



# Report and Recommendation of the President to the Board of Directors

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Project Number: 55016-001  
October 2021

## Proposed Policy-Based Grant Kingdom of Tonga: Economic Recovery Support Program

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Asian Development Bank

## CURRENCY EQUIVALENTS

(as of 23 September 2021)

Currency unit	–	pa'anga (T\$)
T\$1.00	=	\$0.4474
\$1.00	=	T\$2.2351

## ABBREVIATIONS

ADB	–	Asian Development Bank
COVID-19	–	coronavirus disease
GBV	–	gender-based violence
GDP	–	gross domestic product
IMF	–	International Monetary Fund
JPRM	–	Joint Policy Reform Matrix
MOF	–	Ministry of Finance
MTDS	–	Medium-Term Debt Strategy
PEFA	–	public expenditure and financial accountability
PFM	–	public financial management
PSC	–	Public Service Commission
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., FY2022 ends on 30 June 2022.
- (ii) In this report, "\$" refers to United States dollars, unless otherwise stated.

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## PROGRAM AT A GLANCE

<b>1. Basic Data</b>		<b>Project Number: 55016-001</b>	
<b>Project Name</b>	Economic Recovery Support Program	<b>Department/Division</b>	PARD/PASP
<b>Country</b>	Tonga	<b>Executing Agency</b>	Ministry of Finance
<b>Recipient</b>	Tonga		
<b>Country Economic Indicators</b>	<a href="https://www.adb.org/Documents/LinkedDocs/ocs/?id=55016-001-CEI">https://www.adb.org/Documents/LinkedDocs/ocs/?id=55016-001-CEI</a>		
<b>Portfolio at a Glance</b>	<a href="https://www.adb.org/Documents/LinkedDocs/ocs/?id=55016-001-PortAtaGlance">https://www.adb.org/Documents/LinkedDocs/ocs/?id=55016-001-PortAtaGlance</a>		
<b>2. Sector</b>		<b>ADB Financing (\$ million)</b>	
✓ <b>Public sector management</b>	Economic affairs management		1.50
	Public administration		1.00
	Public expenditure and fiscal management		2.50
		<b>Total</b>	<b>5.00</b>
<b>3. Operational Priorities</b>		<b>Climate Change Information</b>	
✓ Accelerating progress in gender equality		GHG reductions (tons per annum)	0.00
✓ Strengthening governance and institutional capacity		Climate Change impact on the Project	Low
		<b>ADB Financing</b>	
		Adaptation (\$ million)	0.00
		Mitigation (\$ million)	0.00
		<b>Cofinancing</b>	
		Adaptation (\$ million)	0.00
		Mitigation (\$ million)	0.00
<b>Sustainable Development Goals</b>		<b>Gender Equity and Mainstreaming</b>	
SDG 1.b		Some gender elements (SGE)	✓
SDG 3.d			
SDG 4.4			
SDG 5.2, 5.5			
SDG 8.10, 8.5			
SDG 16.3, 16.6			
SDG 17.1, 17.4			
<b>4. Risk Categorization:</b> Low		<b>Poverty Targeting</b>	
		General Intervention on Poverty	✓
<b>5. Safeguard Categorization</b>		<b>Environment: C Involuntary Resettlement: C Indigenous Peoples: C</b>	
<b>6. Financing</b>			
<b>Modality and Sources</b>		<b>Amount (\$ million)</b>	
<b>ADB</b>		<b>5.00</b>	
Sovereign Program grant: Asian Development Fund		5.00	
<b>Cofinancing</b>		<b>23.40</b>	
Government of Australia - Program grant (Not ADB Administered)		10.80	
New Zealand Grant - Program grant (Not ADB Administered)		7.60	
World Bank - Program grant (Not ADB Administered)		5.00	
<b>Counterpart</b>		<b>0.00</b>	
None		0.00	
<b>Total</b>		<b>28.40</b>	
<b>Currency of ADB Financing: US Dollar</b>			

## I. THE PROPOSAL

1. I submit for your approval the following report and recommendation on a proposed policy-based grant to the Kingdom of Tonga for the Economic Recovery Support Program.

2. The program will help Tonga restore and accelerate inclusive growth, which has been adversely affected by the coronavirus disease (COVID-19) pandemic. The program aims to achieve this by (i) strengthening fiscal management, (ii) improving the enabling environment for the private sector, and (iii) enhancing human resource management. It builds on reforms supported by Asian Development Bank (ADB) programs since 2009 and ongoing discussions with the government.<sup>1</sup> A single tranche stand-alone policy-based grant is proposed under the program as key reforms intended to improve debt management, limit public wage bill growth, attract foreign and domestic investment, promote greater labor force participation by women and better manage scarce labor resources through improved mobility institutions are already under implementation. The program was developed in collaboration with the World Bank and the governments of Australia and New Zealand, who also provide budget support and technical assistance (TA) to Tonga to support its reform agenda.

## II. PROGRAM AND RATIONALE

### A. Background and Development Constraints

3. **Development context.** Tonga's population of about 107,000 is dispersed across 36 of its 172 islands in the South Pacific, with a quarter of the population in the capital, Nuku'alofa. Tonga faces many structural challenges because of its geographic remoteness, small size, and exposure to disasters caused by natural hazards. These factors reduce competitiveness by raising the costs of production and public service delivery, lower private sector participation in economic activity, and constrain institutional capacity development, hampering growth.<sup>2</sup>

4. The public sector is the major driver of the economy, providing infrastructure and public services. Public sector resources help sustain growth, manage risks, and reduce poverty. Private sector growth is constrained by a weak business environment, low foreign investment inflows, and skilled labor shortages.<sup>3</sup> While women have higher participation rates than men in education at all levels, their labor force participation is 14 percentage points lower than men.<sup>4</sup> Gender-based violence (GBV) is a key barrier to women's participation, including in the labor force: of ever-partnered women aged 15–49 years, 40% have experienced intimate partner violence.<sup>5</sup> Extreme poverty is rare, but there is significant material deprivation and vulnerability, especially in rural areas. Migration and remittances help alleviate poverty and finance the current account deficit. In fiscal year (FY) 2019, Tonga received remittances of 27.3% of gross domestic product (GDP), compared with a Pacific average of 7.2%, with an estimated 5,774 workers (about 14% of the total domestic workforce) engaged in seasonal worker schemes in Australia and New Zealand.

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<sup>1</sup> ADB. [Tonga: Economic Support Program](#); ADB. [Tonga: Strengthening Public Financial Management Program](#); ADB. [Tonga: Building Macroeconomic Resilience Program, Subprogram 1](#); ADB. [Tonga: Building Macroeconomic Resilience Program, Subprogram 2](#); ADB. [Tonga: Building Macroeconomic Resilience Program, Subprogram 3](#); and ADB. [Tonga: Strengthening Macroeconomic Resilience Program](#).

<sup>2</sup> During 1999–2019, per capita gross domestic product (GDP) in Tonga grew 1.2% annually, slightly above the 0.9% average for small Pacific economies but lower than the global average of 1.7%. World Bank. [World Development Indicators](#) (accessed 20 September 2021).

<sup>3</sup> In FY2019, net foreign direct investment inflows to Tonga were 1.7% of GDP.

<sup>4</sup> Government of Tonga, Ministry of Internal Affairs. 2019. *Gender Equality: Where Do We Stand? The Kingdom of Tonga*. Nuku'alofa.

<sup>5</sup> United Nations Women. [Global Database on Violence against Women](#) (accessed 13 September 2021).

5. **Economic growth.** Although Tonga has not recorded any case of COVID-19, border closures and reduced economic activity because of the pandemic have exacerbated Tonga's development challenges. Tonga recorded successive years of growth between FY2015 and FY2019, averaging 2.4%. Along with Tropical Cyclone Harold in April 2020, the COVID-19 pandemic, however, caused the economy to contract by 0.8% of GDP in FY2020.<sup>6</sup> As the pandemic continued, declines in tourism and delays on construction projects hit the private sector hard, affected employment, and caused a deeper contraction estimated at 5.3% in FY2021.<sup>7</sup> Recovery of growth (projected at 1.8% in FY2022) will depend largely on reopening borders and resuming tourism, underpinned by the rollout of COVID-19 vaccines.<sup>8</sup>

6. **Macroeconomic management.** The government has maintained a generally prudent fiscal stance during 2017–2020. Stable revenue collections despite frequent disasters, expenditure controls, and strong policy reforms that attracted support from development partners, led to fiscal surpluses in FY2017–FY2020.<sup>9</sup> This helped build up cash reserves, which contributed to financing the government's COVID-19 response, while containing external debt at 40.1% of GDP in FY2021, well below the government's ceiling of 50.0%. However, government spending increased in FY2021 and is projected to expand further in FY2022 as health-related expenditures ramp up and a recovery package to support productive sectors and vulnerable populations is disbursed. Revenues fell in FY2021 and only a modest recovery is forecast in FY2022. Consequently, Tonga had fiscal deficits estimated at 1.0% of GDP in FY2021 and projected at 1.6% of GDP in FY2022. The risk of debt distress is rated *high*; this does not indicate that the debt position has deteriorated, but mostly reflects the potential effects of future disasters on fiscal and debt dynamics.<sup>10</sup>

7. Overall, ADB assesses that the macroeconomic outlook is stable and debt is sustainable. Economic growth is expected to revive in FY2022, supported by stimulus expenditures and policies.<sup>11</sup> The government is committed to improving expenditure composition and efficiency and shoring up revenues. Fiscal deficits are projected until FY2024 but will remain at manageable levels that can be financed through government's cash reserves, concessional borrowing from the International Monetary Fund (IMF), and continued support from development partners for the government's reforms. Starting in FY2022, public debt is projected to decline from the FY2021 peak of 46.3% of GDP. External debt will also decline from FY2022 in line with the government's Medium-Term Debt Strategy (MTDS) and remain below 40% of GDP as recommended by the IMF. This is consistent with the IMF's assessment that the government's policy agenda broadly supports priorities for achieving higher budget surpluses to stabilize debt dynamics and achieve

<sup>6</sup> ADB. 2021. *Asian Development Outlook 2021: Financing a Green and Inclusive Recovery*. Manila.

<sup>7</sup> While data on employment impacts of the COVID-19 pandemic are not available, an estimated 43% of salaried workers in Tonga depend on the private sector for their livelihoods and could potentially have been affected.

<sup>8</sup> As of 13 September 2021, 44% of Tonga's population had received their first dose, and 26% had received both doses of COVID-19 vaccination. [World Health Organization. Tonga: WHO Coronavirus Disease \(COVID-19\) Dashboard with Vaccination Data](#) (accessed 19 September 2021).

<sup>9</sup> Sector Assessment (Summary): Public Sector Management (accessible from the linked documents in Appendix 2).

<sup>10</sup> Tonga's external debt distress rating changed from *moderate* risk to *high* risk in 2017 as the debt sustainability analysis of the International Monetary Fund (IMF) incorporated the effects of disasters into the methodology. IMF. 2018. [2017 Article IV Consultation—Press Release; and the Staff Report for Tonga](#). *IMF Country Report No. 18/12*. Washington, DC. The assessment was maintained in a more recent analysis. IMF. 2020. [Tonga: Staff Report for the 2020 Article IV Consultation and Request for Disbursement Under the Rapid Credit Facility—Debt Sustainability Analysis](#). However, debt remains sustainable.

<sup>11</sup> Agriculture, construction, and tourism (which contributed about 15% of GDP pre-pandemic) are expected to recover in FY2022.

development goals.<sup>12</sup> However, downside risks from the continuation of the COVID-19 crisis remain high.

8. **Key constraints.** The government recognizes that an inclusive economic recovery and subsequent acceleration of economic growth are constrained by several interrelated factors, including (i) limited fiscal space for sustaining growth and poverty reduction, (ii) a weak enabling environment for the private sector, and (iii) inefficient management of Tonga's human resources.

9. **Limited fiscal space.** Rising expenditure requirements in the face of limited revenue growth mean that recovery efforts must be underpinned by strong fiscal management. Specific attention to managing public debt is particularly important with the government projecting fiscal deficits until FY2024. As of June 2021, debt remains low-cost and manageable. However, debt repayments are expected to spike starting in FY2024, and most of these will need to be refinanced with new borrowing. Further, more than 85% of debt is denominated in foreign currency and is exposed to exchange rate risks. While domestic debt is less than 15% of total public debt, the average term to maturity is low (2.6 years) and the small size of the domestic market means that refinancing risk is high. The government must also better manage government guarantees, estimated at about 4% of GDP. While contingent liabilities enable projects to be financed without incurring immediate public debt, they create fiscal risks and could increase debt if they are called. Guarantees also introduce moral hazard risks because they reduce the private sector's incentives to scrutinize the viability of projects, increasing chances that they may in fact be called.<sup>13</sup> However, there are no clear criteria for cabinet approval of guarantees and the framework for managing them was weak.

10. Efforts to maintain critical public expenditures are hampered by a growing public sector wage bill. After declining from 12.7% of GDP in FY2017 to 11.6% in FY2019, the total wage bill for public sector employees is estimated to have gone up to 14.0% of GDP in FY2021 (footnote 9). While the government has instituted strict controls on recruitment, implementation is weakened because of incomplete and inconsistent employment registers. There is a significant disparity—about 9.1% of the workforce—between the Public Service Commission (PSC) establishment list and the list that the Ministry of Finance (MOF) has in their budgeting and payroll system. The absence of a link between the two lists has allowed people in positions formally unapproved by the PSC to draw a salary. Another issue is that overtime payments grew substantially in FY2021.<sup>14</sup> As of 2021, overtime is payable to all staff below the level of chief executive officer, on the approval of the chief executive officer, with no limits on accrual. Many staff claim more than 4 hours overtime each day of the work year, making this not just a fiscal problem but also an occupational health and safety issue.

11. Public financial management (PFM) systems are generally functional and support basic service delivery. A gender-responsive public expenditure and financial accountability (PEFA) assessment, however, identified several areas for improvement.<sup>15</sup> Many of these relate to budget reliability, public availability of fiscal information, and audits (footnote 9). The government produces an annual medium-term fiscal framework to improve policy-based fiscal strategy and budgeting. However, budget proposals, budget execution reports, audit reports, and macroeconomic forecasts are not publicly released, constraining fiscal transparency. The

<sup>12</sup> International Monetary Fund Assessment Letter (accessible from the linked documents in Appendix 2). Based on the IMF assessment, long-term debt sustainability hinges on continued donor support in the form of grants, debt relief to finance substantial fiscal and external gaps, and sizeable fiscal adjustment.

<sup>13</sup> ADB. [Philippines: Management of Contingent Liabilities Arising from Public-Private Partnership Projects](#).

<sup>14</sup> In FY2021, the overtime bill alone is estimated to have cost the government just under 1% of GDP.

<sup>15</sup> IMF. 2020. [Tonga: Public Expenditure and Financial Accountability Assessment: Agile Report](#). Washington, DC.



assessment also highlighted the need for gender-responsive budgeting training for ministries and the collection of sex-disaggregated data in ministry annual reporting.

12. **Weak enabling environment for the private sector.** The expansion of the private sector will be important to accelerate economic growth and create new jobs. A stronger private sector will also help to broaden the tax base and increase fiscal resilience. A key constraint facing businesses in Tonga is access to finance, especially for small and medium-sized enterprises.<sup>16</sup> Developing nonbank financial institutions that complement the formal banking sector could help. However, this would require improved supervision of nonbank financial institutions to control growing risks to financial sector stability, especially during the COVID-19 pandemic.<sup>17</sup> As of 2021, credit unions, the main nonbank financial intermediaries, are outside the purview of the National Reserve Bank. A more conducive business climate for foreign and domestic investments will also help private sector growth. However, Tonga lacked an international arbitration legislative framework, which discouraged foreign investment by raising the costs and uncertainty associated with international business agreements.<sup>18</sup> Despite recent streamlining of registration process, burdensome regulations for foreign investment continue to deter investors.

13. A reliable, sustainable, and affordable supply of energy is important for recovery. Reliability of energy supply and cost and transparency of tariffs are constraints for businesses (footnote 16). More than 91% of Tonga's grid-connected electricity demand is supplied by generators fueled by imported diesel. Petroleum dependency makes Tonga vulnerable to oil price changes, and high system losses raise costs.<sup>19</sup> There is a need for a vision for the energy sector and strategic planning and coordination among agencies to mitigate the difficulties Tonga faces because of its location. However, the energy sector lacks a coherent institutional and regulatory framework, with multiple legislations governing renewables, gas, petroleum, and electricity.<sup>20</sup>

14. **Inefficient management of human resources.** Because of the small labor force, improving the supply of skilled workers is critical to support growth. This will require stronger female labor force participation, which is constrained by sexual harassment in the workplace. There is no specific policy to address this, even in the public sector where 42% of employees are women.<sup>21</sup> Another important channel for generating employment and helping workers acquire skills is circular migration. Strategic labor supply management and targeted marketing are important to increase opportunities while minimizing negative social impact from migration. However, there are weaknesses in recruiting potential migrant workers, providing them appropriate pre-departure training and skills, and facilitating migration. The government also lacks clear gender-balanced selection procedures that would allow women to take full advantage of opportunities abroad. ADB's 2020 budget support program supported cabinet approval of a Labor Mobility Policy for managing low-skilled and semiskilled labor flows abroad.<sup>22</sup> It also supported cabinet approval of a complementary technical and vocational education and training sector

<sup>16</sup> Private Sector Development Initiative. 2020. *Tonga: Country Overview*. April 2020.

<sup>17</sup> IMF. 2021. [2020 Article IV Consultation and Request for Disbursement under the Rapid Credit Facility—Press Release; Staff Report; and Statement by the Executive Director for Tonga](#). *Country Report 21/26*. Washington, DC.

<sup>18</sup> An effective arbitration law allows disputants to reduce delays and costs by avoiding going to courts.

<sup>19</sup> ADB. 2016. [Sector Assessment \(Summary\): Energy. Outer Island Renewable Energy Project- Additional Financing](#). Project No. 43452-024. Manila.

<sup>20</sup> Parts of the energy sector are under the purview of the Ministry for Meteorology, Energy, Information, Disaster Management, Environment, Communications, and Climate Change—with the ministry's multiple responsibilities constraining its ability to develop a single coherent energy sector strategy and effectively regulate price and quality.

<sup>21</sup> Sexual harassment was being addressed through the Public Service Code of Conduct and Ethics, but this does not explicitly define sexual harassment.

<sup>22</sup> The policy provides guiding principles and an institutional framework for the management of low-skilled and semiskilled overseas employment opportunities and migrant workers from Tonga.

strategic policy framework to help diversify employment opportunities.<sup>23</sup> The implementation of these policies and frameworks has commenced, and needs to be progressed further.

15. **Alignment with national and ADB strategy.** The proposed program aligns with the Tonga Strategic Development Framework, 2015–2025 that has adopted a vision for “a more progressive Tonga supporting a higher quality of life for all.”<sup>24</sup> This vision is translated into five pillars, of which “economic institutions” seek to address constraints to more inclusive, sustainable, and resilient economic growth, including through improved macroeconomic management and increased access to economic opportunities. The government has also moved to mitigate the macroeconomic and social risks posed by the COVID-19 pandemic. The program is consistent with ADB’s Strategy 2030 priorities of strengthening governance and institutional capacity and accelerating progress in gender equality.<sup>25</sup> It is also aligned with ADB’s Pacific Approach for 12 small Pacific island countries, 2021–2025 that seeks to support developing member economies in preparing for and responding to shocks and promoting inclusive private sector growth.<sup>26</sup>

## B. Policy Reform, ADB’s Value Addition, and Sustainability

16. **Program description.** The program supports Tonga’s ongoing reforms, as reflected in the Joint Policy Reform Matrix (JPRM) framework (para. 26), to restore and accelerate inclusive economic growth led by the private sector, which has been impacted by COVID-19. The program comprises 10 prior policy actions under three reform areas. Specific policy actions are prioritized based on government needs and build on reforms supported under previous programs while responding to policy challenges intensified by COVID-19.<sup>27</sup> All policy actions under the program have been completed.

17. **Reform area 1: Fiscal management.** The government recognizes that strategic public debt management, sound expenditure controls, and strong PFM systems that promote fiscal discipline will provide macroeconomic stability and enable private sector growth. As prior policy actions under the program, the cabinet approved and the MOF commenced implementation of (i) an MTDS to guide borrowing and public debt management during 2021–2025, including rules for no new non-concessional external borrowing; and (ii) a new Government Guarantee Policy to contain contingent liabilities by providing a framework for and transparency in procedures for guaranteeing loans. The cabinet also (i) established and operationalized a consolidated and sex-disaggregated employment registry to strengthen controls on the public sector wage bill; (ii) approved amending the government’s overtime policy to control, monitor, and limit the cost of overtime payments to public servants; and (iii) approved a rolling time-bound PFM action plan, which is now under implementation by the MOF, as part of Tonga’s overall PFM reform program.

18. The MTDS commits the government to not taking on any new non-concessional external borrowing, and building reserves along the whole strategy period to finance external debt

<sup>23</sup> Government of Tonga. 2019. *National Technical and Vocational Education and Training (TVET) Policy Framework*. Nuku’alofa. Implementation requires revamping the Tonga National Quality Assessment Board and providing it with the legal basis to carry out its core mandate. The board is responsible for developing a national qualifications framework, establishing appropriate policies, monitoring and reviewing compulsory education and training, and registering and providing accreditation to providers.

<sup>24</sup> Government of Tonga. 2015. *Tonga Strategic Development Framework, 2015–2025*. Nuku’alofa.

<sup>25</sup> ADB. [Strategy 2030: Achieving a Prosperous, Inclusive, Resilient, and Sustainable Asia and the Pacific](#). Manila.

<sup>26</sup> ADB. 2021. [Pacific Approach, 2021–2025](#). Manila. The program is included in ADB. 2020. [Country Operations Business Plan: Eleven Small Pacific Island Countries, 2021–2023](#). Manila. The program name has been revised from *Macroeconomic Resilience Program to Economic Recovery Support Program*.

<sup>27</sup> Overview of Policy Reform Actions, 2009–2021 (accessible from the list of linked documents in Appendix 2).

repayments.<sup>28</sup> It also assesses the cost and risk profile of public debt and sets benchmarks to manage public debt, which will be regularly monitored to evaluate implementation of the strategy.<sup>29</sup> MTDS benchmarks underpin the FY2022 budget statement. The Government Guarantee Policy lays down minimum criteria, additional guidelines, and information requirements that will be used to evaluate a request for a government guarantee; the fees it will charge and other obligations it may impose on the borrower; and guidelines for public disclosure. It makes clear that the approval of any guarantee by the cabinet will be based on the soundness of government finances, including projected debt sustainability. It is under implementation, with all new government guarantees to be approved based on the policy. Both documents have been publicly disclosed as part of the prior actions to increase fiscal transparency.

19. Two of the prior actions in this reform area are intended to improve expenditure control. Unifying the PSC and the MOF lists into one employment register as a real time database of approved roles with approved salary band levels, and identifying who is filling the position and linking this with the payroll system, is critical to controlling the size of the government workforce. In addition, collection of sex-disaggregated data through the employment registry will allow for the analysis of gender statistics relating to public sector employment. To ensure that the employment register is maintained and kept up-to-date on a regular basis, the PSC is required to provide the cabinet with annual updates. The cabinet also approved amending the government's overtime policy, with the PSC and the MOF working out caps on overtime hours. Limiting overtime accrual is important to limit wage bill growth and aligned with good practice across the world. An overtime cap at 20 hours per fortnight per worker, and setting up two levels of control to monitor overtime payments—at the line ministry and at the MOF levels—is proposed for implementation in a phased manner. Setting a limit on overtime per worker each fortnight, along with operationalizing the unified employment register, will save the government an estimated 0.5% of GDP.

20. Finally, a gender-responsive PFM action plan received cabinet approval and is being implemented. It is a live document, developed on a rolling basis, with the initial set of actions to be implemented during 2021–2023.<sup>30</sup> The plan prioritizes necessary measures under each pillar and identifies key tasks, responsible officers, timelines, capacity development needs, and estimated costs. Capacity building of budget officers is ongoing, macro-fiscal models have been strengthened, and publication and disclosure of fiscal information has improved. Work has also begun on reviewing the existing PFM Act with a view to amending it by late 2022 to modernize PFM.<sup>31</sup> A PFM advisor has been appointed in the MOF to oversee implementation, and a steering committee has been set up to monitor progress on a quarterly basis.<sup>32</sup> Steps towards implementing gender-responsive budgeting have also begun.<sup>33</sup>

21. **Reform area 2: Business environment for the private sector.** The government is

<sup>28</sup> These two constitute policy actions under the Sustainable Development Finance Policy adopted by ADB.

<sup>29</sup> The benchmarks are the share of public debt in foreign currency and the average time to maturity of domestic debt.

<sup>30</sup> The main pillars of the plan include strengthening (i) budget reliability, (ii) transparency of public finances, (iii) management of assets and liabilities including public debt management and reporting, (iv) policy-based fiscal strategy and budgeting, (v) predictability and control in budget execution, (vi) accounting and reporting, (vii) external scrutiny and audit and (viii) strengthening the enabling environment including through updating the existing PFM Act.

<sup>31</sup> Government of Tonga. *Public Financial Management Act 2002*. Nuku'alofa, Tonga.

<sup>32</sup> The steering committee is chaired by the Minister of Finance, and includes the chief secretary; auditor general; chief executive officer, Ministry of Revenues and Customs; and chief executive officer, Ministry of Public Enterprises.

<sup>33</sup> Gender-responsive budgeting is included in the consultation process with key service delivery ministries including the ministries for Health; Internal Affairs; and Police, Fire and Emergencies for the first time ever, and in reviewing the chart of accounts to include a specific gender code to allow for gender tagging and analysis of gender programs. This is a cornerstone to implementing gender-responsive budgeting.

stepping up efforts to stimulate new private investment to help Tonga's economy recover from the COVID-19 pandemic. The program supported the preparation of three key legislative reforms that will support private sector growth:

- (i) The Parliament passed the Credit Unions Bill, 2021 to register, license, supervise, and regulate nonbank financial institutions by bringing them under the purview of the National Reserve Bank. This will support efforts to enhance financial inclusion and access to finance for the private sector by developing credit unions to encourage savings and promote lending, especially in rural and remote islands without banks. This will also help better monitor financial sector vulnerabilities, which may be exacerbated during the COVID-19 pandemic impacts.
- (ii) The Parliament passed the International Arbitration Act, 2020. The act will facilitate fair and timely resolution of commercial disputes through transparent arbitration processes, provide recognition and enforcement of arbitral awards, and bring Tonga in accord with the United Nations Convention on the Recognition and Enforcement of Foreign Arbitral Awards (1958).
- (iii) The Parliament passed the Energy Bill, 2021 that will provide an institutional, regulatory, and policy framework for the Tonga energy sector, including electricity, petroleum, gas, renewable energy, and other energy sources. The bill envisages the creation of a new ministry of energy to provide policy direction for the entire sector, a new energy commission responsible for regulating price and non-price elements (health, safety, and environment), and a department of energy responsible for implementing and enforcing the bill's provisions. It clarifies the roles and responsibilities of key stakeholders and seeks to facilitate more private sector investment in Tonga's electricity sector by providing suitable investment incentives. It also includes explicit provisions to ensure women's participation in energy policy and decision-making.

22. **Reform area 3: Human resource management.** As a prior action, the cabinet approved a sexual harassment policy to address sexual harassment in government offices. The policy defines sexual harassment, sets out procedures for addressing complaints, and describes the roles and responsibilities of stakeholders. The policy is a first for the public service in Tonga, and aligns with requirements under the Employment Relations Act, 2020 that specifically calls for policies to eliminate sexual harassment at the workplace.<sup>34</sup> It is under implementation, with all new sexual harassment cases to be handled following the provisions in the policy. As a prior action, the government also adopted a new gender-sensitive labor mobility operations manual to enhance management and core services of Tonga's Labor Sending Unit, required to operationalize the Tonga Labor Mobility Policy (para. 14).<sup>35</sup> The Labor Sending Unit is implementing the operations manual. As part of the prior action, a steering committee was established and operationalized to provide high-level leadership and oversight to the implementation of the Labor Mobility Policy; the committee is chaired by the Minister for Internal Affairs and co-chaired by the Minister for Trade and Economic Development.

23. **Post-program partnership framework.** ADB's long engagement with Tonga has developed strong relationships and government ownership of reforms. Regular dialogue helped

<sup>34</sup> Government of Tonga. 2020. [Employment Relations Bill 2020](#). Nuku'alofa.

<sup>35</sup> The Labor Sending Unit oversees operational procedures to guide immigration. The Labor Mobility Policy is being operationalized through implementation of the operations manual, which includes processes to cover the full course of labor mobility, including reformed procedures for recruitment and selection, pre-departure training, and the establishment of work-ready pools, with a special focus on increasing female participation in work-ready pools. It also strengthens data management processes and systems to better inform policy decisions, optimize operations, and reduce costs.

to institutionalize reforms and provided an opportunity to build on them. To further ensure sustainability and desired medium-term impacts from actions initiated under the program, ADB has developed a post-program partnership framework with the government. Under reform area 1, the government commits to following its MTDS and regular tracking of monitorable indicators identified in it. The government will sustain the operations of the consolidated employment register so that there is a single source of information about approved roles across the public service. The limits of 20 hours per fortnight per worker on overtime hours claimed will be implemented by the PSC, based on the cabinet approval under the program. The government will regularly monitor implementation of the PFM action plan, and update and extend it as needed. It will also seek TA support and commence implementation of gender-responsive budgeting training for ministries. The government will review tax exemptions to assess viability of removing them to shore up revenue mobilization. Under reform area 2, the government agrees to set up and capacitate the energy commission to regulate energy price and quality, following the enactment of the Energy Bill, 2021. The government will also further simplify foreign investment regulations to align with the Foreign Investment Act, 2020.<sup>36</sup> Under reform area 3, the post-program partnership framework will evaluate implementation of the sexual harassment policy, including awareness-raising sessions and training, and continue improving the technical and vocational education system. The government will continue efforts to strengthen the Tonga National Quality Assessment Board, including through providing a legal basis for its operation. ADB and partners will continue close policy dialogue with the government and support its reform efforts through TA as necessary.

24. **ADB's value addition.** The program builds on reforms supported by earlier ADB TA and programs (footnotes 1 and 27). On fiscal management, past engagement improved civil service performance management to control the wage bill; introduced a new debt management law and medium-term fiscal targets; and strengthened PFM, including by conducting a PEFA in partnership with the IMF to identify priorities in future PFM reform planning. ADB TA mobilized economic and PFM advisors to help formulate development strategies.<sup>37</sup> On private sector development, ADB's advisory services helped strengthen corporate governance practices and commercialize selected state-owned enterprises to improve service delivery and reduce the burden on the budget.<sup>38</sup> They built the foundations for an enabling environment for foreign direct investment by supporting the approval of the Foreign Investment Act, 2020 and helping develop regulations to implement it.<sup>39</sup> Earlier programs also built the foundations for energy sector reform and improved regulatory practices. On human resources, ADB's previous policy-based grant helped develop a gender-sensitive labor mobility framework and improve the technical and vocational education and training sector. Specifically for the program, ADB TA helped develop economic and fiscal forecasting and planning models that supported MTDS preparation.<sup>40</sup> TA support has been provided for developing the International Arbitration Act, 2020. The program complements ADB's support to Tonga's recovery from the COVID-19 pandemic.<sup>41</sup>

25. **Lessons.** This program reflects lessons from previous policy-based operations, including

<sup>36</sup> Government of Tonga. 2020. [Foreign Investment Act 2020](#). Nuku'alofa

<sup>37</sup> ADB. 2013. [Technical Assistance for Pacific Economic Management \(Phase 2\)](#). Manila.

<sup>38</sup> ADB. 2013. [Technical Assistance for the Pacific Private Sector Development Initiative, Phase III](#). Manila.

<sup>39</sup> ADB. 2019. [Technical Assistance for the Pacific Private Sector Development Initiative, Phase IV](#). Manila.

<sup>40</sup> ADB. 2020. [Technical Assistance for Supporting Public Sector Management Reforms](#). Manila.

<sup>41</sup> In 2020, ADB disbursed a \$0.47 million grant from the Asia Pacific Disaster Resilience Fund and a \$6.0 million grant from the Pacific Disaster Resilience Program (Phase 2) and provided budget support of \$12.2 million. In May 2021, ADB provided a \$5.5 million grant to Tonga to help roll out COVID-19 vaccines. ADB. [Regional: Systems Strengthening for Effective Coverage of New Vaccines in the Pacific Project under the Asia Pacific Vaccine Access Facility \(Additional Financing\)](#); ADB. [Tonga: COVID-19 Emergency Response](#); ADB. [Tonga: Strengthening Macroeconomic Resilience Program](#); and ADB. [Regional: Pacific Disaster Resilience Program \(Phase 2\)](#).

(i) budget support can achieve results if there is strong government ownership; (ii) coordination with development partners is critical, especially in sectors where ADB has limited engagement; (iii) TA, provided in parallel to budget support programs, aids the implementation of reform; (iv) flexibility helps ensure that policy actions remain relevant, especially with upcoming elections and continuance of the impacts of the COVID-19 pandemic, which can lead to changing reform areas and uncertainty; and (v) limiting reforms to a few substantive actions avoids overloading national capacity.<sup>42</sup> Based on these lessons, the program focuses on policy actions prioritized by the government to avoid overloading limited capacity, builds on earlier reforms for sustainability, and accommodates political economy considerations in its design.

26. **Development partner coordination.** The JPRM forms the basis for reforms supported under the program, and the process provides an effective platform to coordinate support among key development partners.<sup>43</sup> ADB, the World Bank, and the governments of Australia and New Zealand coordinate budget support and related TA through the JPRM process, with the European Union also participating.<sup>44</sup> ADB has worked with partners through the JPRM process since 2011, and this has helped design policy actions and TA based on government priorities. Similar to past programs, the JPRM process brought together key ministries and development partners to map out critical constraints, design specific policy actions and TA measures, and monitor reform implementation for the program. ADB holds discussions on policy issues and macroeconomic projections with the IMF during their annual Article IV consultations and discussed the reform program with the IMF. The IMF provided an assessment letter for the program (footnote 12).

### C. Expected Outcome of the Reforms

27. The program is aligned with the following overarching development objective: a more progressive Tonga supporting a higher quality of life for all (footnote 24). The expected development outcome is to restore and accelerate inclusive private sector-led economic growth in Tonga. Supported by program reforms, it is expected that Tonga will not take on any new non-concessional debt, the public sector wage bill will come down, and PFM systems will be strengthened, all of which will improve fiscal sustainability for better development outcomes. Further, the frameworks for the energy sector and for arbitration of international commercial disputes are expected to be improved, the supervision of nonbank financial institutions to be enhanced, and the number of workers in work-ready pools to increase. These measures will help ensure better access to finance, higher skill levels for workers, and a better business environment, which are expected to spur private sector-led growth.<sup>45</sup>

### D. Development Financing Needs and Budget Support

28. Tonga's economy is strongly impacted by the COVID-19 pandemic. In FY2022, government expenditures are expected to go up to 51.0% of GDP because of continued efforts to build health preparedness, support key economic sectors, and increase capital spending. Domestic revenues are expected to be 24.0% of GDP, resulting in a fiscal deficit (excluding

<sup>42</sup> Independent Evaluation Department. 2015. *Corporate Evaluation Study: ADB Support to Small Pacific Island Countries*. Manila: ADB; ADB. 2011. *Policy Brief: Policy-Based Programs for the Pacific Islands*. Manila; and ADB. 2020. [Completion Report: Building Macroeconomic Resilience Program Project in Tonga](#). Manila.

<sup>43</sup> Development Coordination (accessible from the list of linked documents in Appendix 2). The JPRM process brings together key development partners and government counterparts to define a medium-term program of reform actions in line with government priorities. Development partners align their own policy-based budget support programs with the JPRM, with each partner disbursing against completion of selected reforms laid out in the overall JPRM.

<sup>44</sup> The European Union coordinates TA and policy dialogue through the JPRM process, but not its budget support.

<sup>45</sup> Program Impact Assessment (accessible from the list of linked documents in Appendix 2).

grants) of 27.0% of GDP (Table 1). This is equivalent to development financing needs of about \$130.5 million for FY2022. The government expects to finance this through mobilization of external grants, a possible concessional loan from the IMF Rapid Credit Facility, and domestic borrowing. ADB's budget support through the program is expected to help meet Tonga's FY2022 development financing needs. General budget support grants of \$23.4 million from other JPRM partners are planned for calendar year 2021: World Bank expects to disburse \$5.0 million, while the government of Australia has provided \$10.8 million equivalent and the government of New Zealand \$7.6 million equivalent in June 2021.<sup>46</sup>

**Table 1: Development Financing Needs, FY2021–FY2022**

Item	FY2021e		FY2022p	
	\$ million	% of GDP	\$ million	% of GDP
Revenues (tax and non-tax)	106.9	23.1	115.8	24.0
Total expenditure	200.4	43.3	246.3	51.0
Fiscal deficit (excluding grants)	(93.5)	(20.2)	(130.5)	(27.0)
External grants	88.8	19.2	122.7	25.4
Of which ADB policy-based grant	12.2	2.6	5.0	1.1
Net lending (borrowing requirement)	(4.7)	(1.0)	(7.9)	(1.6)
Net change in reserves (drawdown)	2.0	0.4	(2.3)	(0.5)
Net acquisition of financial liabilities	6.5	1.4	5.5	1.1
Domestic borrowing	0.0	0.0	0.4	0.1
External borrowing	6.5	1.4	5.2	1.1

( ) = negative, e = estimate, FY = fiscal year, GDP = gross domestic product, p = projected.

Sources: Government of Tonga Budget Statement for year ending 30 June 2022; and Asian Development Bank estimates.

29. The government has requested a grant not exceeding \$5 million from ADB's Special Funds resources (Asian Development Fund) to help finance the program. ADB grant proceeds will support development financing needs, excluding ineligible items.

## E. Implementation Arrangements

30. The government's budget support management committee leads the JPRM process, with the MOF as the executing agency. The committee is responsible for providing overall guidance and for coordinating program implementation, monitoring, and evaluation. The MOF, Ministry of Internal Affairs, the Ministry of Trade and Economic Development, and the PSC are implementing agencies for the program actions. JPRM partners' forums are held twice a year, allow all major partners to discuss the government's reform priorities and coordinate assistance. This is complemented by bilateral consultations and cross-partner dialogue. The government also consults with the private sector and civil society on individual reform initiatives as needed. ADB is consulting with the government and other partners on the possibility of hiring an independent agency to monitor reform progress. The program is implemented from July 2020 to September 2021. ADB will monitor the implementation of reforms under the post-program partnership framework. The proceeds of the policy-based grant will be withdrawn, upon effectiveness, in accordance with ADB's *Loan Disbursement Handbook* (2017, as amended from time to time).

<sup>46</sup> JPRM support from Australia and New Zealand has been accounted in FY2021. The World Bank expects to disburse its JPRM grants in November 2021 through the proposed Resilience Development Policy Operation, subprogram 2. Development partners support overlapping sets of policy actions within the overall JPRM, for disbursement of their respective budget support funds. Amounts are converted to dollar equivalent using exchange rate as of 10 May 2021.

### III. DUE DILIGENCE

31. **Governance.** Despite capacity limitations, the 2020 PEFA assessment indicated that Tonga's PFM system is generally functional and supports basic service delivery. The government can implement its budget, but there are some accounting, financial reporting, and auditing weaknesses (footnote 9). The main issues relate to budget reliability with variances in aggregate expenditure and revenue relative to the budget. Public availability of fiscal information was also identified as an issue.<sup>47</sup> Reform area 1 of this program, complemented by development partner TA, will address some of these weaknesses. The World Bank Worldwide Governance Indicators rank Tonga in the 41.8th percentile on control of corruption in 2019.<sup>48</sup> Tonga has taken steps to strengthen anticorruption measures, including creating the Parliament Standing Committee on Anti-Corruption and acceding to the United Nations Convention Against Corruption.

32. **Poverty and social.** The public sector is a key provider of services to low-income households, and reform area 1 will help ensure that the government has the fiscal resources to respond to future economic shocks and disasters (which disproportionately affect the poor) while maintaining critical public services. Reform area 2 will aim to enhance private sector investments, which should create more employment opportunities, including for the poor. Reform area 3 will create opportunities for women to participate more actively in the work force and increase poor households' access to overseas employment opportunities and the associated remitted income.

33. **Gender.** This program is classified *some gender elements* and includes proactive policy actions that directly address key gender gaps, particularly in supporting women's economic empowerment and addressing GBV. The key action is the adoption of a groundbreaking public service sexual harassment policy that not only provides mechanisms to respond to work-based sexual harassment and abuse, but also sets an important normative standard for respectful and safe workplaces in Tonga. Besides addressing a significant form of GBV, the policy also tackles a key barrier to women's employment and economic empowerment. ADB TA is helping implement the sexual harassment policy.<sup>49</sup> Significant gender mainstreaming in overseas labor opportunities is another key action.<sup>50</sup> In FY2016, only one in 10 workers in the overseas employment program was a woman. In addition, establishing more gender-balanced work-ready pools will support new opportunities for Tongan women. Other actions include establishing a sex-disaggregated employment register and payroll that will allow collection and analysis of gender data and statistics for public sector employment and gender mainstreaming in the Energy Bill, 2021.<sup>51</sup>

34. **Safeguards.** Following ADB's Safeguard Policy Statement (2009), this program is classified *category C* for the environment, involuntary resettlement, and indigenous peoples. Program activities will be confined to policy and institutional reforms. The prior policy actions have been assessed and are not expected to result in or lead to involuntary resettlement, or negatively affect indigenous peoples or the environment.

35. Major risks and mitigating measures are summarized in Table 2 and described in detail in

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<sup>47</sup> Although budget documents are tabled in Parliament, these are generally not uploaded to a government website until sometime after the budget has been approved, making access difficult.

<sup>48</sup> World Bank. [Worldwide Governance Indicators](#) (accessed 24 August 2021).

<sup>49</sup> ADB. [Regional: Advancing the Transformative Gender Equality Agenda in a Post-COVID-19 Asia and the Pacific](#).

<sup>50</sup> The Labor Sending Unit's operations manual includes explicit actions to ensure procedures are gender sensitive, including in recruitment, selection, and pre-departure training (e.g., pre-departure training includes modules on sexual harassment, pregnancy, and sexual and reproductive health).

<sup>51</sup> The bill includes specific provisions for women's participation in technical committees and promotes women's participation and involvement in the development of the energy policy.



the risk assessment and risk management plan.<sup>52</sup> Development partners have determined that PFM systems are mostly reliable for budget support (para. 31). Policy reforms and TA address other fiduciary risks.

**Table 2: Summary of Risks and Mitigating Measures**

Risks	Mitigation Measures
A further health shock or disaster caused by a natural hazard leads the government to divert resources away from the program	ADB's Pacific Disaster Resilience Program provides Tonga with contingent financing for response, recovery, and reconstruction in the face of disasters caused by natural hazards. <sup>a</sup> Further, reforms under the Economic Recovery Support Program are prioritized to avoid overburdening the small public administration and decision makers. Technical assistance will be mobilized by ADB and development partners to supplement capacity as needed. The post-program partnership framework will also help sustain the ongoing policy dialogue and reform momentum.
Non-availability or slow rollout of COVID-19 vaccine(s) slows down efforts to open the economy	Tonga is a member of the COVAX facility. ADB, along with other donors, is actively supporting the government's vaccination efforts.
Economic conditions in overseas markets deteriorate, and there is a decline in overseas labor programs	ADB will monitor national, regional, and global economic developments and stand ready for further assistance in coordination with the JPRM and other development partners.
High staff turnover aggravates existing capacity constraints, affecting reform formulation, coordination, and delaying reform implementation	As necessary, technical assistance from development partners is available to bridge gaps through short- and medium-term capacity supplementation. The JPRM process facilitates prioritization of reforms and allows partners to absorb substantial coordination and transaction costs to avoid overburdening the small public administration and decision makers.

ADB = Asian Development Bank, COVAX = COVID-19 Vaccines Global Access, COVID-19 = coronavirus disease, JPRM = Joint Policy Reform Matrix.

<sup>a</sup> ADB. 2020. [Regional: Pacific Disaster Resilience Program](#).

Source: Asian Development Bank.

36. ADB's Anticorruption Policy (1998, as amended to date) was explained to and discussed with the government and the MOF.

#### IV. ASSURANCES

37. The government has 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 grant agreement. No disbursement shall be made unless ADB is satisfied that the government has completed the policy actions specified in the policy matrix relating to the program.

#### V. RECOMMENDATION

38. I am satisfied that the proposed policy-based grant would comply with the Articles of Agreement of the Asian Development Bank (ADB) and recommend that the Board approve the grant not exceeding \$5,000,000 to the Kingdom of Tonga from ADB's Special Funds resources (Asian Development Fund) for the Economic Recovery Support Program, on terms and conditions that are substantially in accordance with those set forth in the draft grant agreement presented to the Board.

Masatsugu Asakawa  
President

14 October 2021

<sup>52</sup> Risk Assessment and Risk Management Plan (accessible from the list of linked documents in Appendix 2).

## POLICY DESIGN AND MONITORING FRAMEWORK

<b>Country's Overarching Development Objectives</b> A more progressive Tonga supporting a higher quality of life for all (Tonga Strategic Development Framework) <sup>a</sup>		
<b>Outcome</b>	<b>Risks and Critical Assumptions</b>	
Inclusive private sector-led economic growth in Tonga restored and accelerated.	<p>R: A further health shock or disasters caused by natural hazards leads government to divert resources away from the program.</p> <p>R: Non-availability or slow rollout of COVID-19 vaccine(s) slows down efforts to open the economy.</p> <p>R: Economic conditions in overseas markets deteriorate and there is a decline in overseas labor programs.</p> <p>R: Institutional capacity constraints are intensified by high staff turnover.</p>	
<b>Prior Actions: Completed July 2020 to September 2021</b>	<b>Outcome Indicators</b>	<b>Post-program Partnership Framework January 2022–December 2023</b>
<b>Reform Area 1: Fiscal management</b>		
<p>1.1 Cabinet approved and the Ministry of Finance commenced implementation of a new Medium-Term Debt Strategy for FY2021–FY2025 to manage public debt through incurring it at the lowest possible cost and keeping it at a level consistent with macroeconomic stability; and made this publicly available on a government website to enhance fiscal transparency.<sup>b</sup></p> <p>1.2 Cabinet approved and the Ministry of Finance commenced implementation of the Government Guarantee Policy for Tonga, with clear criteria and information requirements for the transparent assessment and approval of requests for government guarantees to limit accumulation of contingent liabilities consistent with public debt sustainability; and made this publicly available on a government website to enhance fiscal transparency.<sup>c</sup></p> <p>1.3 Cabinet established and operationalized a consolidated and up-to-date establishment employment register that is linked to payroll, to</p>	<p>By December 2022</p> <p>a. Government takes on no external borrowing except on highly concessional terms (FY2016–2018 baseline: 100% of new external borrowing is on terms above 35% concessionality) Source: Government Budget Statements</p> <p>b. Approval of all government guarantees after June 2021 follows provisions laid down in the Government Guarantee Policy for Tonga (FY2020 baseline: Guarantee Policy does not exist) Source: Ministry of Finance</p> <p>c. Decline in public sector wage bill as a proportion of total government expenditure (FY2021 baseline: 32.3%) Source: Government Budget Statements</p>	<p>Government will track monitorable public debt indicators as indicated in the Medium-Term Debt Strategy, and update the strategy if necessary to ensure debt and macroeconomic stability.</p> <p>Government will prepare an action plan on reducing tax exemptions with a view to improving revenue mobilization and addressing current fiscal pressures, and commence its implementation.</p> <p>Rules and regulations for full implementation of controls of overtime payments to public sector employees (including caps in the number of hours for various employment categories and monitoring mechanisms) are prepared and rolled out.</p> <p>Government's steering committee will regularly monitor progress on implementation of the PFM Action Plan</p>

<b>Prior Actions: Completed July 2020 to September 2021</b>	<b>Outcome Indicators</b>	<b>Post-program Partnership Framework January 2022–December 2023</b>
<p>strengthen controls on the size of the establishment and control the public sector wage bill.</p> <p>1.4 Cabinet approved the Public Service Commission and the Ministry of Finance to amend the policy governing overtime in the public sector, to control and monitor the cost of overtime payments to public servants.<sup>d</sup></p> <p>1.5 Cabinet (i) approved and Ministry of Finance commenced implementation of a PFM Action Plan for 2021–23, that includes gender responsive budgeting activities,<sup>e</sup> as part of its program to improve PFM systems; and (ii) established and operationalized a steering committee chaired by the Minister of Finance to provide oversight for the time-bound implementation of the Action Plan.<sup>f</sup></p>		<p>against set milestones, and take appropriate action to maintain reform progress as needed.</p> <p>Government will seek TA support for and commence implementation of gender responsive budgeting training for ministries and the collection of sex-disaggregated data in ministry annual reporting.</p>
<b>Reform Area 2: Business environment for the private sector</b>		
<p>1.6 Parliament passed the revised Credit Unions Bill, 2021 for supervision and regulation of nonbank financial institutions to strengthen financial sector stability and enhance financial inclusion.<sup>9</sup></p> <p>1.7 Parliament passed the International Arbitration Act 2020 to improve the enabling environment for foreign investment and make Tonga compliant with the United Nation Convention on the Recognition and Enforcement of Foreign Arbitral Awards (1958).</p> <p>1.8 Parliament passed the Energy Bill, 2021 to strengthen the institutional, regulatory and policy framework for the Tonga energy sector and encourage greater private sector</p>	<p>a. Annual reporting on credit union regulation and supervision produced (FY2021 baseline: No annual reporting) Source: National Reserve Bank of Tonga</p> <p>b. Arbitration of all cross-border commercial disputes follow dispute resolution framework adopted through the International Arbitration Act 2020 (2019 baseline: Framework does not exist) Source: Ministry of Trade and Economic Development</p>	<p>Ministry of Trade and Economic Development will simplify regulations governing foreign investment in line with the Foreign Investment Act 2020, which will reinforce positive impact of the International Arbitration Act 2020.</p> <p>Government will establish and operationalize an independent Energy Commission to regulate the energy sector (including regulation of price, quality and environmental aspects).</p> <p>Government will prepare a national energy policy that establishes national objectives and targets for the sector.</p>

Prior Actions: Completed July 2020 to September 2021	Outcome Indicators	Post-program Partnership Framework January 2022–December 2023
participation, as well as gender diversity. <sup>9</sup>		
<b>Reform Area 3: Human resource management</b>		
<p>1.9 Cabinet approved and the Public Service Commission commenced implementation of the public service Sexual Harassment Policy, which includes definition, process for reporting and investigation, and responsibilities of different parties in cases of sexual harassment, to foster an inclusive and safe environment in the public service sector.<sup>h</sup></p> <p>1.10 Cabinet (i) established and operationalized a Labor Mobility Steering Committee that provides oversight to the implementation of the Tonga Labor Mobility Policy;<sup>i</sup> and (ii) adopted a revised Labor Mobility Operations Manual, which is being implemented by the Labor Sending Unit (including gender sensitive reformed procedures for recruitment and selection, enhanced pre-departure training, and the establishment of more gender balanced work-ready pools), to improve the management of Tonga's labor mobility supply.<sup>j</sup></p>	<p>a. The number of Tongans in the Ministry of Internal Affairs worker pools increased to at least 900 new workers of which at least 50% of new additions are women. (December 2019 Baseline: 511 Tongans in the Ministry of Internal Affairs work pools, of which 162 are women) Source: Ministry of Internal Affairs</p>	<p>Public Service Commission will conduct training and awareness raising in ministries and public enterprises on the Sexual Harassment Policy.</p> <p>Government will submit to Parliament for enactment a revised Tonga National Quality Assessment Board Bill that provides a legal basis for the Board to perform its core functions, including providing workers skills relevant for national and overseas markets.</p>
<p><b>Budget Support</b></p> <p>Asian Development Bank: \$5.0 million grant  Government of Australia: \$10.8 million grant (A\$13.75 million)  Government of New Zealand: \$7.6 million grant (NZ\$10.5 million)  World Bank: \$5.0 million grant</p> <p>Each development partner manages the disbursement of their respective grants in parallel.</p>		

A = assumption, A\$ = Australian dollars, COVID-19 = coronavirus disease, FY = fiscal year, NZ\$ = New Zealand dollars, PFM = public financial management, R = risk, TA = technical assistance.

Note: US dollar equivalent calculated using exchange rate as of 10 May 2021.

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

<sup>b</sup> The budget statement for FY2022 is underpinned by the Medium Term Debt Strategy, and the government does not project taking on any non-concessional debt.

<sup>c</sup> The policy is in effect, with all new guarantees being approved following the procedures and guidelines laid out in the policy.

- <sup>d</sup> A cap on overtime at 20 hours per fortnight per worker, and setting up two levels of control to monitor overtime payments—at the line ministry level and at the Ministry of Finance level—is proposed for implementation in a phased manner.
- <sup>e</sup> Gender responsive budgeting is included in the consultation process with key service delivery ministries including Ministry of Internal Affairs, Police and Health for the first time ever, and in reviewing the chart of accounts to include a specific gender code to allow for gender tagging and analysis of gender programs. This is a cornerstone to implementing gender responsive budgeting.
- <sup>f</sup> The Action Plan is a live document, developed on a rolling basis, with the initial set of actions to be implemented during 2021–2023. In line with the provisions of the Action Plan, capacity building of budget officers is ongoing, macrofiscal models have been strengthened, and publication and disclosure of fiscal information has improved. Work has also begun on reviewing Tonga’s Public Financial Management Act 2002, with a view to identifying amendments required to further improve PFM systems and processes. The steering committee is chaired by the Minister of Finance, and includes the Chief Secretary; Auditor General; Chief Executive Officer, Ministry of Revenues and Customs; and Chief Executive Officer, Ministry of Public Enterprises. The committee is receiving regular reports on the implementation of the Action Plan.
- <sup>g</sup> The approved bills will be presented for Royal Assent before being gazetted to become an Act.
- <sup>h</sup> The policy is in effect, and all new cases being handled following the procedures and guidelines laid out in the policy.
- <sup>i</sup> The Labor Mobility Policy was approved as a prior action under the 2020 ADB program. It provides guiding principles and an institutional framework for the management of low- and semi-skilled overseas employment opportunities and migrant workers from Tonga. The Labor Mobility Steering Committee is chaired by the Minister for Internal Affairs and co-chaired by the Minister for Trade and Economic Development. It also includes as members the Australian and New Zealand High Commissions, and other relevant officials from the two chairing ministries. Its mandate includes problem solving, effective administration and aid coordination. The committee directed that development of working groups on areas covered by the manual commence immediately and that the Chamber of Commerce could also be included to participate actively in some of these working groups.
- <sup>j</sup> The Labor Mobility Policy is being operationalized through the revised operations manual that includes processes that covers the full course of labor mobility including reformed procedures for recruitment and selection, pre-departure training, and the establishment of work-ready pools, with a special focus on increasing female participation in work-ready pools. It also strengthens data management processes and systems to better inform policy decisions, optimize operations and reduce costs.

**Contribution to Strategy 2030 Operational Priorities:** Operational priority indicators to which this operation will contribute results are detailed in Contribution to Strategy 2030 Operational Priorities (accessible from the list of linked documents in Appendix 2).

Source: Asian Development Bank.

**LIST OF LINKED DOCUMENTS**

<http://www.adb.org/Documents/RRPs/?id=55016-001-2>

1. Grant Agreement
2. Sector Assessment (Summary): Public Sector Management
3. Contribution to Strategy 2030 Operational Priorities
4. Development Coordination
5. International Monetary Fund Assessment Letter
6. Summary Poverty Reduction and Social Strategy
7. Program Impact Assessment
8. Risk Assessment and Risk Management Plan
9. List of Ineligible Items

**Supplementary Document**

10. Overview of Policy Reform Actions, 2009–2021



**OFFICE OF THE  
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**MF.176/1**

2021

6<sup>th</sup> September,

Mr. Masatsugu Asakawa  
President  
Asian Development Bank  
Manila, Philippines

Dear Mr. President,

**Letter of Development Policy**  
for the Tonga Economic Recovery Support Program

Tonga has been hard hit by the coronavirus disease (COVID-19) pandemic. While we are fortunate to have remained COVID-19 free hitherto, the virus continues to have a profound impact on our economy and society. We have recorded negative growth rates for the last two fiscal years FY2020 and FY2021. This comes even as we were still recovering from the devastating effects of Tropical Cyclone Gita in 2018, Cyclone Tino in January 2020 and Cyclone Harold in April 2020 that caused damage to key infrastructure and livelihoods and highlighted our vulnerability to disasters caused by natural hazards.

Government has and will continue to prioritize prevention and protection against the COVID-19 pandemic, as the first and foremost priority considering the context of the Tongan economy including vulnerability and limited resources. It is encouraging to note the availability of vaccines against COVID-19 which are being rolled out rapidly in Tonga and across the world. This will be critical to our recovery. I would like to acknowledge our appreciation to Asian Development Bank (ADB) for their support towards this effort, through the fast disbursement of grants from the Asia Pacific Disaster Resilience fund and the Pacific Disaster Resilience program. We also acknowledge the budget support ADB extended to us in FY2021 through the Strengthening Macroeconomic Resilience Program.

We are also guided by the Tonga Strategic Development Framework 2015–2025, that espouses a vision for “a more progressive Tonga supporting a higher quality of life for all.” Government recognizes that addressing constraints to more inclusive, sustainable, and resilient economic growth will be key to achieving this objective. We have been implementing an ambitious reform program over the past decade that has helped strengthened our public financial management systems, increased tax collections, and improved public enterprise performance. Our debt position has stabilized, allocation of public resources is more strategic, and their use more efficient. Efforts to improve the policy and regulatory environment for the private sector have also led to substantial improvements in the ease of doing business.

We are encouraged by the strong support from the ADB and our development partners to continue these reform efforts. Since 2011, the government and development partners have been working together through the Joint Policy Reform Matrix process to prioritize, implement and monitor reforms that are critical for Tonga's sustainable and inclusive development. Closely aligned to the priorities of the Tonga Strategic Development Framework, the Joint Policy Reform Matrix aims to strengthen Tonga's fiscal management and promote private-sector led growth. This will not only assist us in the current crisis but establish stronger systems to manage future risks.

However, the ongoing coronavirus pandemic threatens to reverse our hard-fought poverty alleviation and development gains. All our key economic sectors including agriculture, fisheries and tourism have seen significant drops in growth. Government's fiscal policy is fundamental in managing available limited resources, supporting development activities and growth, upholding the quality of the public service deliveries, and sustaining conducive environment for the private sector to grow.

In FY2021, government prioritized health expenditures to support preparedness in relation to COVID-19. It also implemented the Economic and Social Stimulus Package to protect vulnerable social segments and productive sectors of the economy. Additionally, government granted financial support towards key sectors' recovery plans including public roads maintenance and key transport infrastructures. Government Budgets FY2022–FY2024 will similarly continue to build on current efforts to support medium-term economic recovery, rejuvenate private sector activity, protect and create jobs, and maintain overall macro-fiscal sustainability. At the same time, government revenue streams declined in FY2021 and are expected to only recover slowly as businesses and economic activity recover. Consequently, after many years of running budget surpluses, government forecasts running budget deficits till FY2024.

A stand-alone policy-based grant requested for the current year's budget support would help the government provide fiscal resources to help Tonga restore inclusive growth led by the private sector, which has been adversely affected by the COVID-19 pandemic.

We recognize that with fiscal deficits projected over the next few years, attention must be paid managing public debt. Debt currently remains low cost and at manageable levels, however our limited access to debt markets and the small size of the economy, mean that managing debt through proper planning is imperative. Government consequently started implementation of a medium-term debt strategy. This commits us to keep debt low cost by not taking on any debt except on extremely concessional terms and to build reserves to finance upcoming external debt repayments. The situation will remain fluid in the medium term, so we will be regularly monitoring its sustainability and risk against monitorable indicators. To complement this, we are also implementing a new government guarantee policy consistent with international good practice, that provides transparency by clarifying government guidelines for providing guarantees; the fees we will charge and for public disclosure of all guarantees we provide. All future approvals will also take account of projected debt sustainability.

Government is committed to improving expenditure composition so that scarce resources can be used towards our development priorities. A critical element of this is controlling the public wage bill. Government undertook a study to understand the causes behind this and possible remedies. We have now taken steps to implement its recommendations. One important part of this is re-establishing a unified employment register between the Ministry of Finance and the Public Service Commission which was not being maintained. Government has operationalized a unified register, and directed the Public Service Commission to provide an annual update to Cabinet on the status of



the register to ensure its sustainability. This measure will help us eliminate roles that have not been approved, and stop unapproved growth in positions. Cabinet has also approved amending the government's overtime policy to control excess growth in overtime payments. This is aligned with good practice across the world.

Tonga has made significant gains in public finance management (PFM) over the past decade however, challenges remain. In January 2020, the Ministry of Finance, together with the International Monetary Fund, approved and published the Public Expenditure and Financial Assessment Agile and Gender Responsive Budgeting Assessment to identify priorities for the government PFM roadmap improvements. Subsequently a PFM reform strategy was developed through a consultative approach and government is now implementing a PFM action plan to address weaknesses. Necessary measures and expected outcomes under each pillar have been prioritized, and key tasks, responsible officers, timelines, capacity development needs and estimated costs identified. To ensure time-bound implementation, a steering committee has been set up under my chairmanship to monitor progress on a regular basis.

An important pillar of our recovery program is to improve the business and investment climate and stimulate new private investment. Government has submitted to Parliament for its enactment, a Credit Unions Bill to regulate nonbank financial institutions by bringing them under the purview of the National Reserve Bank. This will support efforts to enhance financial inclusion and access to finance for the private sector through development of Credit Unions, especially in rural and remote islands where there are no banks. It will also help better monitoring of financial sector vulnerabilities, as strongly recommended by the International Monetary Fund.

Parliament recently approved the International Arbitration Act 2020. The Act will facilitate fair and timely resolution of disputes through arbitration and bring Tonga in accord with the United Nation Convention on the Recognition and Enforcement of Foreign Arbitral Awards (1958). We recognize the support provided by ADB in developing this piece of legislation.

Government also submitted for Parliament's enactment, an Energy Bill that will provide an institutional, regulatory and policy framework for the Tonga's energy sector. Key features of the bill are aligned with global best practice and are intended to support energy resilience, affordability, access, reliability, and sustainability and create new opportunities for the private sector. A new Ministry for Energy will be set up to focus attention on this important sector.

Finally, our human resources are limited, and we must utilize them optimally to sustain growth. Government recognizes the importance of supporting more women into entering the workforce. We also understand that gender-based violence could be a key deterrent. To address this, government has approved a sexual harassment policy to address sexual harassment in government offices, a first for the country. The policy defines sexual harassment, sets out procedures for addressing complaints and describes the roles and responsibilities of stakeholders. In the coming months, we will also be conducting training and launching an awareness raising campaign to ensure the greatest benefit from this initiative.

We also want to take better advantage of the opportunities that seasonal worker schemes in Australia and New Zealand offer us. Through support from the previous ADB program, government adopted a Labor Mobility Policy. We have now started implementation of the policy through operationalizing a Labor Mobility Steering Committee to provide high level leadership and oversight. The committee is chaired by

the Ministry of Internal Affairs and co-chaired by the Ministry of Trade and Economic Development, and brings together relevant stakeholders. On the advice of the committee, government also adopted a new gender sensitive Labor Mobility Operations Manual to enhance management and core services of Tonga's labor mobility institutions. The operations manual includes processes that covers the full course of labor mobility including reformed procedures for recruitment and selection, pre-departure training, and the establishment of work-ready pools, with a special focus on increasing female participation in work-ready pools.

The government is firmly committed to implementing this program to support Tonga's economic recovery efforts. We look forward to working closely with ADB and continue active engagement with other partners to assist Tonga's rapid recovery from the economic difficulties of the coronavirus pandemic, and to promote further reforms to achieve longer-term growth. We also would be happy to continue our partnership with the ADB beyond the program to enhance and sustain our reform efforts.

Yours sincerely,

  
Hon. Tevita Lavemaau  
Minister for Finance

