



Report and Recommendation of the President to the Board of Directors

Project Number: 48361-001
May 2016

Proposed Programmatic Approach and Policy- Based Loan and Grant for Subprogram 1 Kingdom of Tonga: Building Macroeconomic Resilience Program

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CURRENCY EQUIVALENTS

(as of 18 April 2016)

Currency unit – pa'anga (T\$)

T\$1.00 = \$0.4563
\$1.00 = T\$2.1915

ABBREVIATIONS

ADB	–	Asian Development Bank
GDP	–	gross domestic product
IMF	–	International Monetary Fund
JPRM	–	joint policy reform matrix
MFNP	–	Ministry of Finance and National Planning
PEFA	–	public expenditure and financial accountability
PFM	–	public financial management
SDR	–	special drawing right
TA	–	technical assistance

NOTES

- (i) The fiscal year (FY) of the Government of Tonga and its agencies ends on 30 June. “FY” before a calendar year denotes the year in which the fiscal year ends, e.g., FY2016 ends on 30 June 2016.
- (ii) In this report, “\$” refers to US dollars unless otherwise stated.

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PROGRAM AT A GLANCE

1. Basic Data		Project Number: 48361-001	
Project Name	Building Macroeconomic Resilience Subprogram 1	Department /Division	PARD/PAUS
Country	Tonga	Executing Agency	Ministry of Finance and National Planning
Borrower	Kingdom of Tonga		
2. Sector	Subsector(s)	ADB Financing (\$ million)	
✓ Public sector management	Economic affairs management		1.00
	Public administration		2.00
	Public expenditure and fiscal management		2.00
	Reforms of state owned enterprises		1.00
	Total		6.00
3. Strategic Agenda	Subcomponents	Climate Change Information	
Inclusive economic growth (IEG)	Pillar 1: Economic opportunities, including jobs, created and expanded	Climate Change impact on the Project	Low
4. Drivers of Change	Components	Gender Equity and Mainstreaming	
Governance and capacity development (GCD)	Institutional systems and political economy	No gender elements (NGE) ✓	
Partnerships (PAR)	Public financial governance		
	Bilateral institutions (not client government) Implementation		
	International finance institutions (IFI)		
Private sector development (PSD)	Conducive policy and institutional environment		
	Promotion of private sector investment		
5. Poverty Targeting		Location Impact	
Project directly targets poverty	No	Nation-wide	High
6. Risk Categorization:	Low		
7. Safeguard Categorization	Environment: C Involuntary Resettlement: C Indigenous Peoples: C		
8. Financing			
Modality and Sources		Amount (\$ million)	
ADB		6.00	
Sovereign Program grant: Asian Development Fund		3.00	
Sovereign Program loan: Asian Development Fund		3.00	
Cofinancing		7.80	
Australian Grant - Grant		3.00	
European Union - Grant		2.80	
World Bank - Grant		1.00	
World Bank - Loan		1.00	
Counterpart		0.00	
None		0.00	
Total		13.80	
9. Effective Development Cooperation			
Use of country procurement systems		Yes	
Use of country public financial management systems		Yes	

I. THE PROPOSAL

1. I submit for your approval the following report and recommendation on (i) a proposed programmatic approach for the Building Macroeconomic Resilience Program, and (ii) a proposed policy-based loan and grant to the Kingdom of Tonga for subprogram 1 of the Building Macroeconomic Resilience Program.¹

2. The program aims to strengthen Tonga's long-term growth prospects and capacity to respond to external shocks. The programmatic approach, with three subprograms from 2016 to 2018, builds on the previous policy-based operations of the Asian Development Bank (ADB) and other partners to sustain government efforts to improve (i) its fiscal position by adopting prudent policies and better public financial management (PFM); and (ii) the business climate by continuing policy, regulatory environment, and public enterprise reforms. The programmatic approach allows sequencing of reforms across a broad range of reform areas, accounting for the limited implementation capacities of the small administration. Alongside ADB, the European Union, the Governments of Australia and New Zealand, and the World Bank are providing financing, and the International Monetary Fund has been part of the coordinated policy dialogue.

II. THE PROGRAM

A. Rationale

3. **Development context.** Tonga has about 104,000 people living across 750 square kilometers of land scattered over 700,000 square kilometers of the South Pacific Ocean. Tonga's economic growth in 2005–2014 has been low, highly volatile, and largely driven by the public sector. Gross domestic product (GDP) only grew by an average 0.7% during the period.² Natural constraints (remoteness, smallness, and dispersion), exposure to external shocks (natural and economic), and internal bottlenecks (thin capacity, small and intertwined networks, and migration) have undermined Tonga's economy. Tonga has the second-highest disaster risk in the world.³ Most recently, Tropical Cyclone Winston caused substantial crop and infrastructure damage in the Vava'u island group in February 2016, only 2 years after the Ha'apai island group was severely damaged by Cyclone Ian, mirroring a tendency toward more frequent and intense extreme weather events across the South Pacific.

4. **Political commitment to reforms.** A period of political transition from 2005 to 2009, which included a push for more democratic participation and an attempt by the government to reform the civil service, led to internal tensions and civil unrest. The resulting reconstruction needs and public wage bill spending strained the country's fiscal and debt positions, leaving Tonga in high risk of debt distress. Subsequent governments have worked to improve the situation by maintaining prudent fiscal and debt policies and reforming public enterprises and the business environment in order to increase private sector activity. These efforts improved Tonga's debt distress risk rating to *moderate* in 2013 and lifted Tonga into a leading position among Pacific countries, with high country performance assessment and ease of doing

¹ The design and monitoring framework is in Appendix 1. The program is included in Asian Development Bank (ADB). 2015. *Country Operations Business Plan: Tonga, 2016–2018*. Manila. It is aligned with ADB. 2009. *Pacific Approach, 2010–2014*. Manila; and ADB. 2015. *Interim Pacific Approach, 2015*. Manila. The concept paper was circulated to the Board of Directors on 22 July 2015.

² ADB. Statistical Database System. <https://sdbs.adb.org/sdbs> (accessed on 7 April 2016).

³ Alliance Development Works and United Nations University. 2015. *World Risk Report 2015*. Berlin.

business scores.⁴ The current government, which took office in January 2015 and is led by a democratically elected prime minister, advocates good governance and inclusive growth.⁵ Public policies are generally pro-poor and have helped Tonga achieve strong Millennium Development Goal outcomes and high human development.⁶

5. **Reliance on external assistance.** Tonga relies heavily on external support. In FY2016, cash and in-kind aid are expected to account for 54.8% of total revenue and grants, and remittances are projected to be 29.8% of GDP. While these inflows support the country's performance, they also create dependencies. If these inflows abate, as seen in the aftermath of the 2007–2008 food and fuel and global financial crises, sustainable service delivery, livelihoods, and human development could be at risk. This shows the urgent need to build macroeconomic resilience. The government recognizes the importance of identifying and implementing critical reforms that leverage public resources—via domestic resource mobilization, better resource allocation, and more efficient spending—and private financing to reduce external dependencies and improve future growth prospects. Policy-based operations play an important role in supporting the government.

6. **Government reforms.** In 2009, the government embarked on an ambitious multiyear, multisector reform program, focusing on both the public and private sectors. These reforms strengthened domestic resource mobilization, debt management, public wage bill management, PFM, the business regulatory framework (receivership and business registration), public service provision (electricity tariff reform and improved governance of public utility providers), and public enterprise portfolio management.⁷ Limited government capacity in each area requires spreading reform efforts across several government ministries, as well as prioritizing and sequencing reforms over several years. Despite thin policy-making and administrative capacity and a political economy environment with small, intertwined political and social networks that pose inherent risks to reform implementation, substantial progress has been made and successive governments have shown persistence.

7. **Volatile external environment and persistent fiscal deficit.** Benefiting from a positive external environment, including low global commodity prices, Tonga's macroeconomic position improved in FY2015. This contributed to low inflation and a narrowing current account deficit, expected at 1.9% of GDP in FY2016, despite increasing imports for investments in the 2019 South Pacific Games facilities, tourism, and government infrastructure. The outlook for Tonga is positive as expanding construction, agricultural production, and tourism are expected to uphold growth at 2.8% in FY2016 and 2.7% in FY2017 (Table 1). Despite these positive external and domestic developments, Tonga's fiscal position remains strained: fiscal deficits (excluding grants) averaged 9.2% of GDP in FY2011–FY2015,⁸ putting substantial pressure on continuous

⁴ International Monetary Fund (IMF). 2013. *Tonga Staff Report for the 2013 Article IV Consultation*. Washington, DC; ADB. 2015. *Annual Report on the 2014 Country Performance Assessment Exercise*. Manila; and World Bank Group. 2016. *Doing Business 2016: Measuring Regulatory Quality and Efficiency*. Washington, DC.

⁵ Government of Tonga, Ministry of Finance and National Planning. 2015. *Tonga Strategic Development Framework, 2015–2025*. Nuku'alofa; and Government of Tonga, Ministry of Finance and National Planning. 2015. *Budget Statement 2015/2016: A More Progressive Tonga*. Nuku'alofa.

⁶ United Nations Development Programme. 2014. *Human Development Report 2014—Sustaining Human Progress: Reducing Vulnerabilities and Building Resistance*. New York; and Government of Tonga, Ministry of Finance and National Planning. 2015. *Millennium Development Goals Final Report*. Nuku'alofa.

⁷ Overview of Past and Planned Policy Reform Actions, 2009–2018 details reforms implemented since 2009 (accessible from the list of linked documents in Appendix 2).

⁸ Details are in the Country Economic Indicators, Sector Assessment, and the IMF Assessment Letter (accessible from the list of linked documents in Appendix 2). The positive external environment and preliminary fiscal outcomes for FY2015 explain a more positive outlook compared with the IMF Assessment Letter.

external support (and/or domestic and external financing). Drastic cuts in capital and recurrent spending would be needed if aid flows abate. With public debt estimated at 51.3% of GDP in FY2015, Tonga is at moderate risk of debt distress and has limited capacity for further borrowing. The South Pacific Games preparations and major disasters pose substantial fiscal risks in the medium term.

Table 1: Fiscal Framework, FY2014–FY2018
(% of GDP if not otherwise indicated)

Item	FY2014	FY2015p	FY2016f	FY2017f	FY2018f
Central government finance					
Total revenue and grants (cash)	28.2	28.6	28.2	29.3	29.1
Total revenue	20.0	21.7	23.8	24.2	24.8
Tax revenue	17.3	18.9	20.8	21.4	21.8
Grants (cash)	8.2	6.9	4.4	5.1	4.3
of which: confirmed budget grants	4.3	3.2	2.4	2.2	2.1
in \$ million	19.2	12.8	9.8	9.3	9.3
Total expenditure (cash)	25.5	28.8	30.5	30.8	30.5
Current expenditure (cash)	24.8	25.5	28.1	27.9	27.8
of which: wages and salaries	11.5	12.0	13.8	13.6	13.5
in % of total revenue	57.4	56.2	59.0	55.9	54.4
Overall balance	2.7	(0.2)	(2.3)	(1.5)	(1.4)
in \$ million	12.2	(0.8)	(9.5)	(6.4)	(6.1)
Overall balance (excluding grants)	(5.5)	(7.1)	(6.7)	(6.6)	(5.7)
in \$ million	(24.6)	(28.5)	(27.8)	(28.1)	(24.8)
Total financing	(2.7)	0.2	2.3	1.5	1.4
Net external financing	(0.8)	0.6	1.2	1.4	1.6
of which: budget support	0.0	0.6	1.0	0.8	0.8
in \$ million	0.0	2.5	4.0	3.5	3.5
Net domestic financing	(1.9)	(0.4)	1.1	0.1	(0.2)
Memorandum items					
Real GDP growth	2.0	3.4	2.8	2.7	2.1
Consumer prices (period average)	2.1	(0.7)	(0.3)	0.5	1.2
Nominal GDP (in \$ million)	449.1	402.1	414.6	426.1	435.6
Public debt (external and domestic)	41.9	51.3	49.2	47.2	47.0
Debt service ratio	1.8	1.9	2.0	2.1	2.1

() = negative, f = forecast, FY = fiscal year, GDP = gross domestic product, p = preliminary.

Sources: Asian Development Bank; Government of Tonga; International Monetary Fund; and World Bank.

8. Tax increases on unhealthy food items and beverages, improvements in tax compliance, and reduced exemptions helped raise tax revenue from an average of 16.5% of GDP in FY2010–2012 to 17.8% in FY2013–FY2015. This trend is expected to continue over the medium term provided that reforms continue to be implemented. On the expenditure side, the large public sector wage bill has gradually increased from 11.4% of GDP in FY2012 to an expected 13.8% in FY2016, which risks crowding out spending on operations and maintenance and capital outlays, and could undermine implementation of policy priorities under the national development plan. The government has made continuous progress in strengthening Tonga's PFM systems and capacity, e.g., in planning, budgeting, and procurement, which is reflected in gradually higher public expenditure and financial accountability (PEFA) assessment ratings.⁹ Weaknesses in procurement, financial management, and audit continue to pose some fiduciary risk, and thin public sector capacity poses a lasting threat to maintaining and advancing achieved functionality. This also threatens effective service regulation, which is important in a small market like Tonga, where limited scope for competition can result in inflated consumer

⁹ Government of Tonga. 2007. PEFA Assessment. Unpublished; Government of Tonga. 2010. *Public Financial Management Performance Report: Kingdom of Tonga (Final Report)*. Nuku'alofa; and Government of Tonga. PEFA Self-Assessment. Unpublished.

prices. This is aggravated by incomplete regulatory frameworks, e.g., on competition and communication service regulation.

9. **Supporting the private sector and diversifying economic growth.** Tonga is the best performing Pacific country in the World Bank's Doing Business ranking, but its private sector is constrained by high cost structures, a small market, and the outward migration of limited skilled labor. In 2009, Tonga embarked on business environment reforms that have since led to substantial improvements to business licensing and secured transaction frameworks, which help minimize transaction costs for businesses and improve access to finance.¹⁰ However, progress has been slow on the business law side—the implementation of legal frameworks for bankruptcy, foreign investment, and contracting is still incomplete—because of extensive reform consultation needs and limited government capacity and technical assistance (TA) support. With the credit bureau inactive, reliable credit information is missing, which drives up the costs of extending credit to new customers.

10. **Improving the productivity of public enterprises.** After implementing a series of reforms focused on strengthening the governance framework of public enterprises, liquidating insolvent public enterprises, and increasing private sector participation in public enterprises in 2009–2015, Tonga's public enterprise portfolio became one of the Pacific's best performers.¹¹ However, fiscal costs and risks can still be reduced substantially, and public enterprises can contribute more to GDP. For example, public enterprises account for 16% of total fixed assets in the economy but contributed only about 6% to GDP in FY2014. Public enterprises in competitive sectors such as telecommunications continue to face stiff competition, which can pose a risk to public asset values in the medium term. Portfolio performance can be further improved through reforms to the governance and ownership structures of individual public enterprises, and service delivery arrangements that make use of private sector efficiencies.

11. **Continued reform.** The reform momentum must be sustained for Tonga to face its diverse challenges and allow fiscal and structural change to take root. The fiscal position must be made more sustainable through continued revenue and wage bill reform and prudent debt management. More efficient and effective PFM systems to make the best use of limited public resources—and reforms to strengthen competition policy, service, and labor market regulation—are vital to establish an inclusive, modern, and accountable state. Lastly, continual reform efforts to improve the business regulatory framework in order to attract foreign and domestic investment, improve financial sector functioning, and reduce the risk from ambiguous legal frameworks are essential to establish a more dynamic and inclusive economy, with increased private sector contribution to job creation, growth, and development.

12. **Partner support.** Development partners have been supporting the government along its reform path with policy advice, TA, and budget financing. Since 2011, reforms have been prioritized and sequenced through the joint policy reform matrix (JPRM) process—widely considered international good practice. This process regularly brings together key ministries and development partners to map out critical constraints, design policy and TA solutions, monitor their implementation, and provide budget financing. By strengthening country systems and facilitating partner harmonization and alignment, the JPRM increases aid effectiveness. The JPRM prioritizes public and private sector reforms under the government's multiyear,

¹⁰ IMF. 2015. *Tonga Staff Report for the 2015 Article IV Consultation*. Washington, DC. Details are provided in the Public Sector Management Assessment (accessible from the list of linked documents in Appendix 2).

¹¹ ADB. 2014. *Finding Balance: Benchmarking the Performance of State-Owned Enterprises*. Manila; Government of Tonga. *Public Enterprise Ownership, Performance Improvement and Divestment Policy*. Unpublished.

multisector reform program and covers budget support by ADB, the European Union, the Governments of Australia and New Zealand, and the World Bank. The International Monetary Fund has also been part of the coordinated policy dialogue under the JPRM. Jointly with the World Bank, ADB has been a lead partner in advancing JPRM discussions and is absorbing substantial reform coordination and transaction costs to avoid overburdening the small public administration and decision makers.

13. **ADB priorities and contributions.** ADB's sector priorities in Tonga are public sector management (including PFM and private sector development), energy, information and communication technology, and urban services (water, sanitation, and waste). ADB provides a combination of investment projects, TA, and policy-based programs to maximize development impact in these sectors. Within the JPRM process, ADB has provided budget support—some years jointly with other partners, some years alternating—to address development financing needs, cover the cost of reforms, and incentivize reform implementation. ADB is the leading TA provider in utility regulation, private sector development strategy preparation, business law and foreign investment framework reform, and public enterprise reform. It also contributes substantially to fiscal strategy preparation, financial sector development, and reforms of the civil service, PFM systems, the labor market, and the energy sector.¹² The reform outcomes supported through TA and under the program, including improved governance and efficiency of public enterprises, better service regulation, and improved public procurement and audit functionality, in turn positively impact and directly complement ADB's sector investments.

14. **Programmatic approach.** The proposed programmatic approach supports the government's reform program, building on two programs in 2009 and 2013. The three subprograms in 2016–2018 allow for reform sequencing while providing flexibility to respond to emerging opportunities and constraints.¹³ The programmatic approach is fully integrated with the JPRM dialogue and aligned with policy-based operations by the European Union, the Governments of Australia and New Zealand, and World Bank.¹⁴ The International Monetary Fund has been involved in the JPRM dialogue, although is not providing funding. The program incorporates past lessons to build a strong political reform consensus, limit reform to a few major actions, institutionalize a government–partner coordination mechanism, and adopt a medium-term view for institutional and structural change to take root.

B. Impacts and Outcome

15. The program is fully aligned with the Tonga Strategic Development Framework, 2015–2025 and its impacts (or national outcomes) of (i) more inclusive and sustainable growth and development; (ii) a more inclusive, sustainable, and dynamic knowledge-based economy; and (iii) more responsive good governance (footnote 5). The outcome will be an improved fiscal position and business environment in Tonga.

¹² ADB. 2013. *Technical Assistance for the Pacific Private Sector Development Initiative, Phase III*. Manila; and ADB. 2013. *Technical Assistance for Pacific Economic Management (Phase 2)*. Manila.

¹³ ADB. 2014. *Completion Report: Strengthening Public Financial Management Program in Tonga*. Manila; ADB. 2012. *Completion Report: Economic Support Program in Tonga*. Manila; and Independent Evaluation Department. 2015. *Corporate Evaluation Study: ADB Support to Small Pacific Island Countries*. Manila: ADB.

¹⁴ The World Bank's policy-based operation was approved on 16 March 2016. World Bank. Tonga First Inclusive Growth Development Policy Operation. <http://www.worldbank.org/projects/P155133?lang=en>. The Government of New Zealand is in the process of determining the amount of budget financing to be disbursed against the JPRM policy actions in FY2016, which is therefore not included as parallel cofinancing under subprogram 1.

C. Outputs

16. The program has four outputs. The first three outputs are fully aligned with the JPRM and continue the government's reform efforts supported by ADB and other partners since 2009.¹⁵ The fourth output reflects a response to damage caused by Tropical Cyclone Winston on the Vava'u island group in February 2016, which increased financing needs in FY2016. All 10 prior actions under subprogram 1 have been completed. Subprogram 2 has 10 tentative policy actions; subprogram 3 has 13.

17. **Output 1: Fiscal resilience supported.** This output aims to increase Tonga's fiscal resilience by updating the fiscal framework, generating more domestic revenue, stabilizing the public wage bill, and ensuring prudent debt management. Subprogram 1 continued tax regime changes related to health and environment through increases in selected excise and import duty rates (on fuel, alcohol, tobacco, and processed food items). It also supported the development, approval, and publishing of a new medium-term debt strategy for FY2016–FY2019, as well as cabinet approval of remuneration review recommendations as a first step in the government's comprehensive civil service reform program. Subprograms 2 and 3 continue tax reforms with the implementation of consumption and corporate tax review recommendations, as well as the civil service reform program. Subprogram 2 introduces a new relative salary structure in FY2017 that provides for fair remuneration, while subprogram 3 introduces a basic performance management framework. Together, these reforms will form an effective management instrument for government, help meet sustainable wage bill targets preset in the fiscal framework that is recalibrated under subprogram 2, and lay the foundation for a performance-based civil service culture. The stabilized wage bill will become more affordable through increases in tax collections, which will gradually free up resources for discretionary spending on infrastructure and social programs.

18. **Output 2: An inclusive, modern, and accountable state supported.** This output groups reforms in procurement, PFM, and regulation of utilities, services, and the labor market, which share the goals of promoting good governance and public sector functioning. Subprogram 1 continued past efforts to establish a centralized procurement system and introduced a revised set of procurement regulations, standard bidding documents, and a procurement manual. It also established the Audit Oversight Committee of the Cabinet to support timely and thorough implementation of audit recommendations. Subprogram 1 also supported new communication and communication commission bills that establish an independent regulator with powers to regulate communication services, as well as issue licenses and set fees. Subprograms 2 and 3 support the development and approval of a government accounting policy and a chart of accounts revision, as well as improved functionality of the financial management information system (commitment control, financial reporting, budget preparation, sales and receipts, and cash management). Subprogram 2 also supports the development and approval of a policy framework and action plan to strengthen institutional arrangements and capacity for service regulation across multiple sectors. Subprogram 3 supports the implementation of the action plan and the approval of a competition policy that is currently lacking. Lastly, subprogram 3 supports the approval of an employment relations bill, which aims to improve labor market functioning while safeguarding employee rights and reducing gender disparities.

19. **Output 3: A more dynamic and inclusive economy supported.** This output covers reforms to establish a supportive environment for private sector development and to improve

¹⁵ Overview of Past and Planned Policy Reform Actions, 2009–2018 provides detailed information on JPRM-supported reforms since 2009 (accessible from the list of linked documents in Appendix 2).

productivity of public enterprises, with the aim of boosting inclusive growth. Subprogram 2 supports the approval of a private sector development strategy to guide reforms over the medium-term. To increase access and affordability of finance, subprograms 2 and 3 support better credit information by mandating credit reporting to ensure universal use of the credit bureau and extending credit bureau coverage to nonbank credit providers such as utilities. Subprograms 2 and 3 also support (i) the approval of new foreign investment legislation and revised foreign investment regulations (including reserved and restricted lists, and work permit rules); and (ii) a bankruptcy policy and legislation to complete the insolvency framework. Subprogram 3 supports the approval of a contracting policy framework and the implementation of an entity structure that facilitates formalization of businesses. Subprogram 1 supported the development of a new policy and reform plan for public enterprise ownership, performance improvement, and divestment as a framework for continued reform. Initial implementation steps included the establishment of shared boards of directors for all public enterprises in a sector and the conclusion of a contract between the Tonga Water Board and a private business to outsource asset maintenance and pipe-laying services. Subprograms 2 and 3 each support the reform of at least two public enterprises in accordance with the new public enterprise policy. TA helps to identify reform candidates and the most suitable reform paths (e.g., privatization, outsourcing of activities, or restructuring).

20. **Output 4: Effective response to disasters supported.** Subprogram 1 supported the development and approval of a costed response plan, based on a post-disaster needs assessment, to guide an effective and efficient response to damage caused by Tropical Cyclone Winston. The response plan aims to alleviate the hardship and secure the livelihoods of the affected populations in the Vava'u island group, as well as increase future disaster resilience by building back better. Financing of \$1.0 million from ADB's Disaster Response Facility, funded by the Asian Development Fund, is provided under subprogram 1 to implement the response plan, particularly to address damage in the agriculture sector and rehabilitate infrastructure in Vava'u.

D. Development Financing Needs

21. Table 1 provides an overview of development financing needs over the expected duration of the programmatic approach in FY2016–FY2018. The fiscal deficit (excluding grants) in FY2016 is estimated at \$27.8 million (6.7% of GDP). Grants are expected to amount to \$18.2 million, of which \$9.8 million is in the form of confirmed budget support (\$3.0 million from ADB plus \$2.8 million from the European Union, \$3.0 million from the Government of Australia, and \$1.0 million from the World Bank—all of which are parallel cofinancing not administered by ADB), leaving an overall deficit of \$9.5 million (2.3% of GDP). In FY2016, budget support loans are expected to amount to \$4.0 million (\$3.0 million from ADB and \$1.0 million from the World Bank), with the remaining gap filled by concessional project loans and issuance of domestic bonds (Table 1). In FY2017 and FY2018, fiscal deficits (excluding grants) of \$28.1 million and \$24.8 million are expected to be covered by \$21.7 million and \$18.7 million in grants (of which \$9.3 million is in the form of budget support, including \$2.5 million from ADB each year), \$3.5 million in budget support loans, including \$2.5 million from ADB each year, and some external project financing (and domestic borrowing in FY2017).

22. The program is expected to contribute to increased tax revenue from an annual average of 17.4% of GDP in FY2011–FY2015 to at least 21.4% of GDP from FY2017 onward. As outlined in the development policy letter, the government's development expenditure program includes increased allocations to social sectors and for the maintenance of infrastructure, as well as an allocation to cover costs resulting from the introduction of a new salary structure as part of the civil service reform. Further financing needs stem from the government's response to

Tropical Cyclone Winston, particularly to address damage in the agriculture sector and rehabilitate infrastructure in Vava'u (Appendix 3).¹⁶

23. In line with financing needs, the government requested a single-tranche loan in various currencies equivalent to SDR2,125,000 from ADB's Special Funds resources (including \$500,000 equivalent allocated from the Disaster Response Facility funded by the Asian Development Fund) to help finance subprogram 1. The loan will have a 24-year term, including a grace period of 8 years, an interest rate of 1.0% per annum during the grace period and 1.5% per annum thereafter, and such other terms and conditions set forth in the draft financing agreement. The government also requested a single-tranche grant¹⁷ of \$3.0 million from the Asian Development Fund (including \$500,000 from the Disaster Response Facility) to help finance subprogram 1. The loan and grant proceeds will be used to finance the foreign exchange cost (excluding local taxes and duties) of items produced and procured in ADB member countries, excluding ineligible items and imports.¹⁸ The loan and grant proceeds will be withdrawn, upon effectiveness, in accordance with ADB's simplified procedure for disbursement of program loans.¹⁹

E. Implementation Arrangements

24. The Ministry of Finance and National Planning (MFNP) is the executing agency. The ministries of public enterprises, commerce and labor, revenue and customs services, and meteorology, energy, information, disaster management, climate change and communications; and the Prime Minister's Office are the implementing agencies. The Budget Support Management Committee, which leads the JPRM process, oversees program implementation and monitoring. It is chaired by MFNP's chief executive officer and comprises all implementing agencies and major development partners, including ADB. Subprogram 1 is implemented from October 2014 to June 2016. Implementation of subprogram 2 is tentatively scheduled from July 2016 to June 2017 and subprogram 3 is from July 2017 to June 2018, in line with the government's budget cycle. The policy matrix (Appendix 4) indicates the program framework, including the policy actions completed before Board consideration for subprogram 1, and those indicatively proposed for subprograms 2 and 3. Subprograms 2 and 3 will be submitted for Board consideration upon completion of the respective indicative actions. The JPRM process facilitates broad consultations on reform priorities, with the cabinet providing strategic guidance. Individual reform initiatives form part of existing sector strategies and are being discussed with private sector and civil society groups during program preparation and implementation.

III. DUE DILIGENCE

25. **Economic and financial.** Envisaged reform impacts include allocative efficiency gains from the rebalancing of expenditure from wage bill and debt servicing to priority areas, including operations and maintenance. Increases in domestic revenue and higher returns (or less drain) from more efficient public enterprises will gradually reduce future development financing needs. Increased macroeconomic resilience will reduce the negative impacts of external shocks,

¹⁶ Tropical Cyclone Winston Response Plan (accessible from the list of linked documents in Appendix 2). Loan and grant financing from ADB's Disaster Response Facility is earmarked to implement the response plan.

¹⁷ A country's eligibility for ADF grants under the revised grant framework is determined by its risk of debt distress. The latest debt sustainability analysis determined that Tonga had a moderate risk of debt distress and was therefore eligible to receive 50% of its ADF allocation as grants.

¹⁸ List of Ineligible Items (accessible from the list of linked documents in Appendix 2).

¹⁹ ADB. 1998. *Simplification of Disbursement Procedures and Related Requirements for Program Loans*. Manila.

including on growth and service delivery.²⁰ Private sector reforms are expected to impact growth and job creation positively. Strengthened utility and service regulation is expected to improve access to and the quality and cost of services—benefiting households and businesses.

26. **Governance.** Promoting good governance is a key priority of the new government. The government is implementing its PFM reform road map, FY2015–FY2019, which aims to close gaps identified in an external PEFA assessment in 2010 and a self-assessment in 2014 (footnote 9). Despite capacity limitations stemming largely from Tonga’s smallness, PEFA ratings have gradually improved. The government is assessed to have the ability to implement its budget, which is integral to the program’s success. Remaining weaknesses in procurement, accounting, financial reporting, and audit are addressed by the program’s policy actions, complemented by development partner TA. Tonga has taken steps to strengthen anticorruption measures, including the creation of a Parliament Standing Committee on Anti-Corruption in 2015, and is seeking to appoint the first anticorruption commissioner.²¹ ADB’s Anticorruption Policy (1998, as amended to date) was explained to and discussed with the government.

27. **Poverty and social.** The program will assist the government in building macroeconomic resilience, improving public service delivery, and promoting inclusive growth. A more resilient macroeconomic and fiscal position will reduce the impact of external shocks and allow the government to respond effectively while maintaining basic social services. Fair and efficient domestic revenue mobilization will increase funding and strengthen accountability relationships between taxpayers and the government, which are both essential for sustainable service delivery. Better prioritized and more efficiently executed public spending will have a positive impact on service delivery in the medium term. Service regulation is expected to have positive impacts on service access, quality, and costs. Private sector development is expected to create jobs—an important way to address income poverty in Tonga. While subprogram 1 is classified as having no gender elements, positive poverty and social impacts through better and more sustainable services and private sector job creation will benefit women equally.²²

28. **Safeguards.** In accordance with ADB’s Safeguard Policy Statement (2009), subprogram 1 is classified as category C for environment, involuntary resettlement, and indigenous peoples. Program activities will be confined to policy and institutional reforms, and none of the activities will result in or lead to involuntary resettlement, nor will they negatively affect indigenous people or the environment. Regular and close dialogue with stakeholders is carried out during program design and reform implementation.

29. **Risks and mitigating measures.** Major risks and mitigating measures are summarized in Table 2 and described in detail in the risk assessment and risk management plan.²³ PFM systems are assessed as strong and able to support mostly reliable services. The remaining fiduciary risks will be addressed through policy reforms and TA support. Integrated benefits and impacts of the program are expected to outweigh the costs.

²⁰ Macroeconomic resilience comprises fiscal health (i.e., manageable fiscal deficits and public debt levels), adequate public financial management systems and regulation for efficient and effective service delivery, sufficient cash and foreign reserves to respond to external shocks, and a growing and gradually more diversified economic base.

²¹ The Joint Policy Reform Matrix, 2015/16–2017/18 (accessible from the list of linked documents in Appendix 2) includes the appointment of an anticorruption commissioner to boost the government’s anticorruption efforts.

²² Summary Poverty Reduction and Social Strategy (accessible from the list of linked documents in Appendix 2). Women’s labor market access and rights, as well as transitioning women-run businesses into the formal sector, will be directly targeted under subsequent subprograms.

²³ Risk Assessment and Risk Management Plan (accessible from the list of linked documents in Appendix 2). The main risks are mirrored in the country risk assessment, which is part of ADB. 2015. *Country Operations Business Plan: Tonga, 2016–2018*. Manila.

Table 2: Summary of Risks and Mitigating Measures

Risks	Mitigating Measures
Commitment to good governance, prudent macroeconomic and fiscal management, and/or specific reforms weakens.	Continuous, intensive joint government–partner policy dialogue with decision makers and other stakeholders to develop joint reform expectations and uphold reform pressures and commitments.
Limited consultations between the executive and legislature and with other stakeholders put the passing of legislative reforms at risk.	Regular consultation on reform direction, through the joint policy reform matrix process, and on specific reform efforts with executive, legislature and the public are a critical program feature.
High staff turnover aggravates existing capacity constraints, which impedes reform implementation and policy coordination and formulation among government agencies.	Reform solutions need to balance benefits from improved systems and regulatory frameworks with additional capacity requirements to maintain them sustainably. Technical assistance provides short- and medium-term capacity supplementation to bridge gaps.
Lack of or delay in technical assistance to support reform design and implementation undermines the pace of reform.	Regular technical assistance coordination meetings among development partners to timely identify gaps in support, and mobilize and deploy resources.
External shocks undermine the revenue base and require increased spending and/or borrowing for reconstruction, and divert attention and/or capacity away from reforms.	Strengthening of the fiscal position through improvements to debt, revenue, and expenditure policy and administration. A more diversified and stronger private sector reduces external vulnerability as well. Additional partner assistance for large-scale disasters.

Source: Asian Development Bank.

IV. ASSURANCES

30. The government and MFNP have assured ADB that implementation of the program shall conform to all applicable ADB policies, including those concerning anticorruption measures, safeguards, gender, procurement, consulting services, and disbursement as described in detail in the loan and grant documents. The government has agreed with ADB on certain covenants for the program, which are set forth in the financing agreement.

V. RECOMMENDATION

31. I am satisfied that the proposed loan would comply with the Articles of Agreement of the Asian Development Bank (ADB) and, acting in the absence of the President, under the provisions of Article 35.1 of the Articles of Agreement of ADB, I recommend that the Board approve

- (i) the programmatic approach for the Building Macroeconomic Resilience Program;
- (ii) the loan in various currencies equivalent to SDR2,125,000 to the Kingdom of Tonga for subprogram 1 of the Building Macroeconomic Resilience Program, from ADB's Special Funds resources, with an interest charge at the rate of 1.0% per annum during the grace period and 1.5% per annum thereafter; for a term of 24 years, including a grace period of 8 years; and such other terms and conditions as are substantially in accordance with those set forth in the draft financing agreement presented to the Board; and
- (iii) the grant not exceeding \$3,000,000 to the Kingdom of Tonga, from ADB's Special Funds resources, for subprogram 1 of the Building Macroeconomic Resilience Program, on terms and conditions that are substantially in accordance with those set forth in the draft financing agreement presented to the Board.

Stephen P. Groff
Vice-President

9 May 2016

DESIGN AND MONITORING FRAMEWORK

Impacts the Program is Aligned with			
1. More inclusive and sustainable growth and development 2. A more inclusive, sustainable, and dynamic knowledge-based economy 3. More responsive good governance (Tonga Strategic Development Framework, 2015–2025) ^a			
Results Chain	Performance Indicators with Targets and Baselines	Data Sources and Reporting	Risks
Outcome Fiscal position and business environment in Tonga is improved	Programmatic approach Annual average, FY2017–FY2019: a. Tax revenue as a proportion of GDP increased to at least 21.4% Baseline: 17.4% (average, FY2011–FY2015) b. Public wage bill as a proportion of total revenue decreased to 55.0% or lower Baseline: 57.4% (FY2014) c. Vetted applications from foreign investors increased to at least 30 applications Baseline: 21 (FY2015) Subprogram 1 By the end of FY2017: d. Excise duty revenue as a proportion of GDP increased to at least 4.7% Baseline: 4.2% (average, FY2011–FY2014) e. Proportion of contracts above the small purchases threshold that are subject to open competition increased to at least 95% of the value of contracts awarded Baseline: 80% (FY2015)	a. IMF Article IV staff reports b. IMF Article IV staff reports c. Ministry of Commerce and Labour annual reports d. IMF Article IV staff reports e. Ministry of Finance and National Planning annual reports	Political commitment to good governance, and/or prudent macroeconomic and fiscal management decreases. External shocks (including disasters) undermine revenue base and require increased recurrent spending and/or borrowing for reconstruction. High additional spending and/or borrowing are required for infrastructure investments for the South Pacific Games.
Outputs^b 1. Fiscal resilience supported	Programmatic approach By the end of FY2018: 1a. Legal instruments for customs, excise, consumption, and corporate tax approved by the cabinet 1b. New public service remuneration structure and performance management framework implemented Subprogram 1 By the end of FY2016: 1c. Rate of fuel duty increased by 12% and other excise duty and import duty rate increases approved by the cabinet	1a. Copies of legal instruments, cabinet decisions 1b. Cabinet decisions 1c. Cabinet decisions	Political commitment to specific reforms decreases. Administrative commitment to reform implementation and compliance weakens. Staff turnover in the already capacity-constrained environment is high.

Results Chain	Performance Indicators with Targets and Baselines	Data Sources and Reporting	Risks
<p>2. An inclusive, modern, and accountable state supported</p>	<p>1d. New medium-term debt strategy adopted by the cabinet</p> <p>1e. Public service remuneration review recommendations approved by the cabinet</p> <p>Programmatic approach By the end of FY2018: 2a. Improved processes and systems for procurement, accounting, financial reporting, and audit implemented</p> <p>2b. New regulatory and policy frameworks for competition, communication, and utility services approved by the cabinet</p> <p>Subprogram 1 By the end of FY2016: 2c. Revised procurement regulations and standard bidding documents adopted by the cabinet</p> <p>2d. Audit Oversight Committee of Cabinet established</p> <p>2e. Communications and Communications Commission Acts passed by parliament</p>	<p>1d. Cabinet decisions</p> <p>1e. Remuneration review report and cabinet decision</p> <p>2a. Cabinet decisions, PEFA assessment</p> <p>2b. Cabinet decisions</p> <p>2c. Cabinet decisions</p> <p>2d. Cabinet decisions</p> <p>2e. Copies of legal instruments</p>	<p>Lack of coordination for policy formulation among key government agencies delays reform.</p> <p>Limited stakeholder consultations with the executive and legislature put the passing of legislative reforms at risk.</p> <p>Lack of or delay in technical assistance to support reform design and implementation undermines the pace of reform.</p>
	<p>3. A more dynamic and inclusive economy supported</p> <p>Programmatic approach By the end of FY2018: 3a. Legal instruments for mandatory and extended credit reporting issued</p> <p>3b. Policy frameworks and legislation for foreign investment, contracting (only policy framework), and bankruptcy approved by the cabinet</p> <p>3c. At least five public enterprises privatized, liquidated, substantially restructured, or services outsourced</p> <p>Subprogram 1 By the end of FY2016: 3d. Public enterprise reform policy and plan approved by the cabinet</p> <p>3e. Tonga Water Board concluded contract with a private sector business to outsource asset maintenance and pipe-laying services</p>	<p>3a. Central bank directives</p> <p>3b. Copies of draft legislation, cabinet decisions</p> <p>3c. Cabinet decisions</p> <p>3d. Cabinet decisions</p> <p>3e. Copy of contract</p>	

Results Chain	Performance Indicators with Targets and Baselines	Data Sources and Reporting	Risks
4. Effective response to disasters supported	<p>By the end of 2016:</p> <p>4a. Tropical Cyclone Winston Response Plan approved by the cabinet</p> <p>4b. Identified recovery activities in the Tropical Cyclone Winston Response Plan implemented</p>	<p>4a. Copy of response plan, cabinet decisions</p> <p>4b. NEMO implementation progress reports</p>	
Key Activities with Milestones Not applicable.			
Inputs Asian Development Fund (grant) \$3.0 million Asian Development Fund (loan) \$3.0 million			
Assumptions for Partner Financing^c European Union (grant) \$2.8 million (€2.5 million equivalent) Government of Australia (grant) \$3.0 million (A\$4.0 million equivalent) World Bank (grant) \$1.0 million World Bank (loan) \$1.0 million Total \$7.8 million			

FY = fiscal year, GDP = gross domestic product, IMF = International Monetary Fund, NEMO = National Emergency Management Office, PEFA = public expenditure and financial accountability.

^a Government of Tonga, Ministry of Finance and National Planning. 2015. *Tonga Strategic Development Framework, 2015–2025*. Nuku'alofa.

^b The first three outputs are fully aligned with the joint policy reform matrix pillars. Baselines for all output indicators are not applicable.

^c Several policy reforms across all three outputs, which are necessary to reach the outcome, are partner supported as outlined in the joint policy reform matrix in Appendix 4. The joint partner engagement in reform dialogue, and technical assistance and advisory across all three outputs, make it infeasible to split outputs by partner.

Source: Asian Development Bank.

LIST OF LINKED DOCUMENTS

<http://adb.org/Documents/RRPs/?id=48361-001-3>

1. Financing Agreement
2. Sector Assessment (Summary): Public Sector Management
3. Contribution to the ADB Results Framework
4. Development Coordination
5. Country Economic Indicators
6. International Monetary Fund Assessment Letter
7. Summary Poverty Reduction and Social Strategy
8. Risk Assessment and Risk Management Plan
9. List of Ineligible Items

Supplementary Documents

10. Joint Policy Reform Matrix, 2015/16–2017/18
11. Overview of Past and Planned Policy Reform Actions, 2009–2018
12. Tropical Cyclone Winston Response Plan

DEVELOPMENT POLICY LETTER

OFFICE OF THE MINISTER FOR
FINANCE & NATIONAL PLANNING

Reference: 350G/59



MINISTRY OF FINANCE &
NATIONAL PLANNING
NUKU'ALOFA
TONGA

7th April 2016

Mr. Takehiko Nakao
President
Asian Development Bank
Manila
PHILIPPINES

Dear President Nakao,

Re: Letter of Development Policy

In its recent past and present, the Kingdom of Tonga has been facing several significant developments. This includes the major political reforms in our country that provide for increased participation by our people and make reform processes more inclusive and open. It also includes increasingly complex global networks, for example for trade and aid flows, and technological changes that bring us closer to the world through better connectivity—physically and virtually through the advances in the field of information and communication technology. Lastly, it includes changes to our natural environment through climate change and related changes in weather patterns and natural disasters that threaten our very existence. All these present at the same time challenges and opportunities for our country and they have to be reconciled with and addressed in harmony with our traditional culture and values that we firmly believe are the basis for a higher quality of life for all Tongans.

In place since December 2014, Tonga's new Government is only the second democratically elected government following fundamental political reforms and the first democratic election in 2010. Honorable Samuela 'Akilisi Pohiva is the first people's representative to become Prime Minister, which has provided a renewed impetus to focus development on supporting the weakest members of our society to achieve a more progressive Tonga, supporting a higher quality of life for all. To achieve this, the new Government, in close consultation with all Tongans, has developed a new Tonga Strategic Development Framework, 2015–2025: A more progressive Tonga: Enhancing Our Inheritance, which provides overarching guidance for the public sector, private enterprises and civil society. At the core of this framework is its focus on inclusiveness and sustainability that we target throughout our actions in pursuit of growth and development.

The Kingdom of Tonga embarked on an ambitious reform program in 2009 in response to the global financial and economic crisis that severely affected our small, open economy. Reforms implemented to date have strengthened our public financial management systems, increased tax collections and improved public enterprise performance. Through the reforms, our debt position has stabilized, the allocation of public resources is more strategic and their use more efficient. Efforts to establish a more business-friendly environment have already led to tremendous improvements in the ease of doing business and further improvements to the investment climate are underway. Successive governments have been persistent in reform implementation, which led to substantial

achievements despite volatile policy-making and administrative capacity in our small country.

At the same time, we recognize that some of the reforms and the deep institutional and structural changes that come with them require time to take root. Tonga is in the middle of a long reform process at which end we see a modernized, performance-oriented and accountable public sector; a vibrant private sector that drives growth and employment; and a strong civil society with healthy social networks that uphold our traditional values and actively participate in political and reform processes. This path requires continuous reform efforts and commitment at all levels of government and our society more widely.

While on this path, we are prepared to encounter and overcome numerous challenges and setbacks. A combination of external factors that include exposure to natural disasters and economic shocks, our extreme remoteness from major markets, limited natural resources, a small population, and wide dispersion of population and land present a constant weight on our shoulders. While we have been able to cope with frequent external shocks in the past, these nonetheless leave us with a growth path well below what we could have achieved otherwise. In addition, they divert attention, capacity and financial resources away from our reform path, thereby requiring even greater efforts to maintain a stable and consistent policy framework and achieve results. While our risk of debt distress has been downgraded to moderate as a reflection of our successful reform efforts and cautious policy decisions, it still indicates that debt thresholds could be breached if there are external shocks or abrupt changes in macroeconomic policies. The recent depreciation of the Tongan pa'anga against the United States dollar and the Chinese renminbi significantly pushed up external debt in percent of gross domestic product reflecting this volatility. Increasing climate change effects present new, additional physical and fiscal risks—the reasons for our active advocacy in global fora for the needs of small island developing states including the Kingdom of Tonga.

In light of this situation, our close relationship with our development partners is ever more important and valued. Since 2011 the Government and major development partners have been working together through the Budget Support Management Committee and its joint policy reform matrix process to develop, implement and monitor reforms for us to advance on our development path. This year for the first time we have prioritized and sequenced reforms over a three-year period spanning our fiscal years from 2015/16 to 2017/18, which aims to address some of the reform volatility we encounter in our country as a whole and at policy and administrative levels in the public sector. The current fiscal year's budget support operations continue our close partnership between the Government of Tonga and some of its key development partners by providing not only fiscal resources to support public service delivery but also technical support to the development of sound policies and reforms that help us achieve our country's vision.

Aligned to the priority agenda of Government, the joint reform program aims at building macroeconomic resilience to support inclusive growth and improved living standards. We plan to achieve this through promoting good governance; an inclusive, sustainable and dynamic economy; and quality, affordable infrastructure and services for all.

In the first year of the three-year reform program, a newly introduced tax policy reform package will increase collections and incentives to consume healthy foods, whilst ameliorating adverse impacts. The approval and subsequent implementation of

remuneration review recommendations is a crucial step towards prudent public wage bill management. A new medium-term debt management strategy footed on thorough analysis will help manage debt levels and fiscal risks including from foreign currency exposure. Continued procurement reforms help embed and guide the recently established central procurement unit, while a newly established Audit Oversight Committee of Cabinet will scrutinize implementation of audit recommendations across all spending agencies. These efforts will be sustained and gradually advanced over the three year period, as outlined in the joint policy reform matrix.

Furthermore, we are committed to prudently manage fiscal risks that stem from the ongoing civil service reform and the South Pacific Games hosting in 2019, both of which have the potential to derail our targeted fiscal balances and debt position in the medium-term. Exemplary of our prudent fiscal risk management is the commitment to finance South Pacific Games investments without taking on new debt and a recent reduction in master plan scale, which resulted in a 25 percent cost reduction of the games.

Reforms to establish a sound foundation for a dynamic economy are critical for Tonga's development path. The new government prioritizes inclusiveness of growth to create decent employment opportunities across all of society, including for disadvantaged groups, and across all island groups. As a first step, Tonga will become a member of the International Labour Organization and adhere to its main labor conventions, based on which foundational employment relations legislation will be developed in subsequent years. Furthermore, analytical work has been initiated on several fronts in support of substantial private sector enabling reforms in the second and third year of the reform program. Resulting reforms to business law, foreign investment and in the financial sector represent some of the most significant program policy actions and aim to tap Tonga's growth potential.

Lastly, improving the delivery of basic service will benefit all Tongans. The first year's reform program includes the establishment of a regulatory function for communication services to promote their affordability and access, which will be complemented with broader regulatory reforms for utility providers, continued energy sector reforms and a new competition policy in subsequent years. Sustained public enterprise reforms will further increase efficiency and effectiveness in their operation and encourage private sector participation through public-private partnerships and outsourcing of functions.

On the fiscal side, expected outcomes of these reforms over the three-year period are an increase in domestic revenue mobilization as a proportion of gross domestic product, a reduction in public wage bill as a proportion of domestic revenue and improved value-for-money in public procurement. We also expect further improvements to the business environment resulting in increased interest from foreign investors in Tonga and growing private sector credit through a better functioning financial sector and business law environment, among others. In terms of infrastructure and service delivery, we anticipate consistently improving public enterprise performance and better regulation of goods and services, especially utilities.

These reforms are complemented by an ambitious development expenditure program under the new government, initiated through the government budget in fiscal year 2015/16 and expected to continue in subsequent budgets over the medium term. Social sectors remain

the spending priority of the new Government. As outlined in the Budget Statement and Budget Estimates for fiscal year 2015/16, new priority expenditure programs include:

- \$2.3 million equivalent (T\$5.0 million) to implement civil service remuneration review recommendations in 2015/16, complemented by rationalizing staffing through careful review of all vacant posts and proposed new posts, with the intention of better aligning staffing needs to required outputs, and reducing the overall staff costs.
- expansion of maintenance programs to protect government infrastructure, including additional allocations of \$0.9 million equivalent (T\$2.0 million) for primary schools and \$1.4 million equivalent (T\$3.0 million) for road maintenance.
- increased operational budgets for priority social sectors, including additional \$0.5 million equivalent (T\$1.0 million) for primary education.
- \$0.4 million equivalent (T\$0.8 million) to implement the National Disability Policy, and \$0.3 million equivalent (T\$0.7 million) for charitable organizations while an allocation of \$1.5 million equivalent (T\$3.4 million) will allow continued implementation of the existing social welfare scheme.
- \$0.5 million equivalent (T\$1.0 million) under the private sector initiatives fund to support youth development and micro finance for women.
- \$0.5 million equivalent (T\$1.0 million) in support of the electricity lifeline tariff to improve access and affordability for lower income groups.
- a new allocation of \$0.6 million equivalent (T\$1.4 million) for the Anti-Corruption Office and Ombudsman to function effectively and independently.
- \$4.5 million equivalent (T\$10.0 million) to further pay off the governments transfer value with the pension fund.

In our quest to promote more efficient and effective public spending, we are further reviewing expenditure of ministries and agencies to reduce excessive spending on non-priority items such as overseas travel, fuel, and utilities. Together with our ambitious domestic revenue targets, which contribute to reducing dependency on budget support over time, the 2015/16 budget and two-year forward estimates strongly reflect the development aspirations of Tonga.

The Government remains firmly committed to the three-year reform program encompassed in the joint policy reform matrix, which is instrumental to achieve the country's ambitious development targets. The Government looks forward to continued active engagement of its major development partners, including the Asian Development Bank and the World Bank, in Tonga's reform and development process.

Unexpectedly, but reflective of the high disaster risk in Tonga—with more frequent and intense extreme weather events, such as cyclones, droughts, and flooding, experienced in Tonga and across the South Pacific in recent years—tropical cyclone Winston caused substantial crop and infrastructure damages on the Vava'u island group on 19 February 2016. Our initial needs assessments carried out by the National Emergency Management Office with participation from government ministries and partners indicated that an estimated 2,700 people (18% of the population) were displaced and approximately 230 buildings, including houses, schools, Prince Ngu Hospital, and community and church halls were damaged or destroyed. Tropical cyclone Winston also destroyed farmlands and agricultural crops on a large scale and compromised the livelihoods of around 80% of Vava'u's population. Damages are currently estimated at about \$6.9 million, with over

80% inflicted on the agricultural sector, pushing affected populations in high risk of hardship.

The Government of Tonga has prepared a recovery plan to alleviate hardship and increase future disaster and climate change resilience through building back better of affected infrastructure and planting of more resilient crops. Our estimates indicate that government's recovery activities will create additional financing needs of about \$2.1 million equivalent (T\$4.7 million) in fiscal year 2015/16, in addition to resources reallocated within the government budget and partner support received and pledged in-kind. We have formally requested the Asian Development Bank's assistance to cover part of the increased financing needs through concessional financing of \$1.0 million from its Disaster Response Facility, which will finance part of the following recovery activities:

- \$0.3 million equivalent (T\$0.6 million) to rehabilitate agricultural crops, with a first phase of replanting that focuses on fast yield crops such as sweet potato, corn and leafy vegetables;
- \$0.5 million equivalent (T\$1.0 million) to build back better 3 Government Primary Schools (GPS Taao, Holonga and Houna);
- \$0.2 million equivalent (T\$0.3 million) to rebuild and retrofit damaged community halls that are used as evacuation centers; and
- \$0.1 million equivalent (T\$0.3 million) to recruit an Early Recovery coordinator for 3 months and an Early Recovery Advisor based for 12 months in Vava'u supporting the District Emergency Management Committee at the Office of the Governor.

We would like to thank you for your messages of sympathy and support following tropical cyclone Winston and greatly appreciate your urgent attention to our request to help the Government bring back normality to and safeguard livelihoods of the thousands of people impacted by the cyclone.

Yours sincerely,




Aisake Valu Eke
Minister for Finance and National Planning

POLICY MATRIX

Reform area	Policy Objectives	Subprogram 1 Actions Accomplished (FY2015/16)	Subprogram 2 Milestones (FY2016/17)	Subprogram 3 Milestones (FY2017/18)
I. SUPPORTING FISCAL RESILIENCE				
Fiscal strategy Gov't lead: MFNP Partners: ADB, IMF, PFTAC, WB	Improved fiscal sustainability and resilience, and public expenditure effectiveness		1. Cabinet has approved a transparent, target-based fiscal anchor system and monitoring framework	
Revenue Gov't lead: Ministry of Revenue and Customs Services Partners: PFTAC (lead), WB	Improve tax compliance, revenue collection, and incentives for healthier living	1. Increase in the rate of fuel duty by 12% and other excise duty and import duty rates in order to improve revenue mobilization and strengthen incentives to consume healthy foods¹	2. Cabinet approval of recommendations of a review of the consumption tax regime to identify how it could be tightened to reduce losses from exemptions and begin to implement the agreed action plan	1. Implement recommendations of a review of corporate tax legislation to improve tax performance
Debt Gov't lead: MFNP (Debt unit, senior management) Partners: WB	Ensure prudent and least cost borrowing to (1) maintain manageable debt and debt service levels, and (2) improve economic and disaster resilience	2. Cabinet has approved a new Medium-Term Debt Strategy which has been made public		
Public service management reform Gov't lead: MFNP Other gov't agencies: Remuneration Authority, PSC Partners: ADB, WB (lead)	Establish a fair and fiscally affordable remuneration system linked to good performance and reduce share of wage bill in total government spending over time	3. Cabinet approval of remuneration review that aligns with the aggregate fiscal targets and which includes a new relative salary structure that ensures fair and appropriate remuneration based on a robust analytical assessment	3. Implementation of a new public service remuneration structure to ensure adequate pay and is consistent with fiscal target to reduce share of wage bill in total government spending over time	2. Cabinet approval of a new public service performance management framework

¹ Excise duty on alcohol and tobacco has been increased, a new excise duty on instant noodle implemented, import duty on turkey tails increased to 15% and import duties on various fruits, vegetables and fresh fish decreased.

II. SUPPORTING AN INCLUSIVE, MODERN AND ACCOUNTABLE STATE				
Procurement Gov't lead: MFNP (Procurement Unit) Partners: DFAT (lead), WB	Improved service delivery through value-for-money and timely procurement of goods and services	4. Cabinet has approved a revised set of Procurement Regulations, and prepared standard bidding documents and procurement manual in support of the Regulations		
Financial management, accounting, reporting and audit Gov't lead: MFNP (Treasury, budget) Partners: ADB, DFAT, PFTAC (lead)	(1) Improve functioning of IFMIS for better reporting, budgeting and funds control; and (2) audit to systematically contribute to improved financial management	5. A new Audit Oversight Committee of Cabinet established that (i) maintains a comprehensive database on past audit recommendations and follow-up actions, and (ii) reports regularly to Cabinet, with the aim of ensuring timely and thorough follow-up of audit recommendations	4. Development and approval of a government accounting policy	3. Implementation of revised Chart of Accounts to improve reporting for line ministries 4. Activate and add key IFMIS modules, such as budget preparation, sales and receipts, cash management
Utility and service regulation Gov't lead: MEIDECC, MCL, MPE Partners: ADB, WB	Improved access and affordability of utilities (e.g., electricity, water and waste) and other goods and services (ICT) through effective and efficient regulation	6. Parliament has approved a new Communications Act and a Communications Commission Act that will establish an independent regulator	5. Cabinet approval of a policy framework and action plan to strengthen institutional arrangements and capacity for regulation across multiple sectors	5. Implementation of action plan to achieve efficient and effective regulation across multiple sectors 6. Cabinet approval of a competition policy
Labour market Gov't lead: MCL Partners: ADB, ILO (lead), WB	Establish foundational employment legislation that will increase labour market functioning while safeguarding employee rights			7. Employment Relations Bill that, among others, reduces gender disparities approved by Cabinet for submission to Parliament
III. SUPPORTING A MORE DYNAMIC AND INCLUSIVE ECONOMY				
Private sector development strategy Gov't lead: MCL Partners: ADB	Provide government and the private sector with a prioritized and sequenced reform agenda to promote private sector development and job creation		6. Cabinet approval of a prioritized and sequenced private sector development strategy that supports inclusive growth and economic participation of women, youth and disabled	

Financial sector development Gov't lead: MCL Partners: ADB, PFTAC, WB	Increase access and affordability of finance through better credit information		7. Issuance of central bank directive to mandate credit reporting in order to ensure universal use of credit bureau reduce costs of due diligence and thereby support access to finance for SMEs and individuals	8. Extension of credit bureau coverage to non-bank credit providers, such as utilities
Business law reform, including foreign investment Gov't lead: MCL Partners: ADB	(1) Reduce risks and costs of doing business through formalization of the business regulatory framework; and (2) attract foreign investment to promote growth and create jobs while safeguarding national interests		8. Foreign investment legislation approved by Cabinet for submission to Parliament 9. Cabinet approval of a policy on bankruptcy	9. Cabinet approval of revised foreign investment regulations, including reserved and restricted lists, and work permit rules 10. Cabinet approval of a contracting policy framework 11. Bankruptcy legislation approved by Cabinet for submission to Parliament 12. Implementation of an entity structure that facilitates transition from informal to formal businesses, with a focus on women-run businesses, based on the findings of an analytical assessment

Public enterprise reform Gov't lead: MPE Partners: ADB	(1) Affordable services delivered by efficient and financially viable public enterprises under effective governance and management; and (2) increase private sector participation and expertise to improve management of public enterprises	7. Cabinet tasks MPE to implement the Reform Plan of the new PE Ownership, Performance Improvement and Divestment Policy 8. Cabinet has approved the appointment of shared boards of directors, in accordance with the PE director selection and appointment process, of public enterprises in the information, communications, and technology sector, and the utilities sector in order to streamline the number of Directors and achieve greater efficiency 9. Tonga Water Board concluded contract with a private sector business to outsource asset maintenance and pipe-laying services	10. Cabinet approval to reform at least two PEs in accordance with the PE Reform Policy, where 'reformed' may consist of privatization, liquidation, substantial restructuring, outsourcing or another form of public-private partnership	13. Cabinet approval to reform at least two additional PEs in accordance with the PE Reform Policy, where 'reformed' may consist of privatization, liquidation, substantial restructuring, outsourcing or another form of public-private partnership
IV. SUPPORTING AN EFFECTIVE RESPONSE TO DISASTERS				
Disaster response Gov't lead: MEIDECC (NEMO) Partners: ADB (lead)	Effective and efficient emergency response to alleviate hardship and secure livelihoods of affected populations, and increase disaster resilience through building back better	10. Cabinet approval of a costed response plan, based on a post-disaster needs assessment, to guide effective and efficient response to damages caused by Tropical Cyclone Winston		

ADB = Asian Development Bank; DFAT = Australian Department of Foreign Affairs and Trade; EU = European Union; FY = fiscal year; gov't = government; ICT = information and communication technology; IFMIS = integrated financial management information system; ILO = International Labour Organization; MCL = Ministry of Commerce and Labour; MEIDECC = Ministry of Meteorology, Energy, Information, Disaster Management, Climate Change and Communications; MFNP = Ministry of Finance and National Planning; MPE = Ministry of Public Enterprises; NEMO = National Emergency Management Office; PE = public enterprise; PFTAC = Pacific Financial Technical Assistance Centre; TBD = to be determined; WB = World Bank.

Note: Joint Policy Reform Matrix actions not supported under the programmatic approach are excluded from the policy matrix but are part of the supplementary documents. Output IV is not part of the Joint Policy Reform Matrix.

Source: Asian Development Bank, Government of Tonga.