

THE INTERNATIONAL DEVELOPMENT ASSOCIATION
AND
INTERNATIONAL MONETARY FUND

MALDIVES

Joint Staff Advisory Note on the Poverty Reduction Strategy Paper

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the International Monetary Fund (IMF)

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December 4, 2007

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I. INTRODUCTION

1. **The Maldives has made impressive development gains, as reflected in high average growth rates and improving human development indicators. Multi-party elections are planned for 2008. The Seventh National Development Plan, which the Government of Maldives (GoM) submitted as its Poverty Reduction Strategy Paper (PRSP), aims to continue on this path. In order to sustain progress, however, it will be critical for the GoM to strengthen the medium-term fiscal framework to mitigate macroeconomic risks, while sharpening the focus on effective development strategies.**

A. PRSP Context

2. **The economy rebounded strongly from the tsunami.** Real GDP growth averaged 7.5 percent over the past two decades, raising per capita income to about US\$2,800 and moving the Maldives well into middle income status. After contracting by 4.5 percent in 2005 due to the tsunami induced fall in tourism arrivals, the economy rebounded by 19.1 percent in 2006, and appears to have remained robust so far in 2007.¹

3. **Poverty rates, as measured by the headcount ratio, have fallen steeply, from 40 percent in 1997, to 28 percent in 2004, and further to 16 percent in 2005, continuing to fall despite the devastation of the tsunami.**² Other human development indicators, such as infant mortality, maternal mortality, or educational attainment, have registered similar improvements. The Maldives is on track to meet most of the Millennium Development Goals (MDGs), and has broadly met already the MDGs on eradicating extreme poverty and hunger, achieving universal primary education, reducing child mortality, improving maternal health, and combating HIV/AIDS, malaria and other diseases.³

4. **While poverty has declined sharply overall in recent years, vulnerability and inequality are a concern, as a significant number of people fell back into poverty, and the disparities between remote islands with small populations and the capital Male region remain substantial.** In the context of overall declining poverty rates, the poverty dynamics based on panel data limited to the atolls found that 11 percent of the

¹ The tsunami struck in December 2004. The damage was national in scope, estimated at the equivalent of 62 percent of GDP.

² The GoM reports these poverty rates in the PRSP based on a poverty line of Rf. 15 per day, which is equivalent to US\$1.17 using the nominal exchange rate, or US\$3.45 in purchasing power parity (PPP) terms. Using the international MDG poverty line of US\$1 PPP per day (estimated at Rf. 4.34 in the 2004 Vulnerability and Poverty Assessment), the headcount ratio is significantly lower, and fell from 9 percent in 2004 to 6 percent in 2005.

³ Millennium Development Goals—Maldives Country Report 2007, October 2007, Government of Maldives.

nonpoor in 1997 had fallen back into poverty in 2004, and 8 percent of the nonpoor in 2004 had slipped back into poverty in 2005. The most important factors in this regard are found to be levels of education, the size of the household, the gender of the head of household, and regional aspects, with people in the north most vulnerable. Although income inequality appears to have declined within Male and within the atolls during this period, inequality between atolls (the south has fared better than the northern regions), and between Male and the atolls has increased. The latter continues to induce migration to the Male capital area, worsening congestion and social issues.

5. **Further effort is also needed if the Maldives is to achieve the MDG on promoting gender equality and empowering women, as well as ensuring environmental sustainability and effective adaptation.** Female-headed households are more likely to be poor and vulnerable, and unemployment among women is significantly higher than among men. Environmental sustainability has been a core part of the GoM's development approach (evident in resort development and fishing practices, for example), but many of the critical environmental challenges faced by the Maldives, such as global warming threatening sea-level rise and coral bleaching, are beyond the GoM's control, making adaptation strategies essential. More effort is needed to increase access to improved water and sanitation facilities in the atolls.

6. **The PRSP covers the period 2006–10, and aims to address some of these structural challenges and chart a course to sustain the strong development trajectory of the Maldives. Emphasizing further poverty reduction and sustainable development, the PRSP is based on eight key principles: (i) national ownership, (ii) enhanced trust and confidence, (iii) economic opportunity for all, (iv) gender equality, (v) environmental sustainability, (vi) human rights, (vii) civil society participation, and (viii) results focus.** The strategy identifies 12 important goals and 88 targets across four areas: economic growth, social equity, environmental protection, and good governance. The PRSP places a strong emphasis on achieving the MDGs, and seeks to emphasize results, as well as noting the need to ensure initiatives are costed and consistent with resource availability. Strengthening social safety nets, fostering growth poles in the outer atolls, generating employment opportunities, especially for women, and encouraging population and development consolidation across islands, are key aspects of the GoM's strategy for overcoming the structural challenges noted above.

7. **The monitoring and evaluation systems underpinning the PRSP are generally adequate.** Although, the PRSP lacks specifics on implementation progress reporting arrangements, it is worth noting that for a small country, the systems for tracking poverty and other indicators are good, based on a series of vulnerability and poverty assessments (VPAs) (1997, 2004), a household income and expenditure survey (2002/03), a tsunami impact assessment following the same methodology as the VPAs for comparability (2005), censuses (2000, 2006), and other administrative data. Related reports and data are well disseminated on the Ministry of Planning and National Development's website.

8. **Consultations along thematic lines were held across the country, involving government ministries, atoll and island communities, and the private sector.** Civil society is nascent in the Maldives, and their participation and influence on the course of the PRSP was limited. The consultation process was also coordinated with the extensive consultations undertaken as a part of the United Nations Common Country Assessment of the Maldives, finalized in 2007.⁴ The PRSP was completed following a final consultative session in the capital.

B. Strengthening the PRSP

9. **In order to protect hard-won development gains, it is important for the GoM to strengthen the fiscal policy framework set out in the PRSP to ensure macroeconomic stability.** While growth prospects for the Maldives are favorable, the key challenge going forward is to ensure that they are supported by prudent fiscal policy. The economy has rebounded strongly since the tsunami, underpinned by solid tourism performance. The tsunami disaster, however, has led to a period of worsening fiscal management. While an increase in spending was warranted in the aftermath of the tsunami to alleviate pressing social needs, there has also been a significant rise in domestic expenditure unrelated to the tsunami. To sustain high growth over the medium term, it is important that fiscal policy be set on a more prudent path with a view to maintaining a stable macroeconomic environment that is conducive to realizing the Maldives' growth potential. It is also important in this context to enhance the realism of the budget process, so that the budget better reflects fiscal policy and expenditure priorities.

10. **While the PRSP could also be strengthened in other ways, staffs believe that two further areas warrant particular focus as the GoM moves forward with the implementation of its PRSP: (i) prioritizing institutional development and capacity building efforts, and (ii) elaborating the policy on population and development consolidation.** Staffs agree with the PRSP's emphasis on the need to strengthen institutions and enhance capacity, but these will need to be rationalized. Institutional development and capacity building in the areas of public expenditure and environmental management are especially important in the Maldivian context. The PRSP discusses the population and development consolidation policy to foster agglomeration of people and economic activity on larger islands as a central component of the GoM's development strategy. The policy needs to be elaborated in greater detail, however, ensuring that other GoM initiatives are consistent with encouraging consolidation, underpinned by extensive consultations with all stakeholders.

⁴ The consultative process is described in great detail in Annex 5 of the United Nations Common Country Assessment of the Maldives, finalized in 2007.

II. MACROECONOMIC FRAMEWORK AND POLICIES

11. **The PRSP could usefully provide more information to facilitate a macroeconomic assessment of government fiscal plans and the overall resource envelope.** While the PRSP includes fiscal projections extending to 2010, it lacks information on specific revenue and expenditure plans. It is also unclear whether the presented fiscal path is based on a medium-term expenditure framework that keeps spending within a projected resource envelope, and is fully endorsed by the GoM.⁵ While a comparatively large share of spending continues to be devoted to education and health, the PRSP could elaborate more on sectoral allocations and prioritization. Therefore, the PRSP could be significantly strengthened by developing a revenue and expenditure framework in support of the fiscal projections. Greater realism would also restore the role of the budget as an important policy instrument.

12. **Although sound macroeconomic policy underpinned the Maldives' strong development performance over the past two decades, the fiscal track record since the tsunami has deteriorated:**

- Domestic expenditures in the Maldives were comparable with those of similar island economies before 2004, but they have reached new highs in the wake of the natural disaster. Correspondingly, the fiscal deficit has deteriorated sharply, from 1.9 percent of GDP in 2004 to 10.9 and 7.3 percent of GDP in 2005 and 2006, respectively, requiring cumulative domestic financing of 10.3 percent of GDP during 2005–06. In particular, non-tsunami related expenditures have contributed significantly to this deterioration.
- The adopted 2007 budget envisaged a further increase in domestic expenditures accommodated by several new revenue measures. However, as these revenue measures are premised on a rapid resort-development schedule that may be difficult to achieve, staff cautioned during the recent Article IV consultation that this could lead to a substantial domestically financed deficit. Therefore, staff urged the authorities to restrain spending in line with realistic revenue projections. The GoM indicated that it would limit domestic spending in line with actual revenues. Most recent data suggest that expenditures are running below budget, and that the domestic deficit through October is 2.6 percent of GDP—well below the staff baseline projection of 9.0 percent for the full year. This favorable outturn partly reflects capacity constraints.

13. **The current account deficit widened from about 16.5 percent of GDP in 2004 to 40.7 percent in 2006, and is projected to remain broadly at the same level in 2007.** Although exports grew rapidly—supported by a quick recovery in tourism—imports also

⁵ The relevant tables note that the estimates were under review at the time of publication.

surged, mainly due to tsunami reconstruction efforts, construction activity relating to new resorts, and high oil prices. International reserves rose from US\$160.3 million at end-2003 to US\$232.2 million at end-2006, supported by foreign grants and increased foreign borrowing (and on-lending to the private sector) by commercial banks. External debt rose from 42 percent of GDP in 2003 to about 65 percent of GDP in 2006. The Debt Sustainability Analysis prepared by staff indicates that in the baseline scenario there will be an increase in debt ratios over the next couple of years as construction activity on resorts and public infrastructure is continued, followed by a gradual decline over the medium term.

14. **Based on the limited information in the PRSP, the government’s medium-term financing plan contains significant risks.** Compared to the staff scenarios presented during the Article IV consultation, the fiscal path of the PRSP falls short of the staff policy scenario to ensure sustainability, which projects an adjustment to a broadly balanced position over the medium term.⁶ As a result, the PRSP scenario resorts to large domestic financing over the medium term, compared to the staff policy scenario which avoids resorting to domestic financing.

Article IV vs. PRSP Fiscal Projections				
(In percent of GDP)				
		2008	2009	2010
Overall Balance	Baseline scenario	-15.4	-7.1	-1.0
	Staff policy scenario	-11.2	-4.0	1.8
	PRSP	-14.4	-10.0	-8.6
Domestic Financing	Baseline scenario	4.5	3.2	2.8
	Staff policy scenario	0.0	0.0	0.0
	PRSP ¹	5.8	4.0	3.4

¹ Based on information provided by the authorities, it is assumed that 40 percent of overall balance is domestically financed.

15. **The envisaged deficit financing in the PRSP carries risks for medium-term macroeconomic stability.** If expenditures are not kept in line with the available resource envelope, financing the large fiscal deficits will pose a significant challenge, with negative implications for inflation, private investment, growth, and external vulnerabilities:

- Deficits have traditionally been financed by borrowing from the Maldives Monetary Authority, which adds to pressures on inflation and the external

⁶ The baseline scenario and staff policy scenario are described in the *Maldives-Staff Report for the 2007 Article IV Consultation*, SM/07/207, IMF, which was concluded on July 30, 2007. The staff policy scenario envisages sufficient fiscal adjustment to ensure sustainability. The baseline scenario assumes much slower adjustment.

account. The government now also has the option of issuing T-bills, but the market is too thin to accommodate a large financing need, and would lead to a substantial crowding out of private sector credit.

- There has been a recent increase in debt ratios due to construction of new resorts and the government's ambitious infrastructure program. In the absence of a more prudent fiscal path, slippages could lead to deterioration in the macroeconomic environment and falling international reserves, thereby increasing external vulnerabilities.

16. **Staffs recommend that the GoM holds spending in line with available revenues.** Although changes in the governance arrangements culminating in the elections scheduled for 2008 complicate efforts to strengthen the macroeconomic and fiscal framework, progress would be significantly harmed if fiscal or balance of payments difficulties arise. The maintenance of a sound framework will be essential to underpinning further robust development performance and poverty reduction.

III. INSTITUTIONAL STRENGTHENING AND CAPACITY BUILDING

17. **The PRSP recognizes that weaknesses in the institutional framework and limited capacity pose major constraints to development in the Maldives. Efforts to address this need to be prioritized.** In most areas, ranging from providing health care to bolstering the judiciary, the strategy calls for the preparation of new legislation and other institution building measures, as well as redoubled training and education of professionals. Much of this is related to the small size of the Maldives, combined with its stage of development, where rising expectations associated with upper middle-income aspirations are placing elevated demands on the GoM for the establishment of more sophisticated institutional arrangements, and the provision of high quality public services. These initiatives will require spending, and as in other areas of the PRSP, they need to be prioritized to ensure sustainability, mindful that the civil service has already been growing rapidly in recent years, and that budgetary resources are limited. Staffs consider the areas of public expenditure and environmental management critical to sustaining robust development and poverty reduction. Implementing the provisions of the recently passed Civil Service Act and other related reforms will contribute importantly to addressing these challenges.

A. Public Expenditure Management

18. **Ensuring the effective deployment of public resources is especially important in the Maldivian context, and staffs recommend that related institutional arrangements and capacity continue to be strengthened.** With the GoM spending a high percentage of GDP since the tsunami, including the 2007 budget which aimed to spend the equivalent of over 90 percent of GDP, sound public expenditure management (PEM) cannot be over emphasized. Yet, capacity at all levels in the areas of budget preparation, financial management, procurement and audit is limited. Among other

factors, this is reflected in the inability of the GoM to implement the high spending budgeted (outturns were significantly lower than budgeted in 2006, a pattern that is likely to be repeated in 2007), and in delays in the preparation of audited statements, for example. Staffs encourage the authorities to give these areas greater priority than is apparent in the PRSP.

19. The GoM has sought to implement a Medium-Term Expenditure Framework (MTEF) since 2003, and while progress has been made, efforts need to be redoubled in order to sharpen this important budget preparation tool. The establishment of the Macroeconomic Coordination Committee (MECC) provided an important institutional mechanism to enable technical staff from across the GoM to coordinate and compile the data needed to make consistent macroeconomic projections and underpin revenue forecasts. The GoM needs to bolster the role of the MECC, improve the continuity of key staff, and use the MECC developed framework in order to strengthen the budget preparation process, including making an integrated set of revenue projections, charting a sound path for strategic fiscal policy variables, and developing budget ceilings by line ministry. Together with fiscal responsibility legislation, this would support greater fiscal discipline. A more prudent fiscal stance could be an important ingredient facilitating the transition to democracy in 2008, and avoid burdening an incoming government with a difficult fiscal legacy when many institutions and government functions will in any case be facing new challenges. The development of an MTEF would also help improve prioritization of the budget, strengthen the links between the capital and recurrent budget, and enhance coordination across spending agencies. Further, institutionalizing the MECC and training/retaining key staff are needed to make further progress. International development partners continue to support the GoM's efforts (the substantial TA loan recently agreed with the Asian Development Bank is particularly noteworthy). Progress in this area will be important to mitigating fiscal risks, improving expenditure allocation, and reducing vulnerability.

20. Staffs note that budget execution and monitoring is emerging as an increasingly important issue where institutional arrangements and capacity pose significant constraints. The passage of the Public Finance Act in 2006 and the introduction of the Public Accounting System were important steps toward strengthening public financial management and accountability, and a substantial change in the public financial management architecture is envisaged. To complete the accountability chain, the law also requires a timely audit, with reports being tabled by the Auditor General in the parliament through the Office of the President within five months of the end of the fiscal year, and then being made public. The independence of the Auditor General is provided for in the Audit Act of 2007. Much effort is needed to create, improve, and sustain the human resources skills of the Audit Office, however, in order to ensure adequate coverage and help it serve as an effective deterrent to corruption. Parliamentary oversight under the new Public Finance Act and Audit Act is also a new and evolving practice, and substantial capacity building is needed at the parliamentary level as well for this function to be effective. Finally, there is a need to strengthen the Anti-Corruption

Board, which was established in 1991 but has had limited resources at its disposal. The effort to enhance transparency, oversight, and accountability in order to underpin better public resource management depends critically on the effective implementation of the new institutional provisions, and the engagement of adequate human resources.

21. **With the GoM (including state-owned enterprises) undertaking substantial procurement of high value goods, equipment, and information systems, there is a heightened need to bolster procurement institutions and build the capacity of the civil service.** The importance of improving procurement practices for increased accountability does not receive adequate attention in the PRSP. In particular, enforcement mechanisms are lacking, and there is no independent complaints mechanism. There is an urgent need to develop the legal framework for procurement and an accompanying independent institutional framework for procurement oversight and monitoring. This includes establishing an efficient and independent procurement grievance mechanism. Human resources for sound procurement are also limited. There is a need to build a cadre of procurement-proficient personnel in order to enable line ministries to handle their own procurement, relieving some of the pressure on the few associated personnel within the Ministry of Finance and Treasury. Improving the retention of trained and experienced civil servants is also a key issue. Strengthening these core elements of sound PEM will be central to the GoM's efforts to bolster country systems, and ensure that public spending effectively underpins development and poverty reduction.

B. Environmental Management

22. **Economic growth has been accompanied by heightened pressures on the fragile Maldivian environment, and staffs urge the GoM to raise management capacity in order to meet growing environmental challenges.** Successive development plans have stressed the importance of sound environmental practices, in recognition that nature-based tourism and fishing indirectly account for almost 80 percent of GDP and underpin the livelihood of most Maldivians. While resort owners have a clear incentive to meet strong environmental guidelines and protect the pristine environment that draws their visitors, the ecological footprint of inhabited islands is growing. Dealing with sewage, solid waste, and other effluents emanating from settlements and fish processing plants, is an increasing concern. Staffs believe that technical, financial, and human capacity needs to be raised in order to deliver the required environmental infrastructure, as well as monitor and control environmental impacts. Baseline information on the status of habitats is lacking, and experience in scientific management methods is limited, although marine assets are a central pillar of the economy. The sensitive coral reefs are also essential protection from storm surges and climate change. Improving the monitoring and enforcement of environmental regulations is essential to safeguarding the Maldives' valuable environmental assets and promoting continued broad based income generation.

IV. POPULATION AND DEVELOPMENT CONSOLIDATION

A. Rationale

23. **The PRSP details a clear rationale for population and development consolidation (PDC), based on the need to reduce the unit costs of public service provision, generate economies of scale, and mitigate vulnerability associated with global warming.** The policy was first proposed in 1998, and is envisaged as a strictly voluntary movement facilitated by the GoM only when the whole community formally requests to move. Since the 2004 tsunami, four communities have been relocated, and several others are preparing to follow suit. One island community recently elected to move, with the island subsequently being leased as a resort. The lease payments were then partially earmarked to help defray the costs of relocation. Legislation on PDC is also being considered. Staffs agree that PDC is an important strategy to sustain progress, especially as the Maldives moves toward meeting upper middle-income aspirations, which will entail stepped-up demands for high quality education and health care, as well as requiring agglomeration to support more sophisticated economic activity. Staffs consider PDC an important vehicle for alleviating the need for increased capacity at the local level, and for adapting to environmental risks associated with tidal surges and climate change. PDC can also potentially play a central role in helping the poor and mitigating vulnerability. It should be emphasized, however, that resettlement is very sensitive, and widely felt progress will depend on careful implementation that reflects the concerns of all stakeholders.

B. Consultations

24. **While the rationale is clear, staffs encourage the GoM to clarify what the policy means on the ground, and undertake deeper consultations, given the noted sensitivity surrounding resettlement.** The risks facing different islands also need to be assessed more comprehensively, helping to prioritize the initiative. The communities planning to move hope for improved housing and public service provision. When implemented, this will imply higher outlays in the short term, offset by lower costs over the medium to long term. In the interim, it is unclear how plans of a future move will affect spending allocations now. Any current investment in immovable infrastructure, like a protected harbor, or improved public service, such as the expansion of a primary school up to the eighth grade, acts as a brake to relocation in the future. Yet equity concerns mean that the GoM is continuing to spend in all islands, apparently at cross-purposes with PDC, and increasing the burden on already strained public finances. The communities expected to receive relocated populations have also shown some ambivalence, especially following the tsunami when communities were relocated before infrastructure and services could be expanded, increasing the burden on existing facilities. Disparities in the provision of new housing to arriving families in communities where existing housing stock is of lower quality also give rise to potential frictions. Still, it is notable that the Tsunami Impact Assessment of 2005 finds that income and opportunities rise for the existing population on host islands, and that vulnerability to

slipping back into poverty is also substantially reduced through agglomeration. Greater community building efforts are needed to help develop a consensus around critical issues, like the trade-off between short- and medium-term priorities, in order to move the PDC process forward.

V. CONCLUSION AND ISSUES FOR DISCUSSION

25. **The Maldives has achieved notable development progress in recent decades through a combination of sound macroeconomic management, private sector-led tourism development, and improving public service provision. To sustain these achievements, it is important for the GoM to strengthen the fiscal policy framework set out in the PRSP.** The economic rebound from the tsunami was swift, and subsequent studies found that poverty continued to fall, with many communities registering substantial increases in income. Looking ahead, maintaining a sound fiscal path will be essential to mitigating risks and ensuring macroeconomic stability. The authorities will also need to shift their focus from recovery and reconstruction to medium-term development strategies. Building institutions and capacity in public expenditure and environmental management will be of particular importance in this regard, as will clarifying the specifics of PDC and undertaking greater consultations.

26. **If the GoM maintains domestic spending in line with revenues, the medium-term prospects of the Maldives are favorable, with continued strong interest in resort development by tour operators, improving human development indicators, and changes in governance arrangements deepening democracy and increasing accountability.** The PRSP helps chart a course for economic development, but needs to be placed in the context of a prudent fiscal framework and a sound, realistic budget process. Moreover, significant further efforts are needed to ensure successful implementation.

27. Do the Executive Directors agree with the broad directions of the Maldives's PRSP, and the staffs' recommendations for implementation, urging the GoM to strengthen the macroeconomic and fiscal framework, prioritize institution and capacity building, and elaborate and deepen consultations on the PDC?