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Macroeconomic Developments

Economic Growth

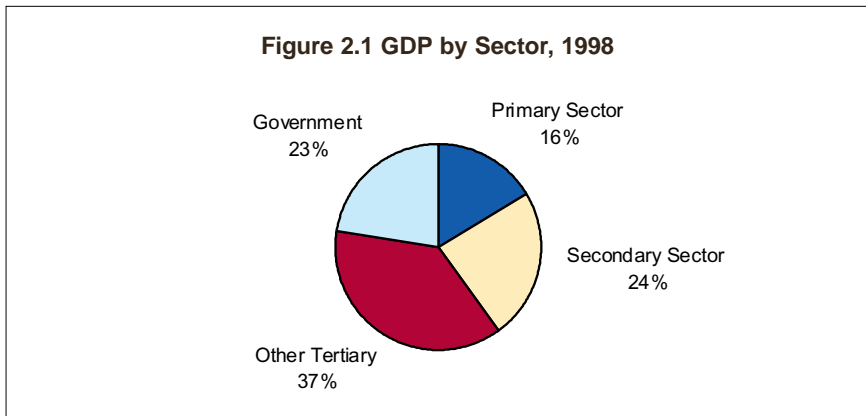
Tuvalu's real gross domestic product (GDP) grew at an estimated average annual rate of 5% from 1988 to 2001 (ADB 1998; Appendix 1, Table A2.2). The lack of continuous, consistent national accounts prevents analyzing the sectoral developments during this period precisely, but it is clear that growth was led by the tertiary sector and the Government of Tuvalu (the Government) sector in particular. The secondary sector expanded strongly, largely as a result of construction activity, while the primary sector grew sluggishly.

The most recent set of national accounts, for 1996 to 1998 (CSD 1999a), shows aggregate growth rates of 3.5% in 1997 and 14.9% in 1998. Expansion of the Government sector accounted for almost half of the rapid growth in 1998, with the construction, finance, and real estate sectors playing supporting roles (Appendix 1, Table A2.2). Gross capital formation (excluding inventory change) fluctuated between 76.9% of GDP in 1996 and 27.1% of GDP in 1998, reflecting the implementation and completion of large projects funded by external assistance agencies (Appendix 1, Table A2.3). Between 1996 and 1998, public sector investment accounted for 73.5% of total investment. See Figure 2.1 for gross domestic product by sector in 1998.

Growth is estimated to have been around 3% in 1999 and 2000, and to have accelerated to 4% in 2001 (ADB 2001a; ADB 2002a). The public sector continued to lead with public administration expanding by close

to 5% in 2001, and construction activity rising as a result of Government-funded projects, most notably road improvement in Funafuti. Other sectors of the economy grew more modestly at around 2%.

The public sector-led growth in formal economic activity is mirrored by a decline in the relative importance of subsistence production as a component of GDP: from 49.5% of total GDP in 1990 to 22% in 1998. The decline in part reflects plausible changes in assumptions used in estimating subsistence agricultural output in the 1998 national accounts. Up to 1994, it was assumed that population determined subsistence production of coconuts, bananas, and pandanus. In the new accounts, lower consumption is assumed because on Funafuti, and to a lesser extent on the outer islands, land scarcity limits production capacity and consumption has switched toward imported foodstuffs (CSD 1999b).



Source: Table A2.1.

Gross national disposable income has been substantially higher than GDP because of

- (i) net inflows of overseas workers' incomes;
- (ii) property income from overseas assets; and
- (iii) current transfers from abroad.

Box 2.1: Tuvalu Trust Fund

The TTF was established in June 1987. Its members are the governments of Tuvalu, Australia, New Zealand, and the United Kingdom. The Fund is to assist the Government of Tuvalu to achieve greater financial autonomy in its recurrent budget, to maintain and perhaps improve social infrastructure and services, to improve absorptive capacity, to enable the Government to meet the maintenance and operating costs for social infrastructure and services, and to assist the development of Tuvalu's economy.

The starting amount of the capital fund was \$26.4 million, which was to be maintained in real terms by reinvestment of the inflationary premium as measured by the Australian consumer price index. Contributions since 1987 have increased the capital fund to a maintained value of \$67.1 million in September 2001, split approximately 50-50 between County Investment and Solomon Smith Barney. The actual market value at that date was \$62.9 million. Only if the actual market value exceeds the maintained value can there be an automatic distribution from the so-called A account in which the capital is held in the Government's Consolidated Investment Fund (CIF or B account) from which public expenditure is funded. The B account target minimum balance is the sum of the previous four years of drawdowns from the account, expressed in real terms according to the Funafuti consumer price index.

Sources: Tuvalu Trust Fund Board 2000; TTF Advisory Committee 2001.

In the early 1990s, net annual income from around 275 seamen in the merchant marine was estimated by the Central Statistics Division to be between \$1.7 million and \$2 million. These remittances more than doubled between 1997 and 2001: in 2001, approximately 450 seamen

Box 2.2: DotTV

In the early 1980s, the Internet Assigned Numbers Authority (IANA) assigned each country a country-code Top-Level Domain (ccTLD) Internet address. In 1999, the Government of Tuvalu signed a contract with USA based DotTV Corporation International to market and manage its ccTLD '.tv' indefinitely. In return for the exclusive rights to sell second-level domain addresses, the Government would receive US\$1 million per quarter for 12.5 years and 20% equity in the company. To 30 September 2000, the Government duly received five quarterly payments of US\$1 million, plus a one-off lump sum payment of US\$12.5 million after the principal investor, Idealabs Inc. Pasadena, California, exercised a call option under the agreement. In late 2000, the Government arranged with DotTV Corporation to forego quarterly payments for the December quarter of 2000 and the first two quarters of 2001, to acquire US\$3 million of preferred stock in the corporation. In mid-2001, the DotTV Corporation ran into financial difficulties and in December 2001 the company was purchased by VeriSign, Inc., the domain administrator for ".com." Tuvalu's share of the sale amounted to about US\$10 million, which was received as a lump sum. The new contract with Verisign provides Tuvalu with US\$2.2 million per annum plus 5% of all revenue exceeding US\$20 million sales per year. VeriSign holds the rights to market '.tv' for 15 years.

Source: GOT.

sent \$4.9 million home, which was equivalent to 20% of nominal GDP (TTF Advisory Committee 2001). Net income receivable from the Tuvalu Trust Fund's (TTF) overseas assets has fluctuated from year to year. Between 1996 and 2001, drawdowns from the Fund's B account provided 21% of the Government's total recurrent revenue (see fiscal

developments below and Box 1.1 that explains TTF). Income is also received from overseas assets of the National Bank of Tuvalu (NBT) and the Tuvalu National Provident Fund (TNPF). License fees for telecommunications dropped from over \$2 million in 1997 and 1998 to under \$1 million from 1999 to 2001, whereas fishing license fees grew rapidly from \$3.6 million in 1997 to \$11.8 million in 2001. Income from the DotTV marketing arrangement went from \$1.1 million in 1999 to \$24.9 million in 2000 and then to \$3 million in 2001 (Box 2.2). Grants for budget support totaled \$1.4 million in 2001.

Employment

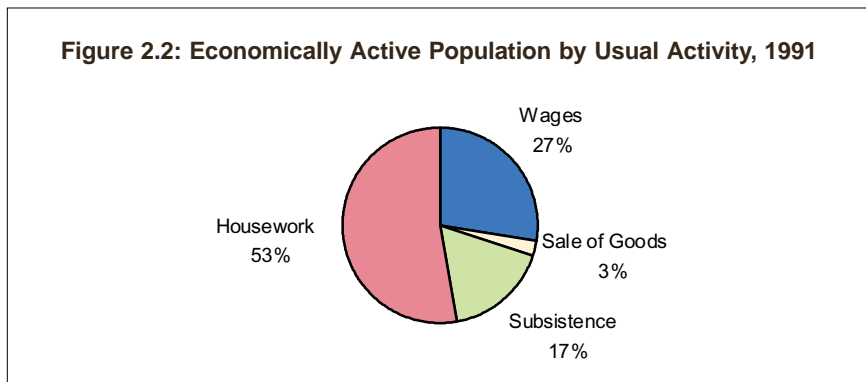
The 1991 Census showed (Figure 2.2) that 70% of the economically active population aged 15 years and over were engaged in subsistence production and housework, with supplementary cash income from the sale of handicrafts, fish, and agricultural crops. Census data on current activity revealed a higher number of 1,468 resident Tuvaluans working for wages, representing 30% of the economically active population. Employment by industry of this wage-earning group is shown in Table 2.1 and the public sector's dominance as a source of jobs is clear.

Completion of the 2002 Census will generate data on the evolution of employment after 1991. In the absence of employment surveys in the intervening years, we must rely on TNPF records, the civil service establishment list, and the civil service payroll, to at least partially quantify employment trends between 1991 and 2001. Figure 2.3 suggests that overall employment in the formal sector grew at the average annual rate of 2.2% between 1991 and 2001. There was relatively rapid growth in employment in public corporations, modest expansion in the number of established civil service positions, and limited growth in private sector activity.

Growth in employment by public corporations was concentrated in the first half of the 1990s, whereas growth in civil service employment occurred in the late 1990s. The 2001 number for Government

employees refers to established positions. In fact, 636 of these positions were filled and a further 201 civil servants were employed as temporary appointees on contract, effectively making the civil service size 837. Both established and temporary civil servants make TNPF contributions. In addition, there were a further 80 casual employees not included in the total. Growth in private sector employment is understated because the 2001 figure only refers to members of the TNPF for whom fund contributions were paid in the preceding 12 months. The extent of employer compliance with requirements to pay contributions is unknown; and there are many self-employed people who choose not to join TNPF. General retailing remained the most common private sector activity in 2001 but, compared with 1991, there was an increased number of construction companies.

As noted, there was significant growth from 1997 in the number of Tuvaluans working as seafarers on German international cargo vessels. This employment is subject to fluctuations in global demand and

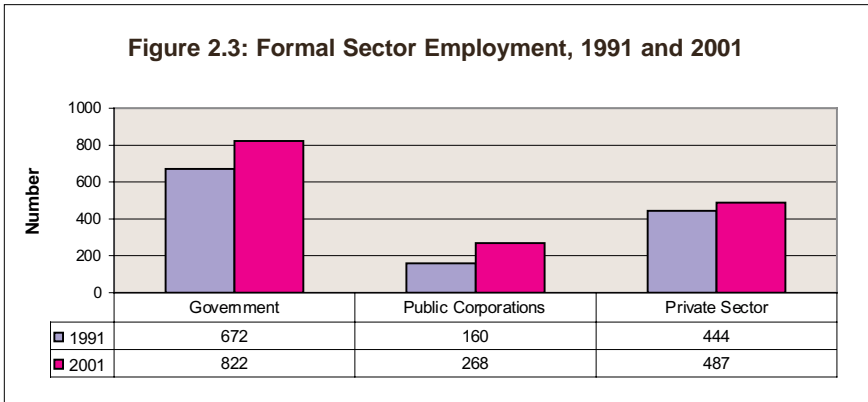


Source: CSD 1992.

Table 2.1: Tuvaluans in Wage Employment by Industry and Sex, 1991

Industry	Males	Females	Total	Percent of Total
Agriculture	53	56	109	7.4
Manufacturing	17	15	32	2.2
Electricity & Water	13	0	13	0.9
Construction	31	1	32	2.2
Commerce	119	88	207	14.1
Transport	38	7	45	3.1
Finance	9	11	20	1.4
Community Services	649	361	1,010	68.8
Administration	570	256	826	56.3
Total	929	539	1468	100.0

Source: CSD 1992.



Sources: ADB 1998; Tuvalu National Provident Fund; Ministry of Finance and Economic Planning.

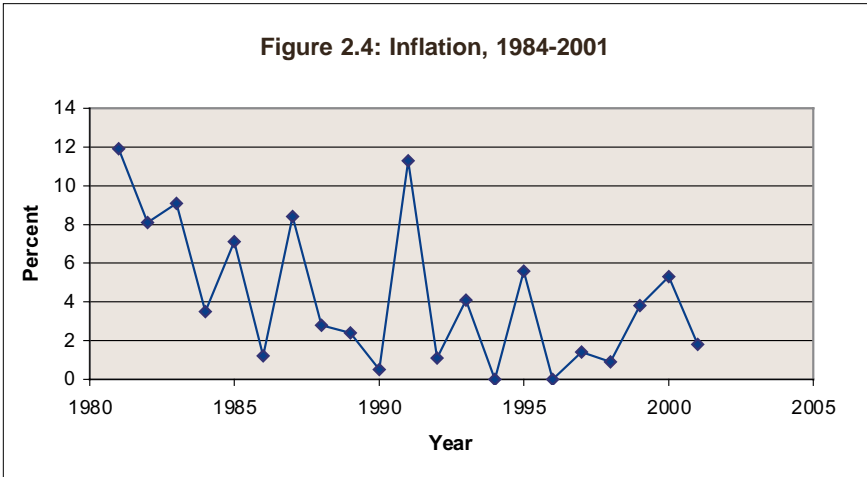
Note: Numbers for employment in the Government refer to established positions to ensure consistent comparison.

competition from other countries, but is a crucial source of income for Tuvalu's island communities (Chapter 7). The key determinant of employment prospects that can be controlled by the Government is the quality of training at TMTI (Chapter 5). In addition to temporary migration, up to 75 Tuvaluans are now permitted to enter New Zealand each year as permanent residents. This will relieve population pressure on Funafuti and provide another source of remittances, although potentially at the price of losing skills in demand domestically.

Prices and Wages

Inflation as measured by Funafuti's consumer price index (CPI) declined substantially in the 1980s and, after double-digit inflation in 1991, has remained in the 0-6% range (Figure 2.4). The index is still constructed using weights based on consumption patterns of the early 1980s, although a reweighting was to have occurred after the 1994 household income and expenditure survey. Movements in price levels of the six broad product groups in the CPI between 1997 and 2001 are shown in Table 2.2. Given that imports dominate the index and that the Australian dollar is used as currency, inflation outcomes are heavily influenced by the Australian inflation rate and movements in the Australian dollar against the currencies of other major exporters to Tuvalu, namely the Fiji Islands, Japan, and New Zealand. In 1998, for example, low inflation in Australia and the January devaluation of the Fiji dollar by 20% were major reasons for a drop in inflation. The inflation acceleration in 1999 and 2000 is largely attributable to rises in transport costs as world oil prices rose, and to higher costs of miscellaneous items, respectively.

There are no price controls, although retail markups are monitored by a Government official, and the Tuvalu Cooperative Society maintains an 18.5% markup on five essential goods (hard biscuits, kerosene, sugar, flour, and rice), compared with 25% on general stock and 33% on frozen goods. There is a need to review current price regulation



Sources: ADB 1998; Table 2.2.

and to establish a regulatory authority governing operations, particularly the pricing policies of the utilities' monopolies.

The public sector largely determines the level and structure of wages and salaries. In 1991, civil servants in established positions received salaries ranging from \$1,836 to \$9,672, giving a ratio of 5.3. By 2001, the respective figures were \$3,223 and \$18,098, and the ratio was 5.6. The top salary for a civil servant thus rose 87%, while that for the lowest paid rose 76%. During the same period, the CPI rose from 143.1 to 181.1, or 27% (ADB 1998; Table 2.2). The real value of civil servants' wages therefore increased significantly, aligning them more closely with regional levels.

Civil service salaries rose in 1998 when servants received a 13% housing allowance, as part of a plan to end subsidized housing for civil servants and to charge market rates. However, the full plan was not implemented, and those civil servants fortunate enough to have been allocated a Government house continue to pay subsidized rents. This inequity remains unresolved, and resolution lies in implementing the original plan to charge market rents for Government houses. Salaries rose by 10% in 2000 (13.8% for level one appointments) and by 3.4% in

Table 2.2: Consumer Price Index, 1997–2001

Index	Weights	1997	1998	1999	2000	2001
Food	49.0	154.22	154.46	160.52	162.22	170.77
Alcohol, tobacco	10.5	211.86	210.92	209.57	210.12	217.16
Clothing, textiles	4.0	174.12	191.66	210.08	266.80	244.60
Transport	12.0	165.56	171.88	189.98	215.34	225.81
Housing	12.5	129.61	132.89	128.04	129.72	131.41
Miscellaneous	12.0	170.98	166.76	175.92	196.53	177.57
All items	100.0	161.36	162.75	168.98	177.86	181.10
Percentage Change						
Food			0.16	3.92	1.06	5.27
Alcohol, tobacco			(0.44)	(0.64)	0.26	3.35
Clothing, textiles			10.07	9.61	27.00	(8.32)
Transport			3.82	10.53	13.35	4.86
Housing			2.53	(3.65)	1.31	1.30
Miscellaneous			(2.47)	5.49	11.72	(9.65)
All items			0.86	3.83	5.26	1.82

Source: CSD 2001b.

2001 (the automatic rate of increase introduced in 1995 assuming this was the trend rate of inflation).

Table 2.3 summarizes the salary structure in 2001. A 1998 salaries review recommended a rise in the relative salaries of professionals (doctors, teachers, and nurses especially), and of skilled tradespeople (plumbers, carpenters, mechanics, and electricians). The recommendation was adopted for 1999 but subsequently reversed in part.

The Financial Sector and Monetary Developments

The formal financial sector in Tuvalu consists of one commercial bank, NBT, TNPF, the Development Bank of Tuvalu (DBT), one insurance company, and a foreign exchange dealer.

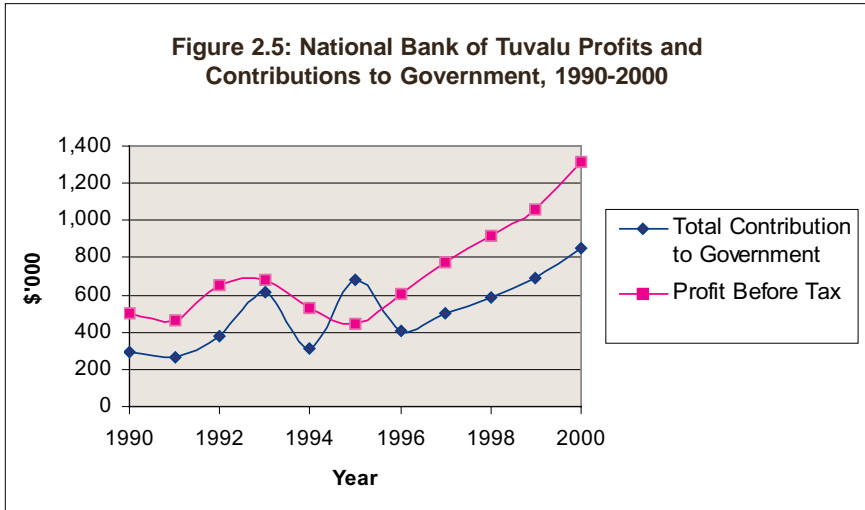
Table 2.3: Government Positions and Salary Scales, 2001

Grade Level	Salary Range (\$ p.a.)	Example of Position
1A	18,098	Secretary to government
1B	17,507	Attorney General
1C	16,915	Secretaries of ministries
1D	16,561	Director of education
2	15,791-16,265	Auditor General
3	14,697-15,555	Doctors, commissioner of police (3/2)
4	11,563 -13,721	Crown counsel, director of budget
5	9,226-11,977	Second engineer, building officer
6	7,896-10,380	Housing officer, dental technician
7	6,832-8,842	Personal assistant to minister; staff nurse
8	5,856-7,541	Plumber, mechanic, electrician
9	4,170-6,565	Clerk, typist
10	3,223-4,584	Driver, cleaner

Source: Tuvalu National Budget 2001.

The Government has owned the National Bank of Tuvalu (NBT) since 1995. Its headquarters are at Vaiaku in Funafuti, and agencies are operated on all eight outer islands. It has been profitable, returning an average 58.3% on net assets before tax between 1990 and 2000, and contributing an annual average of \$507,000 to the Government in company tax and dividends (Figure 2.5). Earnings on foreign exchange transactions have been the major source of income, while loans and advances have been around 28% of total deposits, reflecting the limited opportunities for domestic lending and conservative reserves management.

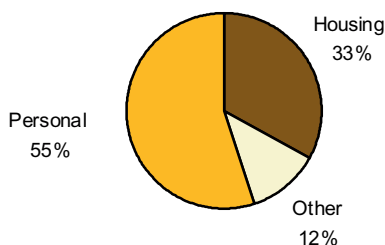
Figure 2.6 presents the breakdown of \$1.2 million in new lending during the first quarter of 2001: 58% of personal loans were for family commitments, including funeral, wedding, and birthday expenses; 29% for traveling; and 11% for education; with the remaining 2% being advances to seamen.



Source: National Bank of Tuvalu records.

NBT's interest rate structure is presented in Table 2.4. Deposit rates are low by regional standards, and lending rates are the same or above those charged in more competitive banking systems, although they have fallen from their 1997 levels. The interest rate spread of approximately 8% compares with 4% in Tonga and 6% in Samoa (ADB 2000; ADB 2002b). Relatively high spreads, fees, and commissions are not surprising in a monopolized banking sector, which probably does not have room for a second profitable commercial bank. Regulation is therefore required to avoid excessive monopoly pricing that hinders private sector development. The TTF Advisory Committee (TTFAC) (2001) has recommended that the Government arrange for regular and independent supervision, using regional assistance, and for an experienced overseas bank executive to act as a visiting director to advise and report to the secretary of finance. The Committee also recommended an open and formal arms-length relationship between NBT and the Government to minimize the risk of improper influence on bank management. To date the NBT board has only considered, and rejected, the second of these recommendations.

Figure 2.6: Distribution of New NBT Loans, First Quarter 2001



Source: National Bank of Tuvalu records.

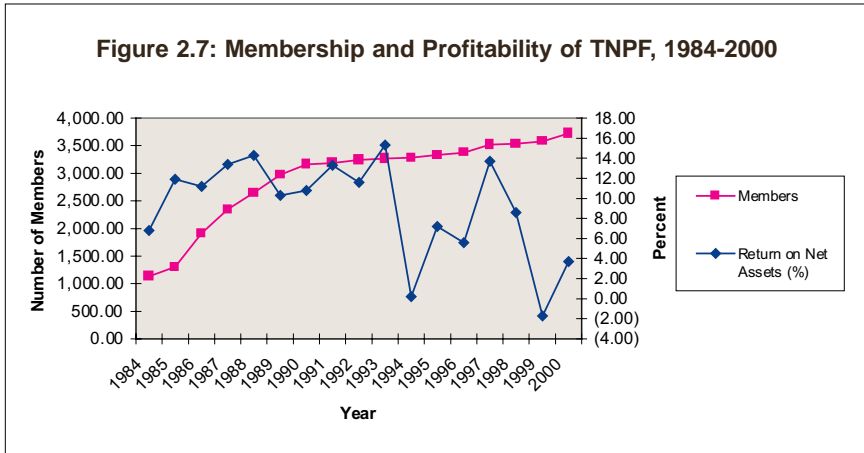
Table 2.4: National Bank of Tuvalu's Interest Rate Structure, 2002

Account	Deposit Rates (%)	Product	Lending Rates (%)
Savings	2.00	Housing loans	8.00
Call Accounts	2.50	Personal loans	11.00
Term 1-6 months		Fully drawn advances	11.00
- \$200-2,000	2.50	Overdraft facilities	13.00
- \$2,000-25,000	3.00		
- \$25,000-50,000	3.50		

Source: National Bank of Tuvalu.

Tuvalu National Provident Fund (TNPF) membership has grown from 1,136 in 1984 to 3,726 in 2000, and net assets from \$1.7 million to \$13 million. The return on net assets averaged 9.2% during this period, but fluctuated between a high of 15.3% in 1993 and a low of minus 1.7% in 1999 (Figure 2.7). TNPF's investment portfolio was re-organized because of management concern over the declining rate of return in the late 1990s. The major part of the portfolio (87%) was held with the Hong Kong Shanghai Banking Corporation (HSBC) and was

transferred from London to Melbourne in August 2000, to be managed by HSBC Asset Management (Australia). Simultaneously, the structure of the portfolio was changed to become a balanced diversified portfolio with 50% to growth assets and 50% to income assets. In addition, Credit Suisse Asset Management and Westpac Investment Management were appointed as new fund managers to handle the remaining 13% of the portfolio.



Source: Table A2.5.

In contrast to NBT and TNPF, the Development Bank of Tuvalu (DBT) has had difficulties since it began in 1993, with a loan portfolio heavily weighted toward general retailing and high provision for bad debts. An average return on net assets of minus 77% was recorded between 1990 and 1996 (ADB 1998); and operating losses totaling \$407,000 were made in 1997 and 1998, despite the inclusion in income of \$51,000 in grants from the New Zealand Government and a \$250,000 grant from the Government of Tuvalu. In September 1998, the Government directed DBT to suspend all lending, pending a merger with NBT. This did not occur because Cabinet rejected the proposal. The lending freeze remained in place in 1999, when the Government provided another

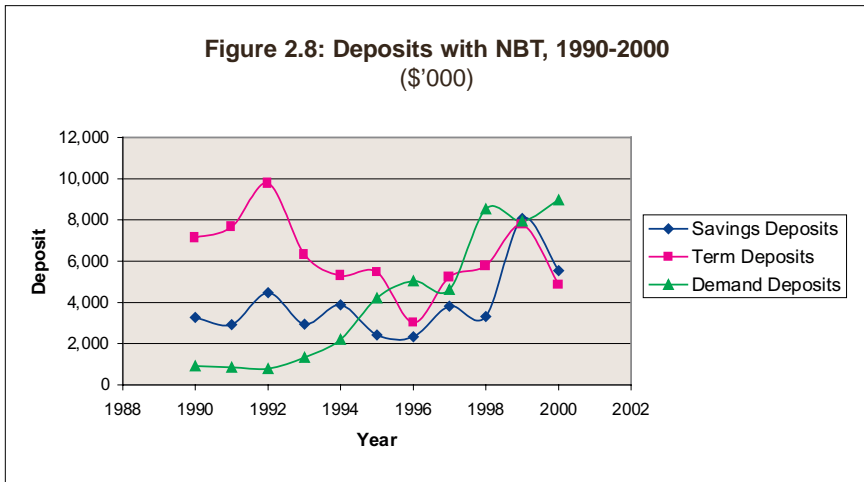
grant of \$295,000. This grant allowed management to report an operating profit, but the bottom-line trading loss was over \$200,000. It was followed in 2000 by an operating loss of \$112,000. Lending resumed in 2000, and the DBT board saw a profitable future with a \$4 million portfolio focused on the housing retail market and personal consumer loans—areas already well served by NBT. The reality was that by the end of 2000, accumulated losses totaled \$1 million, net worth was minus \$77 million, and arrears, although down on previous years, were still 17% of a \$1.6 million loan portfolio. The proposal to merge DBT with NBT should be revisited, to create a microfinance unit to fulfill DBT's original mandate of promoting private sector development.

Using the Australian dollar as currency in Tuvalu's ultrasmall and open economy effectively eliminates monetary policy as an instrument of macroeconomic management. Figure 2.8 shows the movements in demand, savings, and term deposits from 1990 to 2000. Total deposits grew at the average annual rate of 5.5%, with term deposits stagnating and rapid growth occurring in demand deposits. Data on currency in circulation are not available, but it is likely the population has grown more comfortable with the formal banking system and consequently shifted its holdings of narrow money away from cash in hand toward demand deposits.

External Trade, Balance of Payments, and Tariff Policy

Tuvalu's merchandise export base is extremely narrow, being confined to copra, stamps, and handicrafts. Copra exports of 381 tons in 1979, peaked at 680 tons in 1984, and have fallen since. Production responded to price subsidies in 1999 and 2000, but in 2001 exports were down to 32 tons valued at \$7,376. Stamp exports also have declined from the levels of the 1980s. Data on handicrafts exports are not available.

Imports of goods valued as free on board (FOB) increased from \$6 million in 1990 to \$12.3 million in 1995 (ADB 1998). Their value

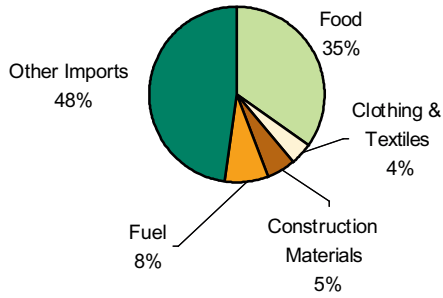


Source: Table A2.4.

inclusive of cost, insurance, and freight (CIF) was \$12.4 million in 1999 and \$13.2 million in 2000 (CSD 2001a). Imports were 53% of GDP in the latter year. The composition of imports in 2000 is shown in Figure 2.9. The share of food imports rose substantially from the 20% recorded in 1995. Historically, large merchandise trade deficits and heavy payments for freight and insurance continued to be covered by net private transfers, fisheries and telecommunications license fees, investment income, DotTV revenue, and official transfers. Figure 2.10 shows the amounts from these sources in 2001.

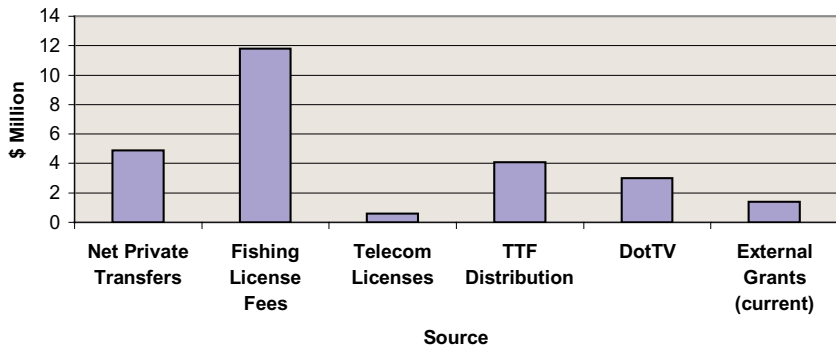
Governments meeting at the Pacific Islands Forum in Nauru in August 2001 signed the Pacific Agreement on Closer Economic Relations (PACER), which includes all forum members. As a first step under PACER, they also initiated a free trade agreement, the Pacific Island Countries Trade Agreement (PICTA), which applies to the 14 Forum Island Countries (FIC) and will come into force in 2002, once ratified by at least six FICs. PICTA is aimed at removing most tariffs on trade between member countries by 2010 and removing all tariffs by 2016. As a signatory to PICTA, Tuvalu is therefore committed to tariff reduction.

Figure 2.9: Composition of Goods Imports, 2000



Source: CSD 2001a.

Figure 2.10: Income from Overseas, 2001



Source: Government of Tuvalu Accounts.

The present tariff system consists of specific rates and ad valorem (percentage) rates applied to import values FOB. Imported goods that are free of duty include fresh, chilled, and dried vegetables and fruits, rice and flour, cement, fertilizers, building products, ships and boats, most items of manufacturing machinery, hand tools, refrigerators, freezers, and outboard motors. Examples of specific rates and of each of the ad valorem rates are in Table 2.5. Specific rates on alcohol and tobacco are high, while other goods purchased by households usually bear a tariff of between 20% and 40%.

Goods in 13 categories are eligible for duty concessions. These include educational materials, equipment and uniforms for sports, goods produced in a Forum island or any other country approved by the minister responsible, goods for producing exports, and frozen chickens. Exemptions also apply to Government imports (except those for commercial use), aid projects, and personal belongings.

In addition to import duties, a sales tax is applied to all imported goods at 2.5% of the import value plus tariff payment. This sales tax is a general ad valorem tariff.

It has been reported that about 50% of imports account for about 75% of import tax collections (Economic Insights 1997). The main sources of revenue are alcoholic beverages and tobacco (21%); electrical machinery and equipment, sound equipment, television, and sound recorders (14%); and petrol, diesel, and oils (12%). Import taxes generated 55% of taxation revenue between 1996 and 2001, and 9% of current revenue and grants (Appendix 1, Table A2.6). Any future tariff reform, therefore, will need to consider the implications for Government revenue.

Reducing import taxes might be covered by a general goods and services tax that removes the distorting effects of just taxing imports. However, the additional administrative costs of this more complex tax system would need to be assessed against the potential benefits. Given the heavy import dependence of the Tuvaluan economy and the constraints on administrative capacity, it is not a foregone conclusion that the net benefits would be positive, as noted in a 1997 review of tariff

policy (Economic Insights 1997). Also as noted in the 1997 review, complete replacement of import taxes by direct taxation is not feasible, since it would require unacceptably high marginal tax rates on personal and company incomes.

Whatever options are to be contemplated, the existing tariff system could be rationalized and its administrative costs reduced by adopting recommendations made in the 1997 review. These include eliminating specific rates, reducing the number of ad valorem rates, formally combining import duties and the sales tax, and levying duties on the basis of import values inclusive of CIF.

Fiscal Developments

An analysis of fiscal developments between 1996 and 2001 must begin with the cautionary observations

- (i) that Government accounts for these years were yet to receive audit certificates in early 2002;
- (ii) that data for any given year have been revised in successive budgets (often substantially); and
- (iii) that there are occasional discrepancies in the data (for example, the sum of operating and capital expenditure may not equal the figure presented for total expenditure).

The Auditor General and Government reviewed accounts for 1996 and 1997 and found major problems with them (TTF Advisory Committee 2001). Problems were also found in reconciling the 1998 accounts with the Government's bank accounts and with the ledgers. However, the Government accountant returned from overseas study leave in early 2002 and submitted the accounts for 1996 to 1999 to the Auditor General in April 2002. Final preparation of the 2000 and 2001 accounts was continuing in early 2002. Public financial management issues are discussed further in Chapter 3.

Table 2.5: Tariff Rates on Major Commodities

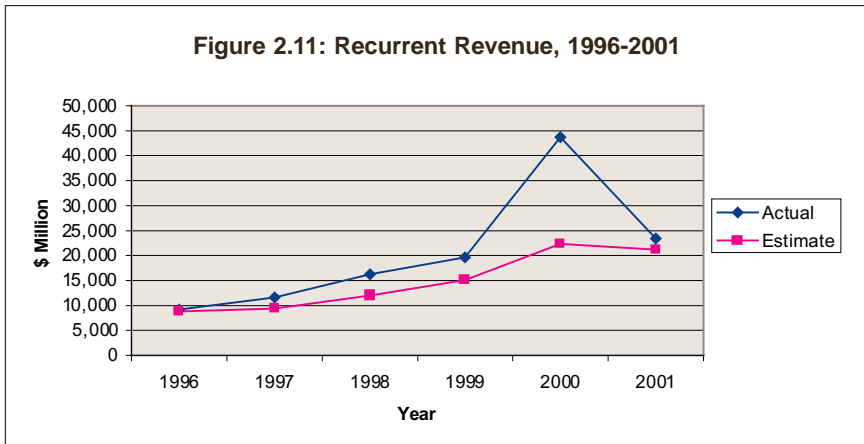
Commodity	Rate
Spirits	\$13 per liter
Wine	\$3 per liter
Beer	\$1.40 per liter
Cigarettes	10 cents per cigarette
Petroleum oil	33 cents per 10 liters
Motor spirit	12 cents per liter
Distillate	7 cents per liter
Kerosene and white spirit	4 cents per 10 liters
Fresh, chilled or frozen meat other than poultry, cameras, musical instruments, watches, air conditioners, motorcycles (subject to minimum payment)	10%
Orange, grapefruit, pineapple, tomato juice	15%
Apple juice, poultry meat other than chicken, animal and vegetable fats and oils, butter and cheese, jewelry, televisions, most paper products	20%
Chicken, processed fish, footwear, clothing (not knitted or crocheted), cooking appliances, most kitchenware, most washing machines, calculators, telephones, furniture, motor vehicle and motorcycle parts	25%
Blankets, spices, ice cream, soap, cotton and synthetic fabrics, floor coverings, clothing (knitted or crocheted)	30%
Coffee, tea, sugar, sausages, sweet biscuits, photographic film, cigarette lighters	40%
Soft drink, hats, safety headgear, precious stones	50%
Motorcycles of 500 to 800cc capacity, firearms	60%
Fish	75%
Other articles of plastics (item 3926.2090)c	100%

Source: ESCAP 1995; Customs Division.

The Tuvalu national budget papers present budget estimates and outcomes for revenue and expenditure in the 4 years preceding the budget year, and show appropriations for the forthcoming fiscal year by 14 line ministries and agencies, broken down by their major subdivisions. Appropriations relate to the recurrent budget, which since 1998 has been further disaggregated into core expenditure and special development expenditures. Core expenditure is an estimate of essential, predominantly current expenditure that must be sustained, and is arrived at by estimating underlying revenue and adding the average automatic distribution from TTF's A account to the CIF, or B, account. Underlying revenue is estimated by assuming that it will rise routinely at the rate of the sum of population growth and inflation. Special development expenditures involve both current and capital expenditures, including some that could be construed as core expenditures (such as subsidies to nonfinancial public enterprises). These special development expenditures are made subject to availability of finance from cash reserves in the Government's CIF and general revenue accounts, and from windfall revenue, which is equal to estimated total revenue minus core revenue.

In addition to core and special development expenditure, the budget papers present estimates of extra-budgetary (XB) development expenditure that is subject to availability of external finance. This expenditure, with special development expenditure, is itemized by line ministry in the first year of a 3-year public investment program included in the budget papers. Generally, the XB development projects so listed do not have secured funding, so that approved and actual expenditure diverge widely. There is also an absence of estimates of the medium- to long-term operations and maintenance costs of assets acquired as a result of XB expenditure. External assistance in kind is not fully recorded.

Between 1996 and 2001 actual recurrent revenue (exclusive of automatic distributions from TTF) exceeded budget estimates in each year (Figure 2.11). On average, the excess was almost 40%; but this largely reflected a major rise in revenue in 2000 attributable to windfall

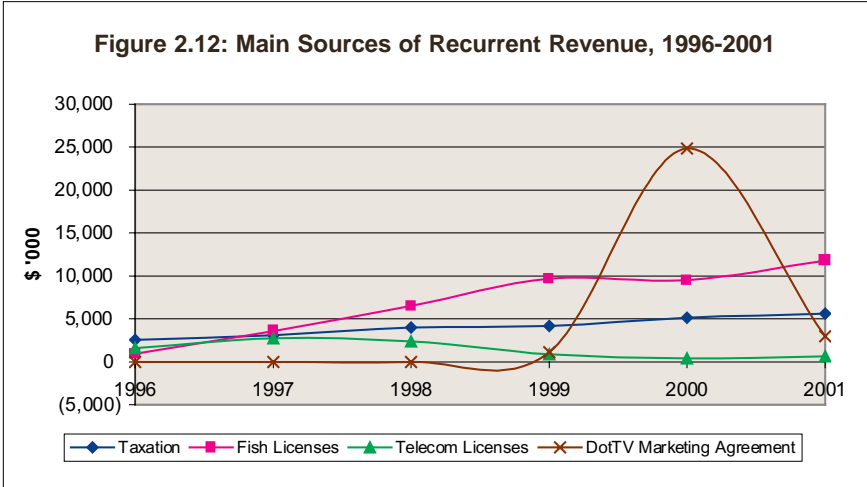


Source: Table A2.6.

Note: Data are exclusive of automatic distributions from the TTF A account to the CIF account.

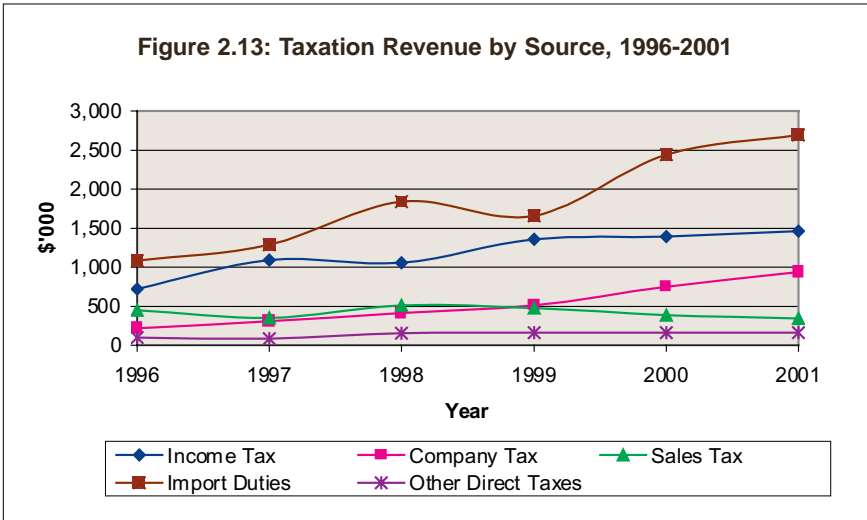
revenue from the DotTV marketing arrangement. Figure 2.12 shows movements in the main components of revenue in 1996 to 2001. Taxation revenue grew steadily as import duties, company tax, and income tax all rose (Figure 2.13). Fishing license fees increased, whereas telecommunications fees fell following nonrenewal of the agreement with the lessee (the lease was controversial because it involved telephone sex services).

Current grants from external assistance agencies are not shown in Figure 2.13, but were significant sources of finance in 1996, 1998, 2000, and 2001 (Appendix 1, Table A2.6). In 1996 and 1998, a European Union-supported Fuel Import Program provided recurrent budget support that involved external financing of diesel fuel purchased by the Government-owned Tuvalu Electricity Corporation (TEC). This created counterpart funds to be spent on health and education, and matching Government contributions to the TTF A account. The Program was replaced by a second budgetary support scheme, the Development Support Program, in 2000. This involves providing 1.9 million euros (about \$3.8 million) in three equal installments for 2000 to 2002, and



Source: Table A2.6.

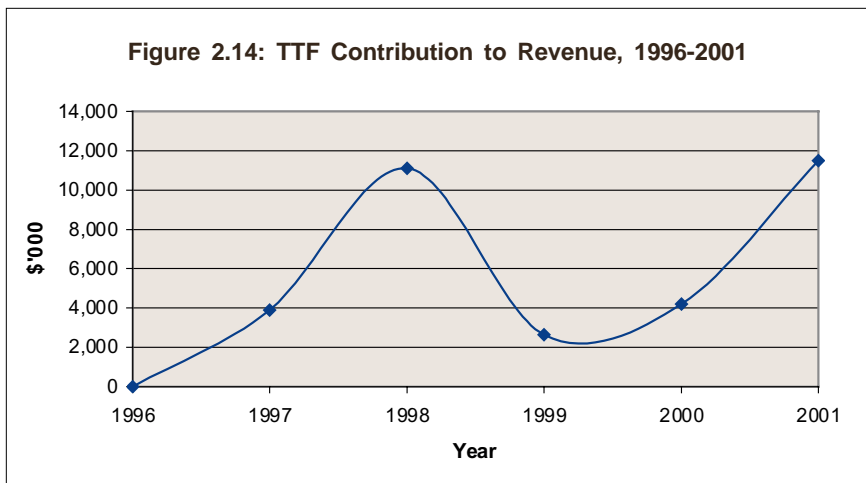
Note: Data are exclusive of automatic distributions from the TTF A account to the CIF account.



Source: Table A2.6.

operates like the Fuel Import Program. Budgetary support is provided to education, the environment, civil aviation, private sector development, and women in development. The consequent budgetary savings are to be transferred to the TTF A account. Grants from Taipei, China were also used for budgetary support in 2001.

As noted above in Box 2.1, TTF provides an important additional source of finance for public expenditure. Strictly speaking, the automatic distribution from the TTF A account to the Government-controlled CIF account should be shown in budget papers as a source of revenue; and drawdowns from the CIF account should be presented as a financing item below the line. The budget papers do not follow this procedure, instead presenting as "other revenue" a line item labeled "automatic distribution from TTF to CIF," which includes drawdowns from CIF. Most notably, for 2001, there was an automatic distribution of \$11.5 million shown, which was entirely a drawdown from the CIF account. That said, Figure 2.14 shows the automatic distributions from TTF to CIF as recorded in the budget papers between 1996 and 2001. Over the entire period, these distributions provided 21% of recurrent



Source: Table A2.6.

revenue (inclusive of the distributions), which compares with 19% between 1990 and 1996 (ADB 1998).

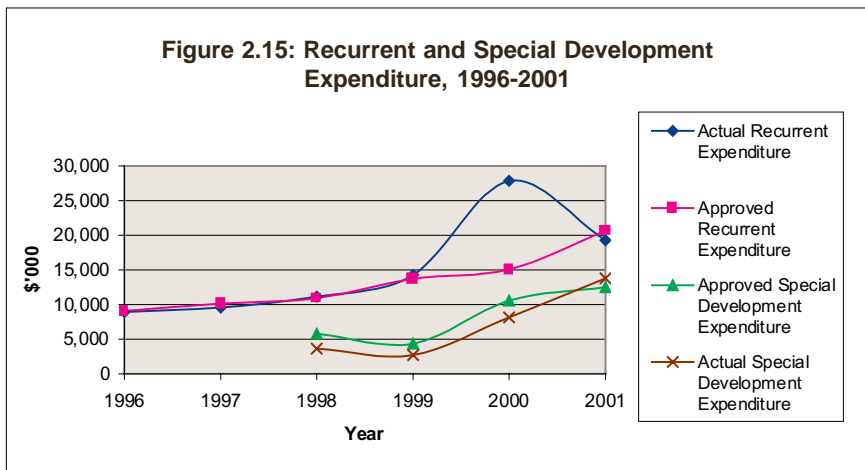
TTF's basic investment objective is to maintain the real capital value of the Fund by reinvesting the inflationary premium as measured by the Australian CPI. Since its beginning with start-up capital of \$26.4 million, the Fund has grown as a result of contributions from the Government and external assistance agencies. These contributions totaled \$8.8 million up to 30 September 1996 (\$7 million coming from the Government's reinvestment of CIF funds), and \$18.2 million between 1997 and 2001 (\$10.2 million reinvested from CIF, \$7.8 million from the Government's General Revenue Account, and \$0.16 million from donors). Augmentation of TTF capital could have been substantially greater had the majority of windfall revenue received in 2000 been allocated to this purpose.

The nominal annual rate of return on the A account between 1 January 1988 and 30 June 2000 averaged 12.2%, compared with an average annual rise in the Australian CPI of 3.2%, so that the objective of maintaining TTF's real capital value was achieved easily. By June 2000, the market value of the A account stood at \$65.3 million (TTF Board 2000). However, the downturn in global financial markets in 2001 adversely affected the market value of the A account portfolio, which was \$62.9 million at 30 September 2001, compared with a maintained value of \$67.1 million (TTF Advisory Committee 2001). Thus no automatic distribution in 2002 was possible. Also, in the context of investment management advice on TTF'S constitution and prospects, the Government needed to consider making contributions to the A account from more DotTV windfall revenue received in 2002 (Box 2.2).

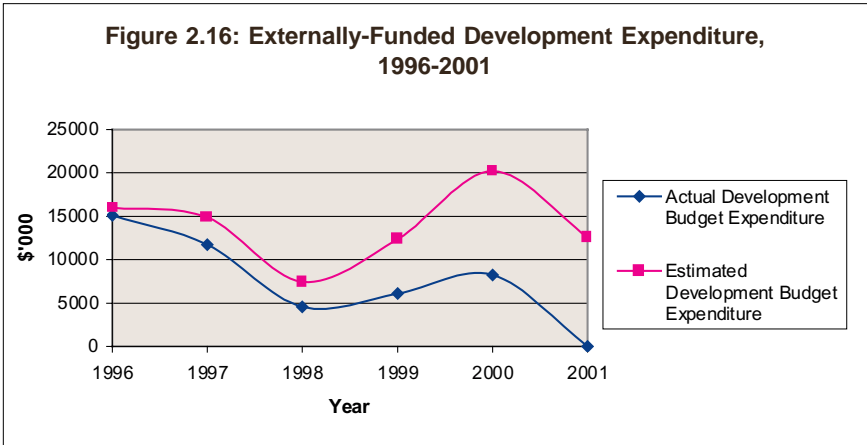
Figure 2.15 shows estimated and actual recurrent and special development expenditure between 1996 and 2001. Actual recurrent expenditure was close to budget estimates except in 2000, when it exceeded estimates because the windfall revenue from DotTV encouraged numerous supplementary appropriations. Special development expenditure fell well short of the estimated level, except in 2001. The

estimated versus actual paths of extra-budgetary development expenditure shown in Figure 2.16 demonstrate the long-established tendency to prepare ambitious, largely unfunded public investment programs. These would place impossible demands on absorptive capacity if they were fully financed.

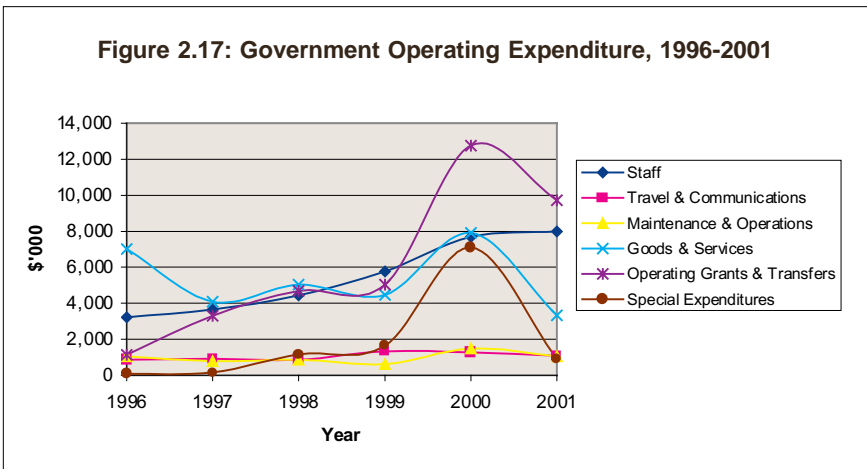
Figure 2.17 shows movements in the components of operating expenditure funded from all sources between 1996 and 2001. The striking features are the rise in the wage bill, the rapid growth in operating grants and transfers, and the growing importance of special expenditures, while expenditure on maintenance and goods and services tended to stagnate. The staff figures include wages and salaries of established, temporary, and casual government workers (including those in statutory utilities), and the statutory salaries and allowances paid to the Governor General, the Prime Minister, ministers, parliamentarians, the Attorney General, the Auditor General and the chief of police. The share of this item in total operating expenditure rose from 24% in 1996 to 33% in 2001.



Source: Table A2.6.



Source: Table A2.6.



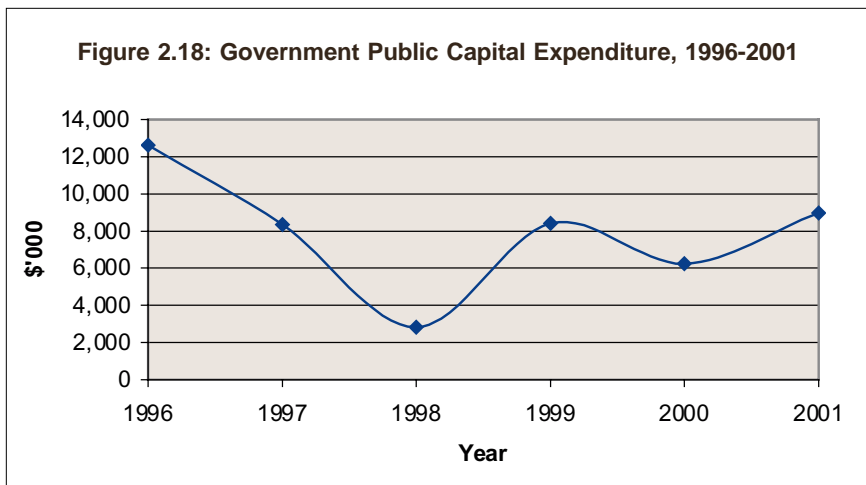
Source: Table A2.6.

The share of grants and transfers in operating expenditure rose from 8% in 1996 to 40% in 2001. This was partly attributable to an enormous expansion in preservice and in-service overseas scholarships (Chapter 5). Special expenditures include one-off payments that supposedly cannot be allocated elsewhere in the budget, including payments

of arrears, compensation, and special parliamentary committee expenses. Growth in such expenditures in 1999 and 2000 was concentrated in the Ministry of Finance and Economic Planning (MFEP), the Office of the Prime Minister (OPM) and the Ministry of Local Government, Women and Youth. Major items in 2000 were the Government's matching payments for the Falekaupule Trust Fund (FTF) and scholarship payments (Chapter 7).

Government purchases of goods and services which include school textbooks, teaching materials, and medical supplies fluctuated markedly between 1996 and 2001, falling from 52% of total operating expenditure in 1996 to 14% in 2001. Expenditure on maintenance halved its share of operating expenditure during the same period, to just 4%.

Public capital expenditure fluctuated between a high of \$12.6 million in 1996 to a low of \$2.8 million in 1998 (Figure 2.18). About two thirds of capital spending during this period was on construction, with the bulk of the remainder being purchases of plant and equipment.



Source: Table A2.6.

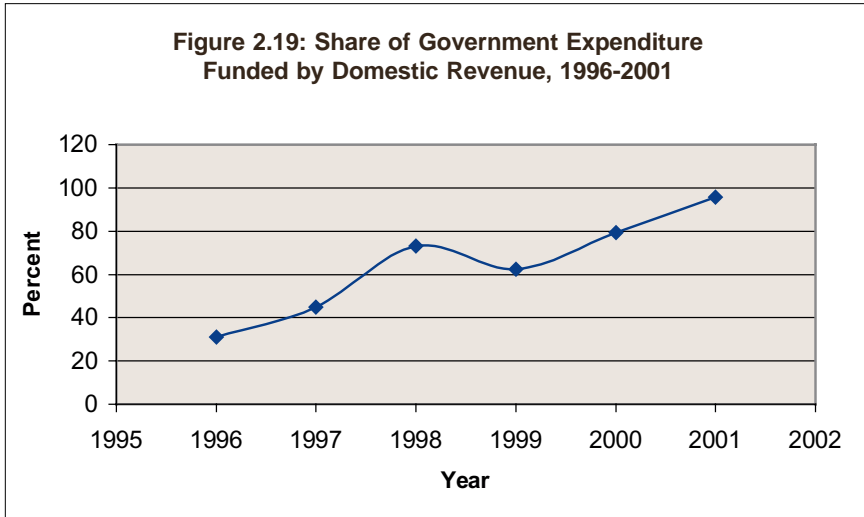
Over three quarters of total public spending between 1996 and 2001 occurred in the six ministries highlighted in bold in Table 2.6. Chapter 5 discusses expenditure by the health and education ministries.

Table 2.6: Administrative Classification of Total Public Expenditure, 1996-2001 (%)

Ministries	1996	1997	1998	1999	2000	2001
Office of the Governor General	0.4	0.3	0.4	0.3	0.2	0.3
Office of the Prime Minister	12.6	19.0	25.6	26.2	15.3	9.3
Legal & Judicial Services	0.4	0.7	0.9	0.9	0.6	0.6
Parliament	0.7	0.8	0.8	1.2	0.7	1.0
Office of the Auditor General	0.3	0.3	0.4	0.3	0.5	0.5
Finance & Economic Planning	6.7	5.4	12.6	11.5	7.2	5.5
Works, Communications & Transport	26.0	9.9	12.3	9.9	25.4	31.7
Health	5.9	6.9	8.5	7.0	5.9	5.5
Natural Resources, Energy & Environment	24.5	14.7	10.8	7.3	6.0	9.4
Local Government, Women & Youth	5.0	3.0	4.7	17.4	12.9	10.1
Police & Prison Services	2.9	3.1	3.2	3.0	2.3	2.7
Tourism, Trade & Commerce	1.6	1.2	0.8	1.3	1.8	1.3
Education, Sports & Culture	13.2	34.8	18.9	13.6	21.1	22.2
Total	100	100	100	100	100	100

Source: Table A2.7.

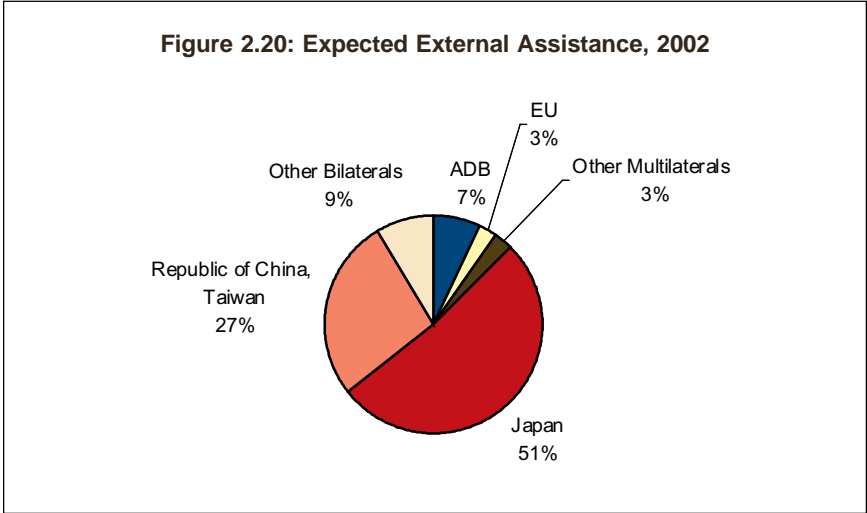
Figure 2.19 shows that the Government has funded an increasing share of its total expenditure in recent years, peaking at 96% in 2001. Special Development Fund expenditures that began in 1998 have substituted in part for development expenditure funded by external capital grants. These remained substantial until a reported zero XB expenditure in 2001; a year in which external current grants covered 4% of total public spending.



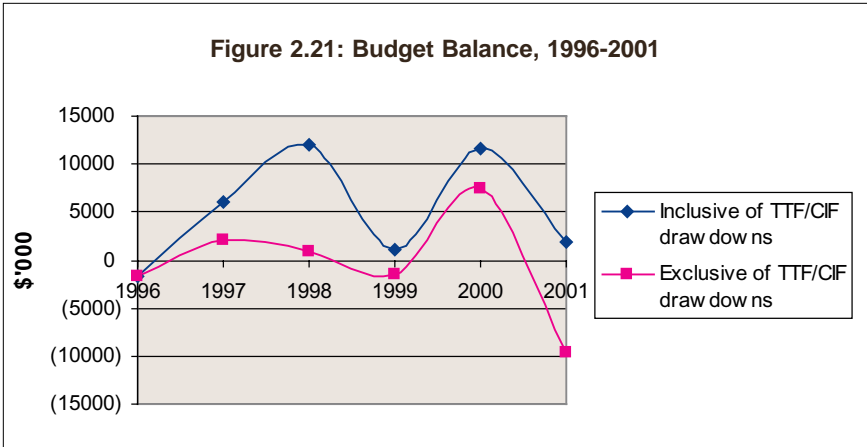
Source: Table A2.6.

The Government took a \$4 million concessional loan from the Asian Development Bank (ADB) in 1999 for establishing the FTF outer-island development trust fund (Chapter 7). The first and second tranches of the loan were released in 1999 and 2001, respectively. Figure 2.20 shows the distribution by agency of \$48.1 million in all forms of external assistance that was expected in 2002, which was (up from \$22.8 million in 2001). However, such numbers are not integrated with the public investment program presented in the budget, and are not elaborated or reported upon in any way. Specifically, the budget papers do not explain the reported zero level of externally-financed development expenditure in 2001, despite expectations of millions of dollars in external assistance that year. The relative contributions of Japan and Taipei, China in 2002 reflect their funding of the new hospital and Government buildings projects, respectively.

The overall budget balances, both inclusive and exclusive of TTF-related drawdowns, and exclusive of extra-budgetary grants and expenditure, are shown from 1996 to 2001 in Figure 2.21. The notable feature



Source: Tuvalu National Budget 2002.



Source: Table A2.6.

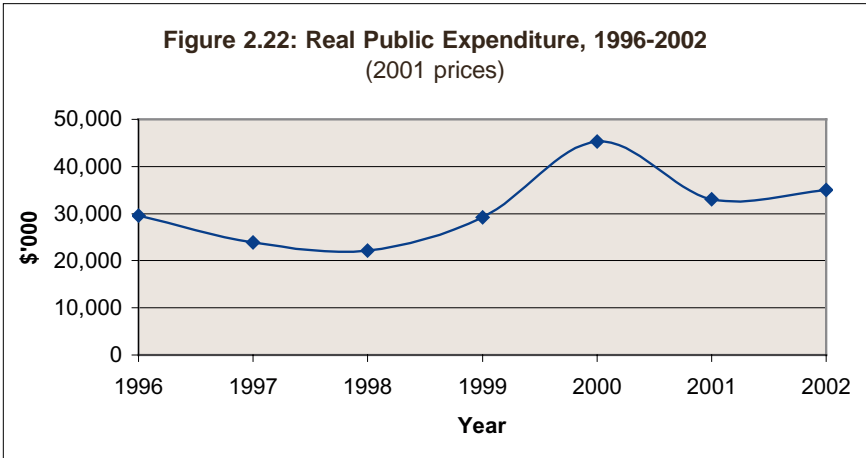
Note: Data are exclusive of extra-budgetary (XB) revenue and expenditure.

is the reliance on the CIF drawdown to finance a \$9.6 million budget deficit in 2001. At the end of 2001, the balance in the CIF account stood at \$7.2 million, which was under half the recommended target balance of four years of drawdowns to the core budget (TTF Advisory Committee 2001). The Government also remained in arrears on some payments: as of 31 March 2000 there was \$3.4 million in outstanding telephone bills (PAC 2001); and as of 31 December 2000 there was over \$1 million in unpaid debts to various domestic and international agencies (Tuvalu Audit Office 2001). In early 2002, there was an apparent need to reorder finances.

The 2002 budget was delayed until late February 2002 because of a change in Government that occurred in December 2001. The new administration said it intended "to pursue appropriate fiscal discipline" (GOT 2002) although the historical convention of confining core budget expenditure (\$20.2 million) to core revenue (\$15.5 million) was again ignored because substantial windfall revenues were expected, mostly from DotTV and fisheries licenses (Appendix 1, Table A2.6).

The published national budget for 2002 shows total operating expenditure to be 94% up on the 2001 level, primarily because of an increase in special expenditures from \$0.9 million in 2001 to \$24.5 million in 2002 (of which \$10.5 million was allocated to OPM, and \$9.3 million to the Ministry of Health). However, extra-budgetary development expenditure was incorrectly posted to this line item, and the true figure for special expenditures was \$3.3 million (TTF Advisory Committee 2002). With this adjustment to the figures approved by Parliament, operating expenditure was projected to rise by 6.5% in 2002. Capital expenditure was projected to be up almost 5% on the 2001 level, so that total (operating plus capital) expenditure was estimated to increase by 6% above the 2001 level (Appendix 1, Table A2.6). This represented a modest rise in real terms (Figure 2.22).

An overall budget surplus of \$10.2 million was projected for 2002. Of this amount, \$7.8 million was earmarked for equity injections into the TTF A account, leaving \$2.4 million to augment the Government's



Source: Table A2.6.

Notes: The figure for 2002 is the budget estimate, adjusted for posting errors in the official budget papers. Other years are reported actuals, deflated by the Funafuti CPI.

cash reserves. Larger contributions to the TTF A account in 2002 might have been considered to increase future core revenue flows; however, the Government announced its intention to investigate establishing a second, solely Tuvalu-owned fund in the United States.

Medium-Term Prospects

Activity in the market economy will continue to be concentrated in Funafuti and will be dominated by the public sector. In 2002, construction of a new \$9 million government office building and a new \$8 million hospital are scheduled to begin, while road reconstruction continues. New school classrooms are to be built in two of the outer islands. A slight increase in public service employment is projected as existing vacancies are filled. These developments will stimulate private sector activity, which generally is constrained by remoteness from markets, poor international transport links, and difficulties of access to

land. Growth in 2002 and 2003 is projected to be about 3%, with inflation of 1-2%.

Given the projected state of regional financial markets, no automatic distribution from TTF will occur in 2002 and any distribution in 2003 is likely to be relatively small. After the large windfall revenue in 2002 from the sale of DotTV Corporation, revenue from the marketing of the Internet domain address will be at least \$4.2 million annually (in early 2002 exchange rates). Fishing license fees are expected to be stable, although as noted in Chapter 6 the medium- to long-term outlook is uncertain. Public expenditure management needs to be conducted in the context of a medium-term perspective, to ensure fiscal sustainability.