. Finally, the fiscal framework is largely consistent with the IMF fiscal framework as set out in the 2016 Article IV, albeit updated to reflect information up to July 2016 (see annex 3).

**20. Climate change may impose additional long-term fiscal costs.** Tuvalu is situated in the Pacific Ring of Fire. Although large-scale natural events do not occur frequently, rising sea levels among others are expected to exacerbate the country's vulnerabilities to natural hazards. In this context, climate change can lead to both structural and cyclical fiscal costs. The Pacific Catastrophe Risk Assessment and Financing Initiative estimates that, on average, Tuvalu should expect disaster-related losses and damages of around 20 percent of GDP to occur once every 10 years (equivalent to 2 percent per annum). The GoT's plans to improve resilience to shocks and sustainability is reflected in the higher capital spending in the baseline. The overall costs associated with physical adaptation, mitigation, and disaster response are very large relative to the size of the economy and may in fact be too high for small states like Tuvalu to fully internalize. As such, financing to support the continued capital buildup of the TTF will also support long fiscal sustainability and Tuvalu's ability to mitigate against climate adaptation and shocks.

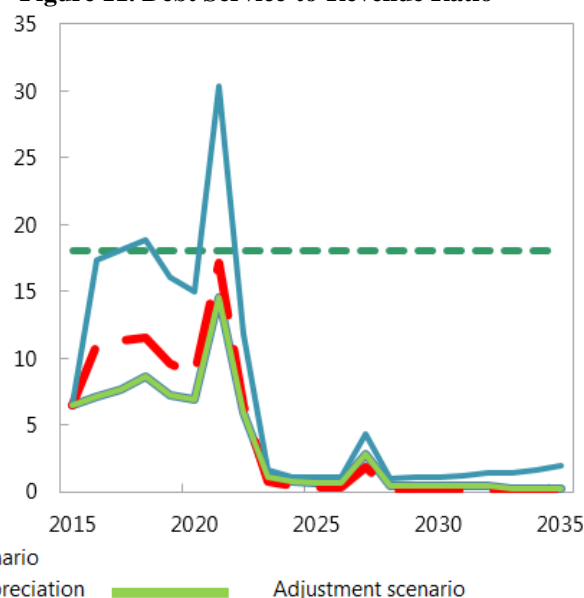
**21. The 2016 joint IMF-World Bank Debt Sustainability Analysis (DSA) concluded that Tuvalu is at a high risk of debt distress although the Government does not face debt servicing**

**risks.** The latest 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.<sup>11</sup> 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 35 percent of GDP) are included in the DSA as they constitute a substantial contingent liability. Known loans contracted by Public Enterprises (PEs), guaranteed by the GoT, and are also included in the baseline of the DSA. The public and publically guaranteed debt stock stands at around 58 percent of GDP, while debt servicing requirements were equivalent to 6.3 percent of revenue and grants. Ensuring that debt risks remain contained while the country's development needs are addressed will require continued donor assistance in the form of grants.

**Figure 10. Present value of Debt-to-GDP ratio**



**Figure 11. Debt Service-to-Revenue Ratio**



Source: 2016 joint IMF-World Bank DSA.

Note: Two spikes in the debt service profile in 2021 and 2027 are related to one-off repayments for the Korean joint venture fishing vessel and an equity injection to the Development Bank of Tuvalu (DBT), respectively.

**22. The GoT is committed to returning its debt to sustainable levels through careful management of contingent liabilities and prudent fiscal policy.** The current high stock of debt in the baseline incorporates contingent liabilities associated with fishing joint ventures, which has been gradually paid down through profits made and corresponds with the sharp reduction in debt over the medium term. To minimize the risk of realizing this contingent liability and ensure that all loans (including those contracted by PEs) adhere to the restrictions of the debt management policy,<sup>12</sup> the GoT has also completed an audit of the fishing joint ventures in 2016. In addition, the

<sup>11</sup> Due to Tuvalu's high risk of debt distress rating, major World Bank- and ADB-supported infrastructure projects are now financed on grant terms, substantially reducing the pace of debt acquisition relative to the pace reflected in the DSA baseline scenario.

<sup>12</sup> 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 accounts and government debt and guarantees, obtaining a comprehensive position of its net liabilities. With recent surpluses, the GoT has largely paid down arrears (approximately \$A 2 million) and expensive overdrafts.

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 public sector reforms, structural reforms to reduce banking sector contingent liabilities, and increasing health sector financing sustainability. The latest 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.

**23. The macroeconomic policy framework is adequate for this operation.** The Government has achieved fiscal surpluses in recent years, which have been prudently saved to rebuild the CIF. Recent increases in expenditures are partly explained by the weather-related crisis response, although there were also increases in recurrent spending, which continued dialogue on policy reforms would support to unwind. Moderate levels of external debt and reserve assets in the CIF support the GoT's capacity to deal with shocks in the future. In the medium to long term, the GoT needs to continue to focus on controlling expenditure and enhancing revenue to overcome budgetary constraints to sustainable service delivery and maintain adequate fiscal buffers to buttress against shocks. 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 reforming the public sector, undertaking 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. To address these, the GoT is committed to improving the investment management of the TTF to be better aligned to its objectives. A depreciation of the Australian dollar could also cause inflation to spike and the trade deficit to widen.<sup>13</sup> The macroeconomic policy framework also depends on the continued availability of grants from development partners over the long term to help Tuvalu maintain a sustainable level of fiscal buffers. This is especially important at present given Tuvalu's high risk of debt distress and limited scope to borrow to cover fiscal deficits.

### 3. THE GOVERNMENT'S PROGRAM

**24. The GoT has recently endorsed the National Strategy for Sustainable Development 2016–2020, also known as the TKIII, focused on reducing Tuvalu's vulnerabilities and improving social service delivery.** The TKIII resulted from broad ranging consultation and was endorsed by the Tuvalu parliament in April 2016. It aligns with the United Nations Sustainable Development Agenda and continues with the priorities set out in the previous plan while taking on new initiatives and development objectives such as climate change. The TKIII mission is to achieve a greater level of security and prosperity for all Tuvaluans, including through achievement of higher standards of quality health and education. More importantly, it aims to (a) significantly reduce Tuvalu's unique vulnerabilities by building resilience to respond better to global economic and environmental crises; (b) increase the proportion of work force employed in the formal economy and real household income; (c) increase the proportion of Tuvaluans living comfortably abroad; (d) increase the number of people educated and trained in skills appropriate to higher earning potential; and (e) provide better protection against land loss and erosion and more effective

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<sup>13</sup> The trade deficit would be expected to widen since Tuvalu's imports (of which food and fuel for electricity generation are a large share) are likely to be relatively inelastic. A depreciation of the Australian dollar could, however, strengthen the income account as U.S. dollar-denominated government income would increase in local currency value.

extraction of marine resource rents. These are to be achieved through the below strategic areas.

#### **Box 2. TKIII Strategic Areas of Focus**

1. **Climate change.** Protect Tuvalu from impacts of climate change through resilience, mitigation, adaptation.
2. **Good governance.** Strengthen institutional capacity to serve the public with competence and justice.
3. **The economy.** Growth and stability through sound macroeconomic management and policy.
4. **Health and social development.** Provide high standards of health care, social opportunities, and social protection free of hardship and gender discrimination.
5. **OI development.** Provide quality services and create more opportunities for development.
6. **Private sector, employment, and trade.** Private sector, employment, and export-led economic growth.
7. **Education and human resources.** Provide high quality education, equip Tuvaluans with knowledge and skills to develop more self-reliance, and promote Tuvalu's cultural and spiritual values.
8. **Natural resources.** Maximize their social and economic returns and sustainability.
9. **Infrastructure and support services.** Provide efficient and high-quality infrastructure and support services.
10. **Environment.** Protect, restore, and promote sustainable use of terrestrial ecosystems and halt and reverse land degradation while protecting and preventing biodiversity loss.
11. **Migration and urbanization.** Mitigate the impacts of urbanization and capitalize migration opportunities.
12. **Oceans and seas.** Conserve oceans, seas, and marine resources for sustainable development.

**25. The GoT has previously used the PRM to focus on reform efforts and mobilize support.** The GoT developed the PRM in 2012, in consultation with development partners, to map out a clear and selective path to achieve priority goals identified in the national development strategies. The preparation of the PRM helped foster a shared strategic focus and policy dialogue around a limited set of reform priorities among the 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. The PRM has proven to be effective in mobilizing government initiatives in tackling difficult areas of reform. Since 2012, the ADB, Australia, New Zealand, and the World Bank have each provided policy-based grants to the GoT reflecting their achievements against the PRM.

**26. The PRM has proven to be an effective tool for delivering a practical reform agenda.** Since the development of the initial PRM in 2012, reforms supported, including by the World Bank through the first series of DPOs, have resulted in 17 out of 28 (or 60 percent) Public Expenditure and Financial Accountability (PEFA) indicators having improved between 2011 and 2015. Reforms to improve social service delivery have also resulted in increased efficiencies in scholarship programs. However, the success of these reforms are, for example, being constrained by the aging population and higher incidence of NCDs. A review of the PRM was completed in June 2016 and noted that (a) the PRM aligned with the GoT's development plan and the process of arriving at the PRM has been a consultative process between the stakeholders; (b) all the reforms set out in the three phases of the PRM have been implemented and verified; (c) substantial improvement has been made in the overall macroeconomic and fiscal management of the economy and greater fiscal discipline has been asserted on the budget process and consideration given to fiscal sustainability; and (d) while some areas can be improved on, PRM should continue.

**27. The proposed operation will support and sustain the momentum of key reforms mobilized by the PRM, focused on, among others, improving basic service delivery and macroeconomic sustainability.** In July 2016, the GoT began the fourth phase of PRM (PRM IV)

drawing from the TKIII. PRM IV draws from consultations among all stakeholders, including the central Government, public enterprises, as well as civil society organizations, and presents a consolidated set of reform measures for the TKIII period with expected biannual updates. Priority areas include improving social service delivery, infrastructure maintenance, macroeconomic sustainability, and quality of government spending. In addition to the development partners who supported the first three phases of the PRM, the European Commission will also support activities in the fourth phase of the PRM. The policy focus for this operation was developed through the process of dialogue and policy analysis that accompanied the PRM IV.

## 4. THE PROPOSED OPERATION

### 4.1 LINK TO GOVERNMENT PROGRAM AND OPERATION DESCRIPTION

**28. The programmatic series of operations supports the GoT’s TKIII mission to achieve a greater level of security and prosperity for all Tuvaluans, including through achievement of higher quality health and education outcomes.** Financing provided through the operations will support the maintenance of buffers to meet long-term financing needs. Maintenance of adequate buffer assets will in turn ensure Tuvalu’s ability to absorb future shocks without disruption to the level of service delivery. The first pillar of the proposed operation supports reforms to improve social service delivery. More specifically, reforms under this pillar which remove secondary education school fees will improve the equity of access, while tightening tobacco controls will encourage healthy lifestyle choices and support health sector financing sustainability. Together these reforms will allow the GoT to achieve higher quality health and education outcomes. The second pillar of the proposed operation supports reforms to improve macroeconomic sustainability. Reforms to strengthen reserve asset management, improve the effectiveness wage bill controls, and enhance banking sector oversight and sustainability will help reduce Tuvalu’s vulnerabilities by building resilience to respond better to exogenous shocks. These reforms are not only aligned with the TKIII objectives of supporting security and prosperity of all Tuvaluans, but are also aligned with the broader World Bank goal of boosting shared prosperity.

**29. Lessons learned from the implementation of other operations in Tuvalu informed the design of this operation.** The proposed operation draws on lessons from previous DPOs and the Pacific regional aviation and fisheries projects on the importance of recognizing capacity constraints, selectivity, and continuous engagement. Tuvalu is a relatively new member of the World Bank with limited capacity and familiarity with the World Bank program and processes. Lessons learned from these past operations informed the approach taken by this operation, to engage with the 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. The experience so far has also demonstrated that the budget support modality is an effective tool for clarifying and sequencing a practical reform agenda. It has also promoted coordination among development partners, reducing fragmentation and increasing the quality of the dialogue. During the consultation process in the preparation of this operation, the GoT also reiterated that in addition to being a financing mechanism, budget support is an efficient modality for focusing government reform efforts,

important for the achievement of the development objectives set out in the TKIII, especially given the thin capacity of the country.

**Table 3. DPO Prior Actions and Analytical Underpinnings**

Prior Actions	Analytical Underpinnings
Operation Pillar I: Improve Social Service Delivery	
<b>Prior action #1</b> The Recipient’s Cabinet has endorsed the removal of secondary education school fees to enhance inclusiveness and equity of secondary education	The 2012 World Bank Education policy note and the 2010 HIES identified the lack of investment in basic education and schools fees being a potential constraint to secondary education.
<b>Prior action #2</b> The Recipient’s Cabinet has approved the Tobacco Control (Amendment) Bill and directed that the amendments be introduced to Parliament to reduce risk factors for noncommunicable diseases.	The 2014 World Bank NCD Roadmap Report found that NCDs pose a major risk to Pacific Island countries and made recommendations to (a) strengthen tobacco control (including raising the excise duty on tobacco products to at least 70 percent of their retail price); (b) introduce policies on reducing consumption of food and drink products directly linked to obesity, heart disease, and diabetes, especially salt and sugary drinks; (c) improve efficiency and impact from the existing health dollar by reallocating resources to targeted primary and secondary prevention of NCDs; and (d) strengthen the evidence base for better investment planning and program effectiveness.
Operation Pillar II: Improve Macroeconomic Sustainability	
<b>Prior action #3</b> The Recipient commissioned a review of the Tuvalu Trust Fund, which provided recommendations to strengthen reserve asset management by focusing on improving governance and investment policy, and this review has been submitted to the Tuvalu Trust Fund Board for endorsement of the recommendations. <sup>14</sup>	The 2016 World Bank TTF Investment Management Review identified key areas of shortcoming with respect to the investment management of the TTF.
<b>Prior action #4</b> The Recipient has introduced an automated payroll system to improve the effectiveness of payroll controls.	The 2015 PEFA identified weaknesses in the effectiveness of payroll controls, with particular weakness in the reconciliation process between the Personnel and Training and Treasury Departments.
<b>Prior action #5</b> The Recipient’s Parliament has enacted the Banking Commission Amendment Act and a framework for monitoring of the Banking sector was established to improve oversight and sustainability.	The 2014 IMF Article IV and subsequent Pacific Financial Technical Assistance Centre reports identified weaknesses in the current banking sector regulatory framework and identified the actions required to establish a context-appropriate banking sector regulatory framework.

## 4.2 PRIOR ACTIONS, RESULTS AND ANALYTICAL UNDERPINNINGS

**30. The policy actions for this operation are described both in terms of content and rationale below.** In selecting these reforms, priority is given to areas where the World Bank can add value in coordination with development partners. These reform areas are consistent with the Country Assistance Strategy (CAS) objectives and have been selected because of their importance for the Government’s core reform priorities as expressed in the TKIII and the PRM. They also reflect demonstrated government commitment while being cognizant of the limits placed on the

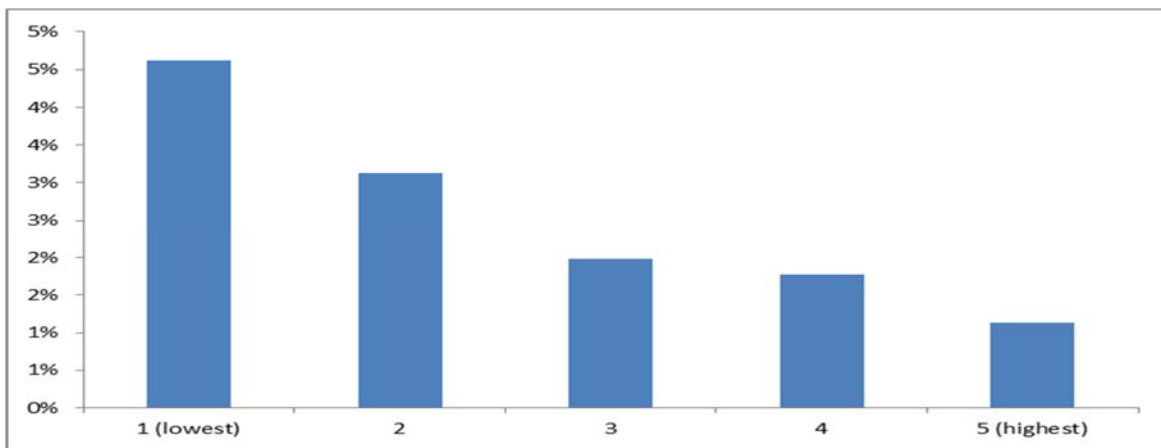
<sup>14</sup> The TTF Board consists of three members, representing the Government of Australia, New Zealand, and Tuvalu, and meets twice a year. In consultation with legal, the prior action was worded as such to reflect the fact that the GoT does not have majority control on the Board of the TTF.

pace of reforms by available capacity. The indicative triggers for this operation reflect the natural next steps in pursuit of the reforms supported by the policy actions, as well as the priorities of the GoT. They are indicative and will be firmed up as dialogue continues with the GoT regarding the next phase of reforms through the annual PRM dialogue process.

**Prior action #1** The Recipient’s Cabinet has endorsed the removal of secondary education school fees to enhance inclusiveness and equity of secondary education

**31. The cost of school fees, particularly to disadvantaged households, may be contributing to low enrollment in secondary education and in turn constraining Tuvaluans from economic opportunities.** In 2015, around 700 students (around 7 percent of the population) were enrolled in the two secondary institutions in Funafuti and Vaitupu. Students from the OIs have to leave home, often quite young, and board in these institutions, the cost of which is mostly borne by the GoT. While primary education is provided free of charge with almost universal access, secondary schooling is provided on a fee basis. In addition to the school fees of \$A 50 per term, schools ask parents to pay a ‘school contribution’, provide children with school uniforms, and purchase stationary as well as textbooks. Gross enrollment rates at the secondary level are much lower compared to primary (55 percent compared to 102 percent in 2012).<sup>15</sup> With national primary pass rate at 70 percent and secondary gross enrollment rate at 55 percent in 2012, it shows that cost of secondary education is also likely to present a barrier to access for poorer Tuvaluans, especially presenting a disadvantage to those from the OIs who have limited access to cash employment. In recent years, the reduction in remittances (such as from seafarers and labor migration) to poorer families in the OIs may have exacerbated the issue. Although a labor market survey does not exist, anecdotal evidence suggests that a large proportion of secondary graduates move on to further vocational or tertiary studies, with increased opportunities for domestic and overseas employment. The SCD has further identified that the lack of education and skills constrains the poor from many economic opportunities.

**Figure 12. Expenditure on Secondary Education/Total Household Expenditure (by Expenditure Quintile)**



Source: GoT and World Bank estimates based on 2010 HIES data.

<sup>15</sup> The fee is waived in cases of financial need as prescribed by policy; however, limited rules exist around their implementation. One *Kaupule (Niutao)* has also been providing loans to parents for student fees to ensure their children attend school. During consultations, the GoT also indicated a recent rise in school fee arrears. Education continues to be compulsory until the end of the year the child turns 15, which is generally two years after primary school. 2012 is used as the reference year for the latest census and a comprehensive statistical report was presented then. At the gender disaggregated level, more girls than boys are enrolled in both primary and secondary schools.

**32. The GoT removed secondary education school fees to enhance inclusiveness and equity of secondary education (prior action).** The GoT, through TKIII, had committed to the Sustainable Development Goal 4 of ensuring inclusive and equitable quality education for all. The decision to remove secondary education fees (Cabinet Decision M283-16) will help remove constraints to access (children not enrolled are estimated to be around 6–700), particularly for children from more disadvantaged households. The design of the program considers the small size of the country and institutional arrangement of the current education system. It is expected to cost less than \$A 35,000 for the GoT to remove secondary education fees (based on actual fees collected in 2015), which could be significantly offset by the current cost to administer the collection of school fees. Since a targeting framework does not already exist in Tuvalu and there are no social protection schemes other than pensions for those over 70 years of age, it was deemed too costly to develop a targeting framework, both in terms of its direct costs as well as administration and the resulting delays it would impose on the launching of the program. Furthermore, the small size of the country and the cultural context makes exclusion of certain households much more difficult. Finally, with a teacher-student ratio at around 11 and ongoing school expansion projects, increased enrollment can be accommodated without major increases in cost.

**33. As a next step, the GoT plans to endorse and begin piloting a national action plan to improve school readiness and early literacy, which will better prepare students to enter secondary education (trigger).** Having removed the immediate cost constraint of accessing secondary education, the GoT plans on removing the other major constraint to accessing secondary education—primary completion. Global evidence suggests that it is more effective to achieve this through focus on early years of education. With data suggesting that 70 percent of the students in Year 4 are already falling behind in literacy and 45 percent in mathematics in Tuvalu, focusing on school readiness becomes even more imperative to allow students the best chance to complete primary education and progress to secondary education. To this end, and in line with the education strategy of improving effectiveness and quality of curriculum and learning programs, the GoT is currently preparing a national action plan for early childhood education, which will act as a ‘road map’ including key action and outcome milestones that the country aims to implement and achieve in the medium term to address the most pressing issues around early literacy and learning. As part of this national action plan, Tuvalu will begin interventions to reduce reading deficits in early grades through a dual approach addressing both school readiness factors and instructional approaches in the early grades of primary education.<sup>16</sup> This roadmap is expected to be implemented over the medium term and be the center piece of the GoT’s education reform agenda. These reforms will not only affect subsequent primary completion, secondary enrollment, and tertiary outcomes, but more broadly the efficiency of public investment in education.<sup>17</sup>

**34. Increasing investment in early childhood, primary, and secondary education will contribute to better education outcomes for Tuvaluans, including the poor.** The increased focus on early childcare development and education to improve primary completion and removal

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<sup>16</sup> The design of the interventions will be based on empirical evidence on the link between school readiness, literacy preparedness, and reading deficits and instructional approaches in the early grades of primary education, drawing on data being collected through the Tuvalu Early Human Capability Index and Early Grade Reading Assessment diagnostic instruments. The design of the interventions will be supported by the World Bank Pacific Early Age Reading and Learning Program.

<sup>17</sup> International evidence suggests that investments made in improving a child’s nutritional status, providing them with early stimulation and learning environment, and protecting them from the kinds of stress faced by children tend to be the most efficient with high economic returns. Children who by age five have received the proper care, carry a stock of physical, cognitive, and socioemotional competencies that they can build upon for the rest of their lives.

of secondary education school fees are two critical constraints to enhancing secondary enrollment, including for the poor, and in turn overall education sector outcomes in Tuvalu. The reforms will also contribute in the medium term to improving overall efficiency of public investment in education. These reforms may also reduce the education expenditure burden on poorer families (Figure 12) and women (section 5.1). Overall, these reforms are expected to make education expenditure more progressive, while improving education outcomes for all Tuvaluans. **Results indicator.** Increase in gross secondary enrollment rate to 60 percent (from 55 percent).

**Prior action #2** The Recipient’s Cabinet has approved the Tobacco Control (Amendment) Bill and directed that the amendments be introduced to Parliament to reduce risk factors for noncommunicable diseases.

**35. Tobacco use is a major cause of NCDs—a leading cause of death in Tuvalu—and their treatment poses a major fiscal cost to the GoT.** Based on latest available data from the World Health Organization (WHO) (2010), NCDs account for 73 percent of all deaths in Tuvalu. Available data from Secretariat of Pacific Communities in 2011 show that circulatory diseases are one of the leading NCDs causing mortality in Tuvalu (295 per 100,000), followed by diabetes (92 per 100,000). Furthermore, Tuvalu is in the top 10 countries in the world for prevalence of diabetes among people between ages 20 and 79. In addition to being a major threat to public health, NCDs also pose a large and increasing burden on public finances in Tuvalu, with 88 percent of cases treated in 2015 at the Princess Margret Hospital caused by NCD-related complications. It has also been one of the causes of increasing Tuvalu Medical Treatment Scheme and overall health care costs in recent years. The rising cost in tertiary care may also be crowding out much needed resources for primary and preventative health care (PPH) to address the root cause of burgeoning NCDs. While this may in the short term be financed through rising windfall revenues, the volatile nature of these revenues limits the prospect for sustained significant increases of GoT expenditure on health in absolute terms. According to the WHO, tobacco use is the only risk factor common to all four of the main NCDs—cancer, cardiovascular disease, diabetes, and respiratory disease. Individuals who smoke will, on average, have higher health costs than non-smokers. Women subject to secondhand smoke are also likely to have babies with a lower birth weight and higher medical costs. While tobacco use accounts for an estimated one in six of all NCD deaths, it is also the single greatest preventable cause of NCDs. Tobacco use is prevalent in Tuvalu, including among the young (see table 3), and together with other factors such as excess alcohol consumption and poor diet may be key factors contributing to these preventable deaths.<sup>18</sup>

**Table 4. Smoking Prevalence (%)**

	Male	Female	Both Sexes
Youth tobacco use	32.4	11.1	21.1
Adult cigarette smoking	54.6	22.7	37.9

*Source:* WHO Report on Global Tobacco Epidemic, 2015, Tuvalu Country Profile. *Note:* Youth (Global School-based) Student Survey 2013, ages 13–15; Adult (Population and Housing Census 2010, ages 15+).

**36. As a first step to reducing risk factors for NCDs, the recipient’s Cabinet approved the Tobacco Control (Amendment) Bill 2016 and directed that the amendments be introduced to parliament (prior action).** The WHO Framework Convention on Tobacco Control is an

<sup>18</sup> WHO estimates that smoking can cause about 71 percent of the cases of lung cancer in the world, 42 percent of chronic respiratory, and nearly 10 percent of cardiovascular diseases.

evidence-based framework developed in response to the globalization of the tobacco epidemic and focuses on both demand reduction strategies as well as supply issues through regulatory strategy. Tuvalu ratified the treaty in 2005. In 2016, the GoT undertook a review of the 2008 Tobacco Control Act as part of the review of excise taxes aimed at utilizing price and tax measures to reduce the demand for select sin goods. As part of the review, weaknesses were found in core provisions of the act which may neutralize the impact of tobacco control strategies in protecting minors, pictorial warnings, support quitting, and effective taxation. To address this, the Cabinet decision M226-16 approved the Tobacco Control (Amendment) Bill 2016 and its subsequent tabling to parliament. The Tobacco Control (Amendment) Bill made the following changes: (a) broadened the definition of tobacco product to include raw tobacco that has not been processed or prepared for consumption; (b) restricted access by minors to cigarettes from purchase and gifts; (c) prohibited the sale of single serve or unpacked cigarettes, making it a more expensive purchase; and (d) introduced licensing requirements for importers and distributors of tobacco products. These reforms will enhance supply-side restrictions on tobacco control, including reducing access by minors and deterring long-run uptake, and reinforce the implementation of broader national tobacco control programs. This will also support future price and tax measures, including tax administration.

**Table 5. Tax on Select Import Items**

Product / Quantity Unit		Duty Rate (%)	Excise Rate (%)	Import Value (\$A)
Unmanufactured tobacco	kg	15	Free	6,930
Manufactured tobacco				
Cigars, cheroots, cigarillos, etc	kg	25	10	27,200
Cigarettes, containing tobacco	stk	25	185	49,840
Other manufactured tobacco	kg	25	10	105,930
Water with added sugar, flavor, etc	L	25	10	45,803
Cordials	L	25	Free	268,942
Beer (Alcohol content < 5%)	L	25	45	53,699
Wine (Alcohol content <15%)	L	25	55	144,463
Spirits (Alcohol content > 15%)	L	25	150	88,036

*Source:* Tuvalu Tariff Schedule, total non-fuel import was \$A 19.8 million in 2014.

**37. As a next step, the recipient plans on increasing selected excise taxes, including on tobacco products, to continue to reduce the risk factors to NCDs (trigger).** Taxes collected from sin goods, including tobacco, constituted around 7 percent of total tax collected in 2014. Table 4 shows that although Tuvalu is already collecting excise duties on sin goods such as tobacco, there exist marked differences in excise rates for similar products with exemptions on products such as unmanufactured tobacco. This unequal treatment of a similar product creates potential loopholes and revenue leakages. At the same time, global evidence and World Bank-led regional work has shown that greater use of fiscal signals to promote healthy consumption choices is one of the top priorities to address the burgeoning NCD epidemic. To this end, the GoT, per Cabinet Decision 203-16, has considered and agreed to proceed to the next steps in revising the tariff schedule, which proposes changes to encourage healthy lifestyle choices and reduce risk factors for NCDs.<sup>19</sup> Reducing NCD incidence will in turn help contain rising costs associated with treating these diseases, create fiscal space for future PPH spending, and subsequently support

<sup>19</sup> On tobacco products and sugary drinks, proposed changes include equalization of excise taxes on cigars, unmanufactured tobacco, and other manufactured tobacco to be in line with cigarettes, which will not only reduce potential tax loopholes, but is also in line with best practices in the region.

health sector financing and service delivery sustainability.

**38. These reforms will encourage healthier lifestyle choices, reduce risk factors and cost associated with treating NCDs, and create room for more PPH spending.** Enhancing tobacco regulation and revising and equalizing excise taxes on sin goods such as tobacco are complementary reforms that could in the medium term improve revenue mobilization and strengthen incentives for healthy lifestyle choices. However, in the long term, reduced consumption is expected to moderate any revenue effect, while reducing the risk factors linked to NCD incidence will bring down the financial burden of the health sector, particularly related costly tertiary care (previous analysis showed that, on average, reducing one diabetic patient requiring overseas treatment would save around \$A 65,000 per year, and for cardiac patients savings of around \$A 40,000 could be achieved per case; to put this in context, \$A 65,000 is over 100 times what the GoT currently spends, on average, per capita on health care in Tuvalu). This will enhance the sustainability of the health sector and create space for greater focus on PPH. This will be complemented by other planned reforms, including improving access to PPH to facilitate early disease detection and treatment, which will further reduce the need for costly tertiary care and improve overall health outcomes.<sup>20</sup> Details on poverty and social impact of this reform are provided in section 5.1. **Results indicator.** Reduce adult smoking prevalence to less than 34 percent (from 37.9 percent currently).

**Prior action #3** The Recipient commissioned a review of the Tuvalu Trust Fund, which provided recommendations to strengthen reserve asset management by focusing on improving governance and investment policy, and this review has been submitted to the Tuvalu Trust Fund Board for endorsement of the recommendations.

**39. Optimizing the management of the TTF becomes critical to ensuring the country's long-term sustainability.** The TTF plays a critical role in financing structural fiscal deficits and ensuring long-term fiscal and service delivery sustainability of the country. However, the returns on the TTF are exposed to the unpredictable fluctuations of international financial markets, and in the aftermath of the GFC, the TTF failed to yield sufficient returns to finance Tuvalu's budget deficit. With climate-related events becoming more frequent and rising costs associated with adaptation, mitigation, and response, enhancing the management of the TTF to ensure the best outcomes against set objectives becomes more important. To ensure that the current investment management is in line with international best practice and consistent with the set investment objectives, the GoT has requested for the World Bank to provide an analysis of the investment policy and management of the TTF. The review identified several weaknesses including the (a) relative weak return compared to the risk profile; (b) relatively high cost of management fee compared to return; and (c) weaknesses in the investment management governance structure. These weaknesses could hamper the optimization of return on the TTF relative to the investment objectives and dampen the distribution from the TTF to support the GoT in delivering critical services.

**40. The GoT commissioned a review of the TTF, to strengthen reserve asset management by focusing on improving governance and investment policy, and this review has been**

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<sup>20</sup> The GoT plans on improving the accessibility of PPH through the piloting of health professional placements in each OI to ensure early diagnosis of diseases and treatment. This will contribute to NCD prevention and, in the medium to long term, reduce the cost of treatment for tertiary health care and improve health sector financing sustainability.

**submitted to the TTF Board for endorsement of the recommendations (prior action).** The draft investment policy and management review was circulated to the GoT and the TTF investment committee for review in April 2016. The report recommended that the first step to addressing these challenges is for the Board to consider peer reviewing the governance arrangements, followed by a formal review. This could then be followed by a review of the investment management policy relative to the investment objectives, risk tolerance objectives, current investment strategy vis-à-vis the current risk, cost and return trade off. And finally in the case of revisions in the investment policy, the Board could consider improving the selection and selection process of investment managers. The report was presented during the TTF Board meeting on May 11, 2016. This, together with the recently established TSF, will support sustained service delivery, especially during times of crises. The next Board meeting is scheduled for mid-November 2016 at which time the Board is expected to consider, in addition to the independent review of the TTF, a regional study comparing the performance of the TTF with other trust funds in the region and endorse specific reform areas for implementation. Going forward, pending the completion of a regional trust fund peer review, the GoT is expected to implement select reforms to address identified weaknesses to better align investment management with the reserve assets' objectives (**trigger**).

**41. Reforms to optimize TTF returns relative to the investment objective will support the GoT in meeting structural fiscal gaps and sustained service delivery, including during times of crises.** With climate change mitigation estimated to cost at least an additional 2 percent of GDP per annum, increasing return on the TTF through reforms to ensure that the cost of investment managers represent value for money and to improve the governance arrangements around investment management will support the GoT to optimize returns against investment objectives, meet any fiscal gap arising from this, and support long-term fiscal sustainability and continued service delivery during times of crises. For example, reducing management cost by changing the management strategy could reduce management cost by up to half a percent, equivalent to \$A0.8 million in savings per annum or 1.8 percent of 2015's GDP. This together with initiatives to respond better to disasters and improving coordination and access to climate financing will support increased resilience and sustainability to shocks. **Results indicator.** Competitive selection of investment managers to reduce investment management fee by 20 basis points (from 63 basis points currently).

<p><b>Prior action #4</b> The Recipient has introduced an automated payroll system to improve the effectiveness of payroll controls.</p>
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**42. The 2015 PEFA identified weaknesses in the effectiveness of payroll controls, with particular weaknesses in the reconciliation process between the Personnel and Training and Treasury Departments.**<sup>21</sup> The Personnel and Training Department maintains records relating to individual employees in the form of a civil list (though these records are not held in a formal database). Line ministries maintain a nominal roll of their employees, although this does not always reconcile with the civil list. Personnel and Training advise Treasury of changes in the situation of individual employees, requiring changes to the payroll, on a case by case basis, which results in some delays and potential leakages. The Treasury Department of the Ministry of Finance runs the government payroll fortnightly. A spreadsheet system is used for the payroll and the auditor-general has noted that such systems are subject to human error unless checked thoroughly

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<sup>21</sup> The Personnel and Training Department is situated under the Office of the Prime Minister while the Treasury Department is situated under the Ministry of Finance.

and reconciled. A Payroll Task Force, comprising the permanent secretary for Finance and representatives of Treasury and Personnel and Training, reviews the payroll each fortnight before it is processed. The current system absorbs significant human resource in a thin capacity environment (with two out of 16 Treasury staff dedicated to this task), which could be used more effectively for public service delivery. Problems are also experienced during budget preparation in reconciling Personnel and Training Department records with budgeted staff costs. With wages and salaries contributing to 37.5 percent of government expenditure in 2015, weaknesses in the management of these costs can affect the achievement of fiscal sustainability.

**43. To address these challenges, the GoT has introduced an automated payroll system to improve the effectiveness of payroll controls, as part of the wider public sector reforms (prior action).** In the 2016 budget, the GoT announced its plans to expand the financial management information system (ACCPAC) to include a payroll and human resource module to improve the integrity of payroll data and effectiveness of payroll controls. The GoT provided \$A 100,000 in the budget and staffing to support its implementation. The Personnel and Training Department has reviewed and updated the civil list and, with the Treasury Department and line ministries, has updated the leave balances for all staff. During this process, some inconsistencies were discovered with respect to leave balances and worker details. This information has been inputted in the newly-installed human resource module under the ACCPAC system. The first test pay run occurred in May 2016 and the system was fully rolled out by mid-2016. Under the new system, any personnel action will be inputted directly into the system and automatically be reflected in the payroll, reducing any leakages. The Treasury Department will no longer need to maintain a spreadsheet for payroll, minimizing any potential over or under payment resulting from human error. In parallel, the Cabinet approved, on April 1, 2016, a revised General Administrative Order, which, among others, streamlined the process for human resource management as well as integrating the automated payroll systems—for example, appointment process, leave requests, and so on. The new automated system will also be less labor intensive, allowing public servants to focus on critical areas for public service delivery. This would also be a foundational step to accurate budgeting and management of staff costs.

**44. Going forward, the GoT plans to improve the linkage between personnel decisions and the budget to support sustainable public service delivery (trigger).** The high levels of wage bill results in expenditure rigidity, which, given the high levels of revenue volatility and limited reserves available, makes for a challenging fiscal policy environment. Available data such as the HIES suggest that public service pay is currently sufficient for attracting and retaining strong candidates in the labor market, perhaps with the exception of a few specialized staff groups. Despite this, several pay increases across the board since 2011 have contributed to wage bill growth and in high average pay of public service professionals. The Cabinet endorsed the Workforce Planning initiative in December 2015, and the GoT has begun to improve the linkage between strategic plans and staffing levels through whole of government staffing reviews in 2016. To embed outcomes of the review, enhance the linkage between personnel decisions and the budget, and inform future policy decisions, the GoT plans on introducing a wage bill forecasting model to inform budget decisions in 2017. This tool will allow policy makers to accurately forecast the fiscal impact of changes in pay policy and employment and form more informed decisions on tradeoffs such as higher pay versus higher levels of employment and higher wage bill expenditure versus more operational expenditures as well as across-the-board wage increases versus more targeted wage increases. It will also allow authorities to consider different policy options to attain

domestic policy targets such as wage bill to GDP in a given year.

**45. The series of reforms supported by the DPO is expected to strengthen budget execution and transparency, which, in the medium term, could improve spending efficiency and fiscal sustainability.** Automating payroll systems will reduce leakages and potentially create room for reallocation to priority areas to improve service delivery. It will also reduce the labor intensiveness of the process, important in a thin capacity environment, allowing public servants to focus on improving critical areas of service delivery needs. This will be complemented by reforms to improve the linkage between personnel decisions with budget implications, which are expected to support improved management of the public sector and fiscal sustainability. Taken together, these reforms are expected to lead to improvements in budget execution and transparency, in turn supporting medium-term spending efficiency and fiscal sustainability. **Results indicator.** Reduce variance between budget and actual wage spending to less than 5 percent (from 12.7 percent).

<p><b>Prior action #5</b> The Recipient’s Parliament has enacted the Banking Commission Amendment Act and a framework for monitoring of the Banking sector was established to improve oversight and sustainability.</p>
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**46. Weak banking sector monitoring has led to the realization of contingent liabilities.** Tuvalu has a non-complex banking sector. However, in the unsupervised state-owned dual-bank system, asset quality remains poor as half of the loan portfolio is nonperforming, which is partly caused by Government-sponsored programs implemented a few years ago and public enterprise borrowing. To address this, the GoT has undertaken a series of reforms to strengthen PEs, including the privatization of the Vaiaku Lagi Hotel and reforms to improve the performance of Tuvalu Telecom and Tuvalu Energy through contract renegotiations and renewable energy initiatives to ensure that nonperforming loans arising from PEs remain low. In addition, both banks, that is, the National Bank of Tuvalu and the DBT, have restricted their exposure to public enterprises and made substantial provisions, an accurate estimate of capital adequacy is impeded by the lack of a regulatory framework. The DBT—accounting for about 10 percent of banking sector assets—has made substantial losses, with its net capital having depleted to \$A 0.7 million (1.7 percent of GDP) in 2014 and subsequently requiring an equity injection from the GoT in 2015 of \$A 0.35 million (0.9 percent of GDP), draining already tight public resources. Given substantial vulnerabilities in the banking sector, which in turn pose a contingent liability to the GoT, recent Article IVs noted an urgent need to establish a framework of banking supervision to avoid future liquidity constraints and contingent liabilities.

**47. The GoT enacted the Banking Commission Amendment Act and established a framework for monitoring of the banking sector to improve oversight and sustainability (prior action).** Taking on board advice from the Pacific Financial Technical Assistance Centre, the GoT enacted the Banking Commission Amendment Act on October 19, 2015 stating that until an independent Commission commences operations, the minister of Finance and Economic Development or his delegate, the permanent secretary of Finance, shall have the interim powers to perform the functions and powers of the commission. This amendment considers the small size of the banking sector and limited capacity in the country, particularly outside of the public sector, which has previously impeded the establishment of an independent banking commission. A streamlined framework for monitoring of the banks has also been established. The Excel-based quarterly reporting sheets (on assets and liabilities, income, loan impairments, and so on) were

completed for the first time by the two banks in June 2016. The banking commissioner, with support from external technical assistance, is also expected to undertake a review of the loan portfolio of the two banks to ascertain loan quality and appropriateness of the current provisions. As a next step, the GoT will need to continue to implement and refine the supervisory framework. More specifically, the Pacific Technical Assistance Center has undertaken a banking supervision mission in October 2016 to inform adequacy of loan provisioning and advise on future reform directions to improve non-performing loans management going forward.<sup>22</sup> A strengthened supervisory framework will help prevent future contingent liabilities from arising and ensure fiscal sustainability.

**48. Going forward, the GoT aims to improve financial sector regulations to enhance taxpayer registration system controls (trigger).** Businesses are required to register with the Industries Department of the Ministry of Finance, under the provisions of the Companies and Business Registration Act. Taxpayer registration is also linked to the business registration process through the issuance of the unique Tax Identification Number (TIN), which is used by the Inland Revenue Department (IRD), Customs Department, and the Tuvalu National Provident Fund. The IRD undertakes field surveys to verify the registration data. Customs entries are not accepted from businesses unless a TIN is provided. However, financial sector regulations do not require a TIN when a business opens a bank account. The IRD has noticed through its field surveys and select audits that some operating businesses do not have a TIN, while others may be electing to pay presumptive tax (designed for businesses with annual gross income of less than \$A 100,000) rather than the higher tax categories. The GoT is considering the revision of financial sector regulations to require a TIN for all business account holders to enhance taxpayer registration system controls and support ongoing efforts to enhance tax administration.

**49. Reforms to the financial sector will support fiscal sustainability and maintain service delivery.** Strengthened banking sector supervision will improve oversight and over the medium to long run, these reforms will also reduce contingent liabilities faced by the GoT. This, together with enhanced controls in the taxpayer registration system, will support the maintenance of fiscal sustainability, which remains a challenge, and is critical to maintaining adequate service delivery, including in times of need. **Results indicator.** Increase oversight of banking sector through regular production of monitoring reports, including information on non-performing loans, which are tabled to Cabinet for information (from none being produced currently).

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

**50. The proposed operation is aligned with the priorities identified in the existing CAS and the new SCD for the eight Pacific Island countries.** The first World Bank CAS for Tuvalu FY2012–2015 is focused around the two themes of mitigating economic isolation by encouraging regional integration and building resilience against exogenous shocks. The proposed operation supports the second theme of the CAS in building resilience against exogenous shocks, including by strengthening Tuvalu’s capacity to manage its budget, thereby improving its ability to respond to shocks from a fiscal perspective. The SCD identified four development priorities: fully exploiting the limited set of economic opportunities; fostering access to economic opportunities and public services; protecting incomes, assets, and services for the poor; and selectively

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<sup>22</sup> This could also inform reform directions supported by the World Bank in future DPOs.

addressing weaknesses in economic governance. The proposed operation will contribute directly to these priorities by supporting reforms to improve TTF management, fiscal sustainability, and removing constraints to accessing education.<sup>23</sup>

**51. Policy actions supported by this operation are also closely aligned with the priorities identified under the ongoing World Bank projects:** (a) Reserve Advisory and Management Program, led by the Treasury, which is helping the Government improve governance, asset allocation, and selection of external managers of the TTF; (b) Telecommunications and ICT Development Project, led by the Transport and ICT Global Practice, which is helping the country achieve the transition to a market-driven telecommunications sector and expand services to the OIs; and (c) Pacific Early Age Reading and Learning Program, led by the Education Global Practice, aimed at improving evidence-based policy and programming decisions on school readiness and early grade reading in Pacific Island countries.

#### **4.4 CONSULTATIONS, COLLABORATION WITH DEVELOPMENT PARTNERS**

**52. This new series of operations has been developed through an extensive and high-level consultation process, with a broad range of stakeholders, drawing on the TKIII.** The proposed operation has been developed through established consultative processes in place for the last four years, including regular meetings between representatives of the Ministry of Finance and Economic Development and with representation from all budget support donors and government stakeholders. The program also draws heavily on the TKIII, which was developed and updated through a series of extensive consultations with parliament, island chiefs and residents, government officials, businessmen, nongovernmental organizations' representatives, religious leaders, women, youth, and the community in general. The proposed programmatic series also reflects broader stakeholder consultation including with women's groups. Discussions here highlighted the importance of increased employment opportunities for women and the inadequacy of services and disproportionate costs being borne by women associated with basic health and education services. Consultation with church and community groups provided insights regarding the greater extent of poverty and hardships faced by the OIs and the potential impact on poverty and hardships following any large reduction in public employment or expenditure.

**53. The World Bank is working in coordination with other development partners to provide budget support to Tuvalu.** The authorities have requested development partners to provide coordinated budget support, where possible, in light of the country's capacity limitations. The World Bank, together with the ADB, Australia, and New Zealand, are supporting the implementation of the PRM—through varying combinations of budget support and technical assistance—and have arranged for joint missions when possible. The World Bank and the IMF also maintain a close working relationship in Tuvalu, with the World Bank participating in all Article IV missions since Tuvalu became a member, facilitating the discussions on structural reforms. In addition, the World Bank and the IMF jointly prepared the 2016 DSA for Tuvalu. Based on this cooperation, the World Bank and the IMF teams share a common view about Tuvalu's macroeconomic and structural reform priorities.

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<sup>23</sup> A regional partnership framework, drawing from the SCD, is being prepared and scheduled for Board approval in Dec-2016.

## 5. OTHER DESIGN AND APPRAISAL ISSUES

### 5.1 POVERTY AND SOCIAL IMPACT

**54. Under the first pillar of the operation, abolishing secondary school fees is expected to have a marked positive impact on the poor.** First, the financial benefit from removing school fees will be disproportionately realized by the poor. Secondary school attendance rates tend to be higher for more wealthy households; World Bank staff estimates based on the 2010 HIES suggest 61 percent of secondary school-age children from non-poor households are attending school, compared to 48 percent of the poor. However, there are twice as many secondary school-age children per poor household relative to non-poor households on average (0.83 versus 0.42 children per household), and ultimately poor households are supporting more children through secondary school (0.40 versus 0.26 students per household on average). Secondary school-related expenses comprise a greater share of total household budgets at the lower end of the expenditure distribution. Alleviating these costs will free up much-needed resources to spend on basic needs, particularly in poorer households. The \$A 150 annual school fee for secondary education is equivalent to roughly 8 percent of the cost of basic needs for one adult over the course of a year in rural areas, and 5 percent in urban areas.<sup>24</sup> More fundamentally, the school fees are more likely to have been a barrier to secondary enrollment for poorer Tuvaluans (consistent enrollment rate differential for poor and non-poor secondary school-age children). Abolishing fees will enhance the equality of opportunity for younger generations and the potential for shared prosperity going forward. Education outcomes are strongly correlated with consumption welfare in Tuvalu. People living in households where the head has attained a lower secondary-level education have a 22 percent real consumption premium (per adult equivalent) compared to households where the head finished their schooling at primary level, and they are 37 percent less likely to be living in poverty (with basic needs poverty rates for poor and non-poor households of 14 and 22 percent, respectively).

**55. The endorsement of the Tobacco Control (Amendment) Bill 2016 for tabling to Parliament and amendment to taxation on sin goods, including tobacco, are expected to lead to net positive impacts on the poor and other vulnerable groups.** These policy actions aim to deter consumption of sin goods, and over the long-run reduce the incidence NCD. The poor in Tuvalu, like the broader population, often have high levels of risk factors for NCD, so they stand to benefit substantially from changing consumption behavior. In the short term, higher taxes on tobacco would have an adverse impact on household budgets for the poor, particularly where members continue their smoking unabated. However, the magnitude of the impact is likely to be relatively small. World Bank staff estimates from the 2010 HIES suggest that on average, households living below the basic needs poverty line currently spend around 1.5 percent of their consumption budgets on tobacco. An analysis of aggregate imports data, coupled with existing excise rates, suggests that around half of current consumer spending on tobacco is on cigarettes—whose excise rate will be unchanged—and the other half on ‘Other manufactured tobacco’—whose excise rate will increase from 10 to 185 percent. This implies that without any change in consumption behavior, the increase in the taxes on sin goods is likely to displace just a little over 1 percent of spending that poor households were previously directing towards other basic needs. Any adverse welfare impact from the prohibition of single serve or unpacked cigarettes would likely arise through an inability to smooth consumption of other goods day-to-day, or week-to-

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<sup>24</sup> World Bank staff estimates using the 2010 HIES and assuming an annual inflation rate in the cost of basic needs of 2.5 percent.

week, depending on the frequency with which tobacco purchases continue to occur. This welfare cost is likely to be small, especially relative to the potential benefits from improved health. The supply-side regulations are most likely to induce behavior change in people who are resource constrained, such as the poor, and young people. Evidence from the WHO suggests that over 20 percent of people aged between 13 and 15 smoke on a regular basis and are vulnerable to developing long term consumption patterns; behavior change amongst these young people would lead to a lifetime of better health.

**56. The policy actions supported under the proposed operation are also expected to have a significant positive impact on poor people and vulnerable groups.** Under the second pillar of the operation, the introduction of an automated payroll system, actions relating to the banking sector, and improving the investment management of the TTF are expected to benefit all Tuvaluans, especially the poor and vulnerable. In general, their well-being is disproportionately dependent on government services, and so they stand to benefit most from improved and/or sustained public service delivery.

**57. Finally, the policy actions supported under the proposed operation are expected to have a positive gender impact.** Under the first pillar of the operation, improving macroeconomic sustainability will support sustained service delivery and economic opportunities, including to women. Under the second pillar of the operation, reforms to remove secondary education school fees will likely disproportionately benefit women. Tuvalu has made significant progress toward the achievement of gender equality in education—there are more girls than boys enrolled in secondary education. As noted earlier, the \$A 150 annual school fee for secondary education represents a significant percent of the cost of basic needs for one adult over the course of a year. Given international evidence and consultations which indicate that women are more likely to meet children’s school costs, women are likely to be financially more advantaged by expenditure allocation choices which are more orientated to basic education. Similarly, reforms to reduce consumption of sin goods could also disproportionately benefit women, including through reduced domestic violence against women which has been a concern in Tuvalu. The 2007 Demographic and Health Survey reported that 4 in 10 women have been subjected to some type of physical violence, with their current husbands or partners being the main perpetrators (84.6 percent) and the frequency of husband’s alcohol consumption is in turn associated with level of spousal violence. In the long term, reducing the cost of treatment for NCDs will create room to reorient expenditure toward primary, preventative, and maternal care, which women disproportionately depend on.

## **5.2 ENVIRONMENTAL ASPECTS**

**58. The policy reforms supported by this operation are not likely to have any negative effects on Tuvalu’s environmental aspects.** Reforms to improve social service delivery have the potential opportunities to attain environmental benefits by having environmental linkages manifest through improvements to health and education service delivery. Reforms to support macroeconomic sustainability through strengthening of investment management of reserve assets, improving the effectiveness of payroll controls, and increasing oversight on the banking sector are not expected to have any significant environmental impacts. Therefore, policy actions supported under the operation are not expected to create negative impacts on Tuvalu’s environment, natural resources, or forests.

**59. In general, Tuvalu’s environmental protection regime is adequate and has been strengthened over time by substantial project engagements and technical assistance from development partners.** 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, capacity in the Department of Environment is thin. As such, Tuvalu will continue to be heavily reliant on outside expertise provided by regional organizations such as the Secretariat of the Pacific Regional Environment Program. Substantial project engagements and technical assistance from partners, including the World Bank, in recent years has supported the strengthening of the environmental protection framework and capacity for risk management. Overall, it is considered that adequate protection would be provided by the existing legal and administrative frameworks for environmental assessment and land management in Tuvalu.

### **5.3 PFM, DISBURSEMENT AND AUDITING ASPECTS**

#### *Public Financial Management Environment*

**60. Tuvalu’s public financial management (PFM) environment is improving.** Key documents relating to PFM include the PEFA assessments, the PFM reform road map, and the Assessment of National Systems. Annual financial statements of the GoT are audited by the auditor-general applying international auditing standards. The most recent audit report was for 2014 issued in September 2015.<sup>25</sup> The GoT had improved its accounting policy in 2013 to include fixed assets in its annual financial statements; however, a disclaimer opinion was issued.<sup>26</sup> The auditor-general’s report for 2014 further noted an improvement in the annual reporting process from the previous year, including the annual reporting process and supporting documentation and internal controls.

**61. 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 the previous series of operations further addressed the need for regular reconciliation of fisheries and treasury records and strengthening the effectiveness of commitment controls and the reporting of subnational fiscal data. The sequence of reforms is as laid out in the PFM reform road map. This was endorsed by the Cabinet in 2012 and sets out a sequenced medium-term reform program to address the key areas of weaknesses identified in the PEFA and

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<sup>25</sup> According to statutory requirements, 2015 audits should be tabled to parliament by September 30, 2016. This section will be updated as and when the 2015 audit becomes public.

<sup>26</sup> This was mainly due to issues of uncertainty of the valuation, completeness, and existence of property plant and equipment, lack of evidence to support the previous year’s comparative figures, non-disclosure of inventories, non-reconciliation of the Tuvalu development fund, unavailability of some Cabinet meetings and decisions, lack of completeness of accounts receivables and payables, and failure to include the accounts of National Fishing Corporation of Tuvalu and Tuvalu Marine Training Institute. Reforms are already under way to address some of these concerns such as bringing the Tuvalu Development Fund into the ACCPAC system and an audit of the National Fishing Corporation and its joint ventures.

ANS. The subsequent 2015 PEFA self-assessment showed broad-based improvements in the area of Predictability and Control in Budget Execution, as well as improvements in the quality of budget documentation (now published via web), financial instructions, monitoring of public enterprises, and commitment control.

#### *Foreign Exchange Environment*

**62. 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, 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*

**63. The proposed USD\$3.3 million equivalent operation is the first in a two-year programmatic operation with the full amount of funds to be disbursed through a single tranche upon effectiveness.** The proposed operation will follow IDA's disbursement procedures for development policy grants. Once the operation becomes effective, and at the request of the recipient, the proceeds will be disbursed, in Australian dollars, by IDA into a deposit account in a separate government account at the National Bank of Tuvalu, provided that the implementation of the program is satisfactory and the macroeconomic policy framework remains adequate. The National Bank's 2014 annual financial statements received an unqualified audit opinion, and it has previously been used for the designated account for previous DPOs and the Pacific Aviation Investment Program in Tuvalu. As a due diligence measure, within 30 days of receipt, the recipient will provide a written confirmation to IDA when an equivalent amount is accounted for in the Government's budget management system. Disbursements would not be linked to specific purchases. The proceeds of the operation would not be used to finance expenditures excluded under the 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.

**64. As an additional mitigation measure, the World 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 World Bank within six months from the last disbursement. In that event, the recipient would (a) report the exact sum received into the deposit account and its supporting details; (b) show that this account was only used for the purposes of the operation and that no other amounts were deposited into this account, including confirmation from corresponding bank(s) involved in the funds flow; and (c) show that an equivalent amount was accounted for in the recipient's budget management system. This will enable IDA to review compliance with the Financing Agreement and achieve the operation's objectives.

## 5.4 MONITORING, EVALUATION AND ACCOUNTABILITY

**65. The implementation of this program’s policy actions will be the responsibility of the GoT under the coordination of the Ministry of Finance and Economic Development.** 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. The MFED will coordinate and monitor the program and the related indicators described in the policy matrix (annex 1), and provide regular reports to the World Bank against agreed timelines. The MFED has adequate capacity to coordinate and monitor the program related indicators, although data availability can be limited.

## 6. SUMMARY OF RISKS AND MITIGATION

**66. Macroeconomic risks.** Tuvalu’s macroeconomic and fiscal framework is vulnerable to shocks that are characteristic of small Pacific economies. The realization of these risks could shift fiscal priorities toward cash-flow management at the cost of the medium-term reform program being supported by this operation, thereby potentially undermining the achievement of its development objectives. On the external front, commodity price shocks could be readily translated into higher or lower domestic prices given the extent to which consumption relies on imported goods, particularly food and fuel. Global or regional economic downturns could yield a shock to Tuvalu’s remittance flows and diminish employment opportunities abroad. Similarly, the returns on the TTF are exposed to the unpredictable fluctuations of international financial markets. Finally, an unexpected decline in receipts from fisheries contracts or donor grants would cause a strain on Tuvalu’s fiscal position. Tuvalu is also vulnerable to weather events that could incur high recovery costs. Beyond external shocks, slower domestic policy reform, for instance, on PE restructuring, including of the banking sector, could also affect fiscal sustainability. The GoT has taken a prudent approach in estimating revenues and grants to provide a cushion against external uncertainties, while continued donor engagement will support reform momentum, including reforms to improve banking sector supervision and strengthening TTF investment management, and reduce these risks. These idiosyncratic risks could also counteract one another, reducing their impact. Finally, the World Bank will also continue to work with IMF staff to monitor macroeconomic risks and provide policy advice to the Government as needed.

**67. Fiduciary risks.** The overall fiduciary risk for Tuvalu is Substantial and could impede the achievement of all development objectives supported by the program should the funds be mismanaged. The GoT has, however, made significant efforts to improve the PFM environment, partly supported through the reforms supported by past and current budget support operations. While an IMF Safeguards Assessment is not available, as Tuvalu does not have a central bank and uses the Australian dollar as its currency and has not accessed IMF funds, there is no indication of major issues within the foreign exchange environment. However, without a safeguards assessment, a set of mitigation measures have been proposed for disbursement purposes, including a separate Local Currency Deposit Account opened in the GoT’s Consolidated Fund held at the National Bank of Tuvalu, together with an audit. See section 5.3 for more details.

**68. Institutional capacity risks for implementation and sustainability.** Thin capacity in the public sector presents a risk that could impede the implementation of all the reform measures and development objectives supported by this program. Capacity constraints are typical in the case of

small island states, especially in the Pacific. These pose the risk that the actions supported by this program might not be implemented as successfully as expected or in the agreed time frame due to staff rotation or unavailability. Dialogue with the GoT has included detailed discussions about the implementation requirements for each policy action to ensure that the program is anchored in realistic expectations. The risks caused by thin capacity are mitigated by reforms to strengthen institutions and systems to reduce reliance on key staff and 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 (banking, health, education) where gaps arise.

**69. Environment and social risks.** Tuvalu's high degree of vulnerability to external shocks, including from natural disasters, poses a risk to the achievement of the development objectives under the second pillar of the operation. If it experiences another major natural disaster over the medium term, Tuvalu's macroeconomic stability will be threatened and large parts of the bureaucracy will have to shift their attention to disaster recovery and reconstruction efforts. It is not necessarily feasible or desirable to mitigate this risk entirely, because in the event of such a major natural disaster, restoring existing capacity would actually be the most important thing Tuvalu could do to restore the livelihoods, particularly for the poor.

**70.** However, to mitigate this risk the GoT is developing Standard Operating Procedures (SOPs) for cyclones and tsunamis, to increase its comprehensiveness and in turn enhance preparedness for future climate and disaster risks. Although large-scale natural events do not occur frequently in Tuvalu, TC Pam demonstrated weaknesses in the current response framework. In June 2015, the GoT endorsed the Tuvalu TC Pam Vulnerability Reduction Plan, which in addition to providing guidance on short- to medium-term recovery efforts, also provides a longer-term road map to building resilience and reducing vulnerability, including through climate-proof investments. Learning from this experience, the GoT is developing SOPs which previously did not exist for key disasters of cyclones and tsunamis. These will then be tested in the national and island levels to ensure their effectiveness while at the same time building the capacity of the national and island disaster committees. Once tested and revised, these SOPs will be approved by the Cabinet and communicated to the relevant ministries and stakeholders in several workshops. This will also inform any need to update the National Disaster Management Act in 2017. To complement these activities, the GoT is also planning to mainstream climate change in the school curriculum throughout the country. Improving disaster preparedness and building community resilience to disasters such as TC Pam will not only save lives, but reduce future response and recovery costs. In the Philippines, Typhoon Haiyan claimed more than 7,000 lives in 2013. Yet, when another potentially destructive storm, Typhoon Hagupit, passed over similar areas just over a year later, the death toll was much lower, at 27 people. According to the Red Cross, this is partly attributable to strengthened emergency plans.

**Table 6. Systematic Operating Risk Rating**

<b>Risk Categories</b>	<b>Rating</b>
1. Political and governance	M
2. Macroeconomic	S
3. Sector strategies and policies	M
4. Technical design of project or program	M
5. Institutional capacity for implementation and sustainability	S
6. Fiduciary	S
7. Environment and social	S
8. Stakeholders	M
<b>Overall</b>	<b>Substantial</b>

## ANNEX 1: POLICY AND RESULTS MATRIX

Prior actions and Triggers		Results
Prior Actions under DPO 1	Indicative Triggers	
<b>Pillar I - Improve Social Service Delivery</b>		
<b>Prior action #1</b> The Recipient's Cabinet has endorsed the removal of secondary education school fees to enhance inclusiveness and equity of secondary education.	<b>(Indicative) Trigger #1</b> The recipient endorses and begins piloting a national action plan to improve school readiness and early literacy.	<b>Indicator 1:</b> Increased enrollment in secondary education <ul style="list-style-type: none"> <li>▪ Baseline: 2012 gross secondary enrollment rate = 55 percent</li> <li>▪ Target: 2019 gross secondary enrollment rate &gt; 60 percent</li> </ul>
<b>Prior action #2</b> The Recipient's Cabinet has approved the Tobacco Control (Amendment) Bill and directed that the amendments be introduced to Parliament to reduce risk factors for noncommunicable diseases.	<b>(Indicative) Trigger #2</b> The recipient increases selected excise taxes, including on tobacco products, to reduce NCD risk factors.	<b>Indicator 2:</b> Reduce adult smoking prevalence <ul style="list-style-type: none"> <li>▪ Baseline: 2015 = 37.9 percent</li> <li>▪ Target: 2019 &lt; 34 percent</li> </ul> <i>Note:</i> As measured by the WHO annual reports on the tobacco free initiative.
<b>Pillar II - Improve Macroeconomic Sustainability</b>		
<b>Prior action #3</b> The Recipient commissioned a review of the Tuvalu Trust Fund, which provided recommendations to strengthen reserve asset management by focusing on improving governance and investment policy, and this review has been submitted to the Tuvalu Trust Fund Board for endorsement of the recommendations.	<b>(Indicative) Trigger #3</b> The recipient implements key reforms to better align investment management with the reserve assets' objectives.	<b>Indicator 3:</b> International best practice applied to TTF investment management <ul style="list-style-type: none"> <li>▪ Baseline: 2015 = Investment managers not selected on competitive basis and annual management fee average 63 basis points</li> <li>▪ Target: 2019 = Investment managers are selected on competitive basis and annual management fee reduced by 20 basis points</li> </ul> <i>Note:</i> Will be refined as the team develops more clarity on the trigger.
<b>Prior action #4</b> The Recipient has introduced an automated payroll system to improve the effectiveness of payroll controls.	<b>(Indicative) Trigger #4</b> The recipient improves linkage between personnel decisions with budget implications to support sustainable public service delivery.	<b>Indicator 4:</b> Reduce variance between budget and actual wage spending <ul style="list-style-type: none"> <li>▪ Baseline: 2014 = 12.7 percent</li> <li>▪ Target: 2019 &lt; 7 percent</li> </ul> <i>Note:</i> 2014 used as a base year to avoid distortions related to TC Pam.
<b>Prior action #5</b> The Recipient's Parliament has enacted the Banking Commission Amendment Act and a framework for monitoring of the Banking sector was established to improve oversight and sustainability.	<b>(Indicative) Trigger #5</b> The recipient revises financial sector regulations to enhance controls in taxpayer registration system.	<b>Indicator 5:</b> Increased oversight of banking sector <ul style="list-style-type: none"> <li>▪ Baseline: 2015 = No regular monitoring reports</li> <li>▪ Target: 2019 = Monitoring reports are produced regularly, including information on nonperforming loans, and tabled to the Cabinet for information.</li> </ul>

## ANNEX 2: LETTER OF DEVELOPMENT POLICY



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

Vaiaku, Funafuti, TUVALU

Phone: (688) 20408; Facsimile (688) 20210; Email: [mtoafa@gov.tv](mailto:mtoafa@gov.tv)

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7 September 2016

#### Letter of Development Policy

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

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 III 2016 - 2020. These priorities and strategies will enable Tuvalu to pursue growth, development and shared prosperity.

**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 over 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 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. The Tuvalu Trust Fund and its auxiliary fund the Consolidated Investment Fund are in turn the main stabilizing tool for volatile fiscal outcomes, and building adequate buffers in these funds to meet short and long term financing needs is critical to the sustainability of Tuvalu.

**Despite large Tropical Cyclone (TC) Pam recovery and reconstruction expenditures fiscal surpluses were achieved in recent years on the back of higher fishing revenues and grants.** Given the narrow economic base, tax revenues finance a relatively small proportion of the budget. Non-tax revenues such as fishing license fees and dot.tv internet domain leases finance the bulk of spending needs and have increased dramatically in recent years largely on the back of higher fishing license fees. However, these revenues have demonstrated a high level of volatility in the past and there potential downside risks. The substantively higher revenues in 2015 are largely offset by

increased TC Pam related spending. The GoT made transfers of A\$4.2 million (or nearly 10 percent of GDP) for TC Pam, including transfers to the Outer Islands for cleanup, rebuilding and replanting. There were also additional recurrent costs which resulted from TC Pam, such as fuel for extra ship runs to the OIs for delivery of goods and labour. Capital expenditure increased on the back of TC Pam related projects, but also reflect higher planned capital spending which had been delayed in the aftermath of the Global Financial Crisis (GFC) given the tight fiscal situation. Grants financed over 80 percent of the pre-grant deficit in the decade to 2014.

**Higher revenues and grants in recent years have also allowed the GoT to replenish the reserve assets from near depletion in the post GFC era and build the capital base of the TTF.** The GFC resulted in accumulated losses estimated at around 15 percent of the value of the assets in the TTF and Tuvalu's savings in the CIF were substantially drained since 2009 to finance subsequent budget deficits. In the ensuing years, the TTF's capital value has recovered gradually with disbursements to the CIF resuming from 2014. Despite the recent increase in spending, the sustained fiscal surpluses over the past several years, supported by higher grants and revenues, have substantially rebuilt the fiscal buffer. Assets in the CIF are currently well above the sustainable target of 16 percent of the maintained value of the TTF. The GoT has in the past two years also reinvested earnings of the TTF to increase the asset base and future distributions, to provide long term fiscal space for climate related investments and mitigate any upward pressure on future cost of service delivery.

**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 Te Kakeega III.** To help implement this vision, the GoT developed a Policy Reform Matrix in 2012, which was updated in 2014 and again in 2016 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 National Strategy for Sustainable Development. These enabling themes are in turn reflected in the World Bank's budget support operation (the first 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.

**One pillar of the reform plan is to ensure sustained provision of adequate services to all Tuvaluans.** To improve social service delivery, the GoT has begun to implement reforms focused on improving basic education and healthcare. In the education sector, the GoT has in line with TKIII, removed secondary education school fees to enhance inclusiveness and equity of secondary education. Removing secondary education fees will support removing constraints to access, particularly for children from more disadvantaged households. To further improve education outcomes, the GoT plans to endorse and begin piloting a national action plan to improve school readiness and early literacy. This is aimed at improve quality and learning outcomes in the early years, which in turn affects subsequent primary completion, secondary enrollment and tertiary outcomes and more broadly the efficiency of public investment in education. In the health sector, the GoT has taken a first step to reduce the threat of NCD to public health and support sustainability of health sector financing, firstly through the amendment of the Tobacco Control Bill, which the Cabinet as directed to be tabled to the next Parliament session. As a subsequent step, the GoT plans on increasing selected excise taxes, including addressing any unequal treatment of similar product that creates potential loopholes and revenue leakages.

**Another pillar of the reform plan to pursue macroeconomic sustainability.** To improve overall fiscal sustainability, the government has begun implementing reforms pursuing improved expenditure and reserve asset management. To improve reserve asset management, the GoT has

taken steps to review the performance of the Tuvalu Trust Fund (TTF) and tabled the findings to the TTF Board. This would support the optimization of return on the TTF relative to the investment objectives, which in turn could enhance the distribution from the TTF to support the GoT in delivering critical services. In parallel and consistent with this objective, the national development strategy also aims to increase the size of the TTF to AUD 200 million by 2020. To this end, the GoT plans on saving a portion of the funded provided under the proposed series of budget support operations in the Tuvalu Trust Fund. To improve expenditure management, the GoT has undertaken reforms to improve effectiveness of payroll controls and plans on enhancing linkage between personnel decisions with budget implication to ensure the sustainability of the wage bill in the long run. In addition we have amended the Banking Commission Act and enhanced the monitoring of the banking sector and plan on revising financial sector regulations. This will support the reduction of potential contingent liabilities and improve tax compliance to enhance long term fiscal sustainability. Finally, the GoT has taken steps to enhance disaster preparedness and removing fiduciary impediments, to improve coordination and access to climate change related financing. These reforms will support improved transparency and control on public expenditure as well as coordination and access to financing to enable the GoT in better adapting to climate change. In the long term, these reforms will support macroeconomic sustainability.

**The government is committed to continue to implement its medium term reform agenda, with support and continued dialogue with the World Bank and other development partners.** 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. 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,



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

## ANNEX 3: FUND RELATIONS ANNEX



INTERNATIONAL MONETARY FUND



Press Release No. 16/445  
FOR IMMEDIATE RELEASE  
October 4, 2016

International Monetary Fund  
700 19<sup>th</sup> Street, NW  
Washington, D. C. 20431 USA

### IMF Executive Board Concludes 2016 Article IV Consultation with Tuvalu

On September 12, 2016, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation<sup>1</sup> with Tuvalu.

The macroeconomic outlook is stable. Real GDP growth in 2015 is estimated at 2.6 percent and is projected to rise to 4 percent in 2016 on account of several large infrastructure projects and recovery spending following Cyclone Pam. Inflation remained steady in 2015 at 3.2 percent and is expected to rise slightly in 2016 to 3.5 percent as economic activity picks up.

The budget achieved a substantial surplus in 2015 for the fourth consecutive year, supported by strong fishing license fees, internet license fees related to the “.tv” domain, and development partner assistance. With four years of budget surpluses, fiscal buffers have been rebuilt and remain at a comfortable level, even though expenditures have increased rapidly. The fiscal position is expected to turn into a small deficit in 2016 and is projected to remain in deficit over the medium term.

Risks to the outlook relate to the effects of climate change, volatility in fishing revenues, and volatile global financial conditions, which could affect distributions to the budget from the Tuvalu Trust Fund.

#### Executive Board Assessment<sup>2</sup>

Executive Directors noted that the near-term macroeconomic outlook is stable and growth is picking up, partly owing to recovery spending following Cyclone Pam. Directors commended

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

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

the authorities for the substantial progress achieved under their Policy Reform Matrix, 2012-15, as well as the commitment to continue these efforts under the national strategy for sustainable development, 2016-2020. However, important medium- and long-term challenges remain. These relate to sustaining investment to mitigate the effects of climate change, strengthening fiscal frameworks, public enterprise reform, and financial sector oversight.

Directors observed that Tuvalu's fiscal challenges are centered around revenue volatility and meeting the long-term costs associated with climate change while maintaining a sound fiscal position. They welcomed the recent initiatives to develop a climate change risk assessment framework and to incorporate disaster costs into budget planning. Directors noted, however, that improvements in public financial management were also needed, particularly with respect to the framework for capital budgeting.

Directors welcomed the rebuilding of fiscal buffers on the back of higher fishing licensing revenue in recent years. They underscored that sustaining adequate fiscal buffers is a critical element in the policy strategy to manage future risks. In this respect, Directors called for restraint on recurrent expenditure to sustain buffers and enhance debt sustainability. More broadly, the adoption of a medium-term fiscal framework that targets a small structural budget surplus will boost resilience. Directors also encouraged the authorities to continue seeking access to global climate change funding, with the assistance of development partners.

Directors emphasized that public enterprise reform remains a key policy priority, including improving corporate management and clearly defining and pricing social services. On financial sector oversight, they highlighted that the banking commission should conduct a review of non-performing assets and on-site supervision of banks, in collaboration with external advisors.

Directors welcomed the assessment that the exchange system is free of restrictions. While noting that the real exchange rate is in line with fundamentals, they encouraged the authorities to continue to implement the national development strategy to strengthen competitiveness. Directors also urged the authorities to make use of technical assistance to improve economic statistics.

## Tuvalu: Selected Social and Economic Indicators, 2012-2017

Population (2014): 9,893  
 Per capita GDP (2014 est.): US\$3,827  
 Main export: Fish  
 Key export markets: Fiji, Australia, Japan

Poverty rate (2010): 26.3 percent  
 Life expectancy (2014): 66 years  
 Primary school enrollment (2006): 100 percent  
 Secondary school enrollment (2001): 79.5 percent

	2012	2013	2014	2015	2016	2017
		Est.			Proj.	
	(Percent change)					
Real sector						
Real GDP growth	0.2	1.3	2.2	2.6	4.0	2.3
Consumer price inflation (period average)	1.4	2.0	1.1	3.2	3.5	2.9
Government finance	(In percent of GDP)					
Revenue and grants	84.3	107.5	123.1	123.5	124.5	113.3
Revenue	56.6	82.9	74.1	105.5	91.7	80.9
of which: Tax revenue	15.0	19.0	18.0	19.4	17.1	17.3
Fishing license fees	21.8	45.4	32.0	60.9	53.2	43.0
Grants	27.8	24.6	49.0	18.0	32.9	32.4
Total expenditure	75.0	81.1	86.8	116.3	127.3	117.6
Current expenditure	75.0	81.0	86.6	116.1	127.1	117.4
of which: Wages and salaries	31.9	32.2	36.1	37.4	43.2	43.8
Special Development Expenditure	6.2	7.4	9.2	13.3	23.9	13.5
Overall balance	9.3	26.3	36.3	7.2	-2.7	-4.2
Tuvalu Trust Fund (stock, \$A million)	131	141	144	149	151	155
Consolidated Investment Fund (stock, \$A million) 1/	4.5	12.2	24.3	30.8	28.9	26.2
Tuvalu Survival Fund (stock, A\$ million)					5.0	5.0
	(Percent change, unless otherwise indicated)					
Money and credit						
Deposits	9.7	29.2	10.6	2.0	...	...
Credit	-11.4	15.2	-32.0	2.0	...	...
Lending interest rate (in percent)	10.6	10.6	10.6	9.1	...	...
	(In millions of Australian dollars, unless otherwise indicated)					
Balance of payments						
Current account balance	6.6	0.5	8.0	3.3	-1.8	-2.7
(In percent of GDP)	17.2	1.2	19.3	7.6	-4.0	-5.7
Exports of goods	19.9	18.8	19.2	19.7	20.1	20.6
o/w Fish	19.5	18.4	18.8	19.3	20.1	20.6
Imports of goods	-21.4	-32.2	-29.3	-33.6	-38.6	-39.9
Current transfers (net)	21.2	18.0	25.6	14.9	17.3	17.8
Capital and financial account balance	-3.4	8.7	-4.9	2.1	-1.8	1.3
of which: .TV domain license fees	3.7	4.4	4.5	6.3	6.3	6.3
Capital transfers (net)	4.7	5.1	5.8	9.1	11.3	8.6
Gross official reserves 2/	27.5	37.9	41.0	46.4	42.7	41.3
(In months of next year's imports)	5.4	8.3	7.4	7.1	6.5	6.1
	(In percent of GDP, unless otherwise indicated)					
Debt indicators						
Gross public debt	25.9	57.2	64.4	58.2	53.7	44.3
External	19.7	51.8	59.8	54.5	51.7	44.3
Domestic	6.3	5.4	4.6	3.8	2.0	0.0
Exchange rates						
Australian dollars per U.S. dollar (period average)	1.0	1.0	1.1	1.3	...	...
End-period	1.0	1.1	1.2	1.4	...	...
Real effective exchange rate (2005=100)	103.8	102.1	97.3	91.9	...	...
Nominal GDP (In millions of Australian dollars)	38.5	39.7	41.3	43.5	46.1	48.1

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

1/ Includes government transfers of unspent capital spending allocations to the Tuvalu Development Fund in 2015, estimated at A\$5.2 million.

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