

# Executive Summary

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## Introduction

Tuvalu's population of approximately 10,300 has a level of human development in the middle range of Pacific island countries and a low incidence of poverty. There is access to basic subsistence resources, and real GDP per head grew at the average annual rate of 3.7% between 1988 and 2001. Income from abroad has grown substantially in recent years, primarily through more Tuvaluan seamen working in the merchant marine, higher fisheries license fees, and increased revenue from marketing Tuvalu's Internet name DotTV.

Growth in the formal economy has concentrated on Funafuti with associated inequality of income distribution. Concern over this inequality has motivated efforts to develop the outer islands.

A new medium-term development strategy is needed. The *Kakeega o Tuvalu, National Development Strategy—1995 to 1998* which still serves as the Government of Tuvalu's (the Government) basic strategy document presents five priorities:

- (i) reforming the public sector;
- (ii) encouraging export-oriented business investment and overseas employment;
- (iii) improving economic infrastructure, particularly interisland shipping and telecommunications;
- (iv) promoting Education for Life (EFL); and
- (v) upgrading human settlements.

This Review investigates progress in achieving the development policy objectives of higher living standards and greater equality of income through implementing the five priorities.

## Macroeconomic Developments

Real gross domestic product (GDP) grew at an average annual rate of approximately 5% from 1988 to 2001, led mainly by the tertiary and Government sectors. The secondary sector expanded strongly, largely as a result of construction activity, while the primary sector grew sluggishly. Gross national disposable income has been substantially higher than GDP because of remittances from overseas workers, property income from overseas assets, and current transfers from abroad.

Available data suggest 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.

Inflation declined substantially in the 1980s and, after double-digit inflation in 1991, has since remained in the 0-6% range. The real value of civil servants' wages increased significantly between 1991 and 2001, although there is inequitable treatment of civil servants because all receive a housing allowance but only some obtain housing at subsidized rentals.

The National Bank of Tuvalu (NBT) has operated profitably, returning an average 58.3% on net assets before tax between 1990 and 2000, and contributing an annual average of \$507,000 in company tax and dividends to the Government. Relatively high interest spreads, fees, and commissions suggest that regulation is required to avoid excessive monopoly pricing that hinders private sector development.

The Tuvalu National Provident Fund (TNPF) membership grew from 1,136 in 1984 to 3,726 in 2000. 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. The Development Bank of Tuvalu (DBT) has had difficulties since it began in 1993, and by the end of 2000 had accumulated losses of \$1 million. A proposal to merge DBT with NBT should be revisited.

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Using the Australian dollar as currency in Tuvalu's ultra-small and open economy effectively eliminates monetary policy as an instrument for macroeconomic management. Total bank deposits grew at the average annual rate of 5.5% between 1990 and 2000.

Tuvalu's merchandise export base of copra, stamps, and handicrafts has diminished and imports have grown. The merchandise trade deficit and payments for freight and insurance continue to be covered by net private transfers, and fisheries and telecommunications license fees, investment income, DotTV revenue, and official transfers.

As a signatory to the Pacific Island Countries Trade Agreement (PICTA), Tuvalu is committed to tariff reduction. Import taxes in total have generated 55% of taxation revenue between 1996 and 2001, and 9% of total current revenue and grants. Any tariff reform therefore needs to consider the implications for Government revenue. The existing tariff system could be rationalized and its administrative costs reduced by

- (i) eliminating specific rates;
- (ii) reducing the number of ad valorem rates;
- (iii) combining import duties and sales tax; and
- (iv) levying duties on imports valued as cost, insurance, and freight (CIF), rather than as free on board (FOB).

Analysis of fiscal developments is hampered by the absence of reliable data. Between 1996 and 2001, actual recurrent revenue exceeded budget estimates, most notably in 2000 when windfall revenue was received from the DotTV marketing arrangement. Taxation revenue also grew as import duties, company tax, and income tax all rose. Fishing license fees grew strongly, whereas telecommunications fees fell following nonrenewal of the agreement with the lessee. Current grants from external assistance agencies were significant sources of finance.

The Tuvalu Trust Fund (TTF) provided additional revenue for public expenditure. Drawdowns into the budget from the TTF-related Consolidated Investment Fund (CIF) account provided 21% of recurrent revenue (inclusive of the drawdowns) between 1996 and 2001.

The nominal annual rate of return on the TTF A account from 1 January 1988 to 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. However, the downturn in global financial markets in 2001 lessened the market value of the A account portfolio, which was \$62.9 million at 30 September 2001.

Between 1996 and 2001, actual recurrent expenditure was close to budget estimates, except in 2000 when it exceeded projections as windfall revenue from DotTV encouraged numerous supplementary appropriations. Externally-funded development expenditure consistently fell far short of estimated levels.

The share of staff costs in total operating expenditure rose from 24% in 1996 to 33% in 2001, while the share of grants and transfers rose from 8% to 40%. Special expenditures including payments of arrears, compensation, and special parliamentary committee expenses jumped in 2000. Government purchases of goods and services fluctuated markedly, falling from 52% of total operating expenditure in 1996 to 14% in 2001. Expenditure on maintenance had its share of operating expenditure halved during the same period to just 4%. Public capital expenditure fluctuated between a high of \$12.6 million in 1996 and a low of \$2.8 million in 1998.

The Government has funded an increasing share of its total expenditure in recent years. Special development expenditures that began in 1998 have substituted in part for development expenditure funded by external capital grants.

A notable feature of overall budget outcomes between 1996 and 2001 was to rely in 2001 on drawdowns from the CIF account to finance a \$9.6 million budget deficit. At the end of 2001, the CIF account balance was under half the recommended target level. The Government also remained in arrears on some payments, and there was an apparent need to improve fiscal arrangements.

A new administration presented a delayed 2002 budget intended to pursue fiscal discipline, but it still involved core budget expenditure

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in excess of core revenue. Once adjusted for posting errors, the budget numbers projected a 6.5% rise in operating expenditure, an approximate 5% rise in capital expenditure, and a 6% rise in total expenditure. With substantial windfall revenues expected from DotTV and fisheries licenses, 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. Larger contributions to the TTF A account in 2002 might have been considered; however, the Government intends to investigate establishing a second, solely Tuvalu-owned fund in the United States.

Activity in the market economy will continue to be concentrated in Funafuti and will be dominated by the public sector. Growth in 2002 and 2003 is projected to be about 3%, with inflation in the 1-2% range. There will be no automatic distribution from the Tuvalu Trust Fund in 2002 and a relatively small distribution in 2003. Ongoing revenue from marketing DotTV will be at least \$4.2 million annually, while fishing license fees are expected to be stable. Public expenditure management needs a medium-term perspective to ensure fiscal sustainability.

## **The Role and Performance of Government**

Tuvalu is a parliamentary British-style democracy. Although ministers responsibilities are broadly defined in a schedule to the Constitution and elaborated in some cases in acts of Parliament, redefinition of roles and responsibilities is required.

Policy-making lacks direction, coherence, and coordination. There is limited capacity to provide policy advice to the Prime Minister and Cabinet members. A previous Prime Minister began the illegal practice of appointing special ministerial advisors from those parliamentarians not holding portfolios. The key Ministry of Finance and Economic Planning (MFEP) is limited in advising on policy, and reviewing policy priorities and resulting budgetary requirements.

A functional review of the needs of the Office of the Prime Minister (OPM), Cabinet, and MFEP would be a first step in strengthening OPM's and MFEP's capacities to advise on policy, develop a Government agenda, and resolve interministerial differences.

The civil service in 2001 had 822 positions, or about eight servants for every 100 people.

The civil service was disrupted by changes in Government between 1997 and 2001 leading to changes of ministers and movement of senior officials, with inevitable inefficiencies in policy formulation and implementation. In addition, efficiency has suffered with the service being scattered around Funafuti in small rented accommodation and increased numbers of in-service scholarships granted to servants in the late 1990s.

Progress in implementing the public sector reform program begun in late 1996 has been slow. A 1998 review proposed changes that Cabinet endorsed in January 1999. However, they remained unimplemented by mid-2002.

The effort to improve public financial management through output-based budgeting seems to have been introduced without diagnosing public financial management, and by erroneously assuming that establishing a performance orientation necessarily required a major change in the budget system. Also, costs of introducing the new system were not explicitly weighed against the purported benefits.

Nonetheless, Tuvalu's National Budget 2000 was introduced as "the first comprehensive output budget." The monitoring and reporting task was so large in relation to domestic capacity that it is difficult to see how it could be fulfilled. Lack of fulfillment inevitably undermines output budgeting, for there is no accountability without management reports, variance analyses, and consequences. Output budgeting could become no more than a ritualistic grafting of an output list onto the traditional line-item budget.

It is recommended that Tuvaluan authorities seek external technical assistance for assessing the budgeting and accounting system, and

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for formulating a strategic plan for improving public financial management. This would require obtaining diverse views and studying actual country experiences.

Private sector development can be encouraged if the Government

- (i) provides a stable macroeconomic environment;
- (ii) promotes education and technology; and
- (iii) invests in physical and institutional infrastructure (law and order, property rights, and contract and bankruptcy laws).

Tuvalu's rejection of a protectionist policy is inherent in its signing of PICTA in late 2001. While tariff reform is on the Government agenda, tax policy and administration are still to be reviewed. Reducing the company tax rate and introducing a tax-free threshold for company tax should be considered.

In early 2002, the Government was considering revising the 1996 Foreign Investment Act to help implement a national investment policy being prepared by a task force that was half-way through its deliberations.

The Government has committed to aligning the commercial legal environment with modern international practices to attract foreign investment. This will be achieved by reviewing commercial laws and prioritizing areas for reform and external technical assistance. The focus in Tuvalu should be on the Companies Act and business licensing.

For property rights, the short- to medium-term need is still to ease leasehold access to small land areas that potential domestic and foreign investors might need, and to ensure the rights are secure. This will require land surveys, title registrations, and dispute resolution for parts of urban Funafuti.

In Tuvalu, the private sector's main concerns are slow decisions and administration in the public sector. Improving public administration therefore is key to private sector development through reduced transaction costs.

## The Public Enterprise Sector

The focus of reform in the public enterprise sector is on improving the corporate governance of 10 government-owned public enterprises to ultimately increase resource productivity. Public enterprise management itself must be improved through transparent selection, training, and a focus on performance.

NBT is the only public enterprise that consistently returns dividends to the Government. But, its monopoly pricing disadvantages consumers and hinders private sector development. TNPF is to complete an effective management information system. The unprofitable DBT could benefit from merging with NBT for economies in administration and better Tuvaluan involvement in monetary activity.

The Tuvalu Electricity Corporation (TEC) generates and distributes electricity on Funafuti, Amatuku, and all outer islands. TEC has not prepared accounts for audit since 1995, and has not presented annual reports to Parliament as prescribed in legislation. TEC appears to operate at a loss; and while Funafuti's power supply is reasonably reliable by regional standards, generating capacity limits are now being reached.

The real price of power fell for households between 1990 and 2001, and rose for other user groups towards the end of the period. The substantial 2000 rise in rates for commercial users and the Government is an effective cost-recovery measure. Greater cost recovery will be essential for improving TEC's finances and reducing substantial Government subsidies. A service operating agreement between TEC and the Government should be negotiated and implemented.

The Tuvalu Telecommunications Corporation (TTC) provides direct dialing domestic and international telephone services, limited operator-assisted and phone card services, and facsimile, telex, and telegraph services. Internet and e-mail services are under OPM. Outer-island and intraFunafuti calls, suffer large losses while international calls are profitable.

The last audited set of TTC accounts is for 1998. TTC contributed

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\$60,000 to the Government in 1997, and received \$1.2 million in grants and aid between 1995 and 1998. The 1998 draft service operating agreement with the Government needs to be reconsidered and implemented.

The history of the Government's commercial fisheries arm, the National Fishing Corporation (NAFICOT), is one of decline in the 1980s, externally-assisted expansion in the early 1990s, and subsequent renewed decline. Net losses were made annually between 1994 and 2001. NAFICOT's draft budget for 2002 anticipates another year of loss-making. There is pressing need for greater accountability and transparency.

The Tuvalu Media Corporation (TMC) operates the national broadcasting service, but has submitted no reports or accounts since 1999. In 2000 and 2001, it relied on Government grants of \$234,750 and \$250,000 respectively, and part of a 2002 revenue shortfall is to be met by a third Government grant of \$100,000. TMC needs to offset future revenue shortfalls by improving and expanding its broadcasting services.

The Tuvalu Philatelic Bureau (TPB) profits from 1998 to 2000 were disappointing. TPB needs to increase market share, reduce sales returns and production costs, and contain operating expenses, particularly its wages bill. To reduce production costs and operating expenses, TPB could amalgamate with the Post Office.

The Vaiaku Lagi Hotel (VLH) reported losses from 1995 to 1998, even with Government grants of \$50,000 in 1995 and 1996. The Government should consider a management contract, although it must have the capacity to prepare and enforce it.

Tuvalu Maritime Training Institute (TMTI) operates a quality control system under International Maritime Organization standards. Its accounts for its first full year of operations (2001) report a small net surplus, but 98% of income was a Government grant, with course fees accounting for just 9%. Large annual cash injections from Government are expected, and upgrading TMTI facilities is to be funded by an Asian Development Bank (ADB) loan. Increasing the degree of cost recovery through fees, especially from seamen receiving in-service training, could be considered.

Tuvalu's domestic shipping is provided by two Government-owned vessels. Freight rates and passenger fares are well below levels that would permit operations to break even, leaving aside depreciation expenses. Continued subsidies seem inevitable, and should be transparent and justified by the quality of service provision they support. A first step in accountability would be to review the appropriateness of current performance indicators, monitor activities, and report on results.

International air services consist of twice-weekly flights by Air Fiji to and from the Fiji Islands. The Government is the largest single shareholder in the airline, and needs to work with the Government of the Fiji Islands to ensure Air Fiji is soundly managed.

## Human Development

Developing human resources through education has been prioritized since Tuvalu's independence in 1978. Regional comparisons of literacy consistently show Tuvalu in the upper quartile with 95% of its population literate. Ambitions to improve this figure and to educate and train its population in skills relevant to Tuvalu's economic and social goals remain key development objectives. For this, the EFL program was introduced in 1994 to provide compulsory quality education for all children to the age of 15 years. In 2002, EFL remains the Government's principal strategy for developing Tuvalu's human resources.

Tuvalu's basic education system consists of 2 years of preschool, 8 years of primary, and 4 years of secondary schooling. Private education is limited to a Seventh Day Adventist (SDA) primary school. In-country postsecondary training and education is confined to seamanship training at TMTI and a University of the South Pacific (USP) Center in Funafuti that offers distance learning. Overseas training remains the principal avenue for tertiary education for in-service and preservice students.

Between 1991 and 2000, national primary student enrollment increased by 21%. The rise reflects the addition of forms 1 and 2 to

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primary schooling under EFL. In 2001, there were 558 secondary enrollments. The teacher-student ratio has improved over the last 10 years: in mid-2002 standing at 18:1 for primary and 17:1 for secondary. The school curriculum and infrastructure have improved and the number of trained teachers has risen. Despite this, basic numeracy and literacy among primary students is declining, and the pass rate in the Fiji Junior secondary examination has fallen from 61% in 1991 to just 13% in 2001. A review of EFL planned for April 2002 had not occurred by mid-2002. The review will examine standards, teacher motivation, and management. Establishing school boards is worthy of consideration.

Plans to establish TMTI as a national center for technical and vocational education and training should consider the high risks of disrupting existing programs, and the negative impact this might have on the number and quality of graduates produced. The USP Extension Center and TMTI lack the capacity to satisfy all of Tuvalu's tertiary education needs. Consequently, the country relies heavily on overseas institutions for tuition, and on overseas governments for funding its students.

The Ministry of Education, Sports and Culture's (MESOC) share of the national budget from 1996 to 2001 fluctuated between 13% and 35%, growing in nominal terms at an average annual rate of 14.8%, while public expenditure as a whole rose at 12.2%.

Primary education absorbed 22% of MESOC's 2002 budget allocation. Salaries absorbed 84% of the Government's recurrent expenditure on primary education, and housing allowances for teachers accounted for a further 10%, leaving little for operations. Secondary education absorbed 16% of the budget allocation, with parents and guardians paying school fees and covering uniform and travel costs. The largest share (36%) of the education budget for 2002 was allocated to preservice scholarships.

The dramatic rise in the number of Government-sponsored overseas scholarship awards since 1999 has affected the Government's ability to function optimally. Many senior Government positions are vacant or

staffed by inexperienced personnel until incumbents return from training. Enforcing the bonding system would ensure that recipients of overseas scholarships return for at least 2 years of public service upon completing studies.

As a first step in solving education problems in the Pacific region, education ministers agreed in early 2001 on a Pacific Islands Forum Basic Education Action Plan which emphasizes different forms of secondary and vocational education, and nonformal education.

Tuvalu's population has a reasonable standard of health by comparison with other lower-middle income countries. The infant mortality rate has fallen from about 43.5 per 1,000 live births in 1990 to just 13.1 in 2000. Life expectancy has increased from approximately 57 years for men and 60 years for women in 1990 to 64 years for men and 70 years for women in 2000.

Acute respiratory infection was the most commonly notified illness in 2000, followed by diarrhea and conjunctivitis. Infectious and communicable diseases are under control. Medical staff report a rising incidence of hypertension, diabetes, heart disease, cancer, and obesity.

Environmental health indicators are mixed: 85% of Tuvalu's population reportedly has access to safe water, but most water needs boiling. Access to sanitation is lower at 49%, and there are some poorly constructed sanitation facilities on the outer islands.

One 45-bed hospital in Funafuti offers public referral and general health services. There is one clinic on each of Tuvalu's outer islands with a midwife, general nurse, nurse aide, and sanitary aide. Cases that cannot be treated domestically are referred to the Colonial War Memorial Hospital in Fiji, or to New Zealand under the NZ Medical Assistance Scheme. Fiji referrals are at Government expense. Plastic surgeon teams from Australia visit biennially. Traditional healers and several nongovernment organizations augment public medical services. There are limited private health services.

The share of health expenditure in total public expenditure fluctuated between 5.5% and 8.5% from 1996 to 2001, with nominal spend-

ing on health growing at the average annual rate of 9.2%, or about 6.6% in real terms. In 2002, staff costs absorbed 53% of the health operating budget, compared with 29% in 1996. Preventative services accounted for just 5% of 2002's health budget.

Any shift in policy emphasis towards curative service provision will have budgetary implications. And any lightening of the budget burden through greater cost recovery and encouraging of membership in voluntary health insurance schemes has implications for those unable to pay. The Government has a role to play in providing a social safety net for this group.

In 2002, the Government signed a \$10 million-\$11 million financing agreement for upgrading Funafuti's hospital. New buildings will be constructed and new equipment acquired. However, the project plan includes no high-temperature incinerator for disposal of hospital waste and no estimate of recurrent costs for effectively running a hospital.

## Social Policy

Tuvalu's social development policy lacks detailed strategies and requires a better quantitative database. A key feature of the policy expects families and nongovernment organizations to deliver most social support services, with the Government assisting where such resources are inadequate.

## Natural Resource Development

The Government supports subsistence agriculture by

- (i) preventing entry of pests and diseases;
- (ii) disseminating improved varieties and breeds; and
- (iii) supporting the copra industry through price subsidies.

A recent production slump, despite artificially high prices, suggests the copra subsidy is ineffective and should be terminated.

DBT has traditionally financed small-scale agriculture but, even with external agency and Government financial support, poor management has left it burdened with defaulted loans. Continuing the DBT function would be best done through a merger with NBT.

NAFICOT continues a range of activities that should be privatized. However, ice making, cold storage, and fish marketing should be retained as essential services. The Government also heavily subsidizes the community fisheries centers on the outer islands. To become viable the centers need to reduce operating costs through alternative management arrangements.

Fishing license fees extracted from foreign fleets are a crucial but unreliable source of Government revenue because of overcapacity in tuna fleets. Domestic production of fresh and canned tuna is unlikely to be commercially viable. Ratification of all existing treaties designed to govern tuna and other international treaties that affect Tuvalu, such as dumping at sea, would be to Tuvalu's long-term benefit.

Fish production from Funafuti lagoon should be monitored for signs of overfishing.

Tuvalu's tourism industry is very small and is likely to remain so, even with the potential for expanding ecotourism.

A comprehensive waste management system on Funafuti has been developed and trialed with bilateral assistance to manage household rubbish as well as industrial, hospital, and animal waste. A dispute over Government and Funafuti Town Council roles in waste management is threatening the system's efficiency. An early resolution is required.

For the Environment Unit to perform as expected, its human resource base needs strengthening.

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## Outer-Island Development

The Tuvaluan economy is dualistic with Funafuti's monetary economy dominated by the public sector and outer-island economies dominated by the subsistence sector. A Funafutian household's average weekly cash income and expenditure in 1994 were \$231 and \$177 respectively, compared with \$68 and \$57 amongst outer-island households.

Food and nonalcoholic beverages is the largest item of expenditure for both Funafutian and outer-island households. Funafutian homes are larger, but so are the households. Houses in Vaitupu are mostly metal-roofed with concrete walls and floors. Homes on the other islands are commonly of thatched roof with rib or coconut-screen walls and crushed-coral floors. Sanitation is mostly by flush toilets in Funafuti and water seal latrines on the outer islands. Outside tanks are the primary source of water everywhere.

All of the main settlement areas on the outer islands have access to diesel-fuelled electricity supply. Funafuti households have more electric appliances and more motorcycles and vehicles than outer-island households.

The extent of inequality between Funafuti and the outer islands is exaggerated if the focus is only on inequalities in cash income and expenditure, and differences in housing and household amenities. Nonmarket production per head is higher on the outer islands.

Island communities believe a better quality of life would result from improving the water supply, health system, housing, education, agriculture, roads, business development, and reef passage.

Increased autonomy for outer islands began in 1997 with the Falekaupule Act authorizing local government (kaupule), to design and implement island programs and projects. Community residents over the age of 18 may participate in community planning and decision-making.

The Falekaupule Trust Fund (FTF) had \$15.9 million by November 2001 for supporting decentralization.

The per capita shares in FTF are estimated at \$2,357 for Funafuti, \$1,885 for Nukulaelae, \$1,212 for Vaitupu, \$1,105 for Niutao, \$1,090 for Nukufetau, \$986 for Nui, \$925 for Nanumaga, and \$695 for Nanumea. The national goal of evenly balanced incomes and living standards across all island communities does not appear to have been assisted by FTF.

The first Fund distribution of \$613,579 was distributed to island communities proportional to their share-holding in FTF in 2001. The distribution formula, has been criticized by outer-island communities which want other criteria like population included.

The types of projects selected for funding appear unlikely to require the level of financial or economic analysis prescribed in the project profile guidelines the Government distributed. It appears the Government may phase out recurrent funding support for local government as the value of FTF rises. To resolve the issue the Government held several meetings, and decided to leave the distribution formula unchanged until 2005. In the interim it will match dollar for dollar all additional contributions from outer-island communities up to the level of the existing Funafuti per capita contribution.

Despite the failed attempt to shift education and agriculture to Vaitupu in the 1990s, the Government is again considering decentralizing its core departments to outer islands, particularly to Nukufetau and Vaitupu. A gradual and well-planned approach to any decentralization is required.

Clearing the airstrips on Nukufetau and Nanumea may promote outer-island development. Air services to these islands could be supported by improved shipping between the northern islands into Nanumea and between the central belt islands to Nukufetau.