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Report No. 103173-TO

INTERNATIONAL DEVELOPMENT ASSOCIATION

PROGRAM DOCUMENT

FOR A PROPOSED DEVELOPMENT POLICY GRANT

IN THE AMOUNT OF SDR 0.8 MILLION (EQUIVALENT TO US\$ 1.0 MILLION)

AND A PROPOSED DEVELOPMENT POLICY CREDIT

IN THE AMOUNT OF SDR 0.8 MILLION (EQUIVALENT TO US\$ 1.0 MILLION)

TO THE

KINGDOM OF TONGA

FOR THE

FIRST INCLUSIVE GROWTH DEVELOPMENT POLICY OPERATION

February 10, 2016

Macroeconomics and Fiscal Management Global Practice
Country Management Unit for Timor Leste, Papua New Guinea and Pacific Islands
East Asia and Pacific Region

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Kingdom of Tonga
GOVERNMENT FISCAL YEAR
 July 1 – June 30

CURRENCY EQUIVALENTS
 (Exchange Rate Effective as
 of January 31, 2016)

Currency Unit	Tongan Pa'anga
US\$1.00	TOP\$ 2.24
SDR1.00	US\$1.3805

ABBREVIATIONS AND ACRONYMS

ADB	Asian Development Bank	IPP	Independent Power Provider
AFS	Annual Financial Statement	JPRM	Joint-Policy Reform Matrix
ANS	Assessment of National Systems	LAL	Liter of Alcohol
AusAID	Australian Agency for International Development	MFAT	Ministry of Foreign Affairs and Trade
BSMC	Budget Support Management Committee	MFNP	Ministry of Finance and National Planning
CAOC	Cabinet Audit Oversight Committee	MTDS	Medium-term Debt Strategy
CAS	Country Assistance Strategy	NCD	Non-Communicable Disease
CPI	Consumer Price Inflation	NPL	Non-Performing Loan
CPIA	Country Policy and Institutional Assessment	NRBT	National Reserve Bank of Tonga
CPU	Central Procurement Unit	PAC	Public Accounts Committee
DFAT	Department of Foreign Affairs and Trade	PE	Public Enterprise
DPF	Development Policy Financing	PEFA	Public Expenditure and Financial Accountability
DPO	Development Policy Operation	PFM	Public Financial Management
DSA	Debt Sustainability Analysis	PFMRP	Public Financial Management Reform Plan
EAP	East Asia Pacific	PFTAC	Pacific Financial Technical Assistance Centre
EIA	Environmental Impact Assessment	PIC	Pacific Island Country
EU	European Union	PIC8 SCD	Systematic Country Diagnostic for 8 small PICs
FDI	Foreign Direct Investment	PPG	Public and Publically-Guaranteed
FMIS	Financial Management Information System	PPP	Purchasing Power Parity
FY	Fiscal Year	PSC	Public Service Commission
GDP	Gross Domestic Product	RA	Remuneration Authority
GoT	Government of Tonga	SDR	Standard Drawing Right
GRS	Grievance Redress Service	SME	Small and Medium Enterprises
HIES	Household Income and Expenditure Survey	SORT	Standardized Operational Risk-Rating Tool
ICP	International Comparison Project	SPG	South Pacific Games
ICT	Information and Communication Technology	TCC	Tonga Communications Corporation
IDA	International Development Association	TCL	Tonga Cable Limited
IFC	International Finance Corporation	TSCP	Transport Sector Consolidation Project
ILO	International Labor Organization	TOP	Tongan Pa'anga
IMF	International Monetary Fund	TSDF	Tonga Strategic Development Framework

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KINGDOM OF TONGA
FIRST INCLUSIVE GROWTH DEVELOPMENT POLICY OPERATION

TABLE OF CONTENTS

SUMMARY OF PROPOSED CREDIT/GRANT AND PROGRAM.....	iv
1. INTRODUCTION AND COUNTRY CONTEXT	1
2. MACROECONOMIC POLICY FRAMEWORK	4
2.1 RECENT ECONOMIC DEVELOPMENTS.....	4
2.2 MACROECONOMIC OUTLOOK AND DEBT SUSTAINABILITY	6
3. THE GOVERNMENT'S PROGRAM	9
4. THE PROPOSED OPERATION	10
4.1 LINK TO GOVERNMENT PROGRAM AND OPERATION DESCRIPTION.....	10
4.2. PRIOR ACTIONS, RESULTS AND ANALYTICAL UNDERPINNINGS	10
4.3 LINK TO CPF, OTHER BANK OPERATIONS AND THE WBG STRATEGY	19
4.4 CONSULTATIONS AND COLLABORATION WITH DEVELOPMENT PARTNERS....	20
5. OTHER DESIGN AND APPRAISAL ISSUES.....	21
5.1 POVERTY AND SOCIAL IMPACT	21
5.2 ENVIRONMENTAL ASPECTS.....	21
5.3 PFM, DISBURSEMENT AND AUDITING ASPECTS.....	22
5.4 MONITORING, EVALUATION AND ACCOUNTABILITY	23
6. SUMMARY OF RISKS AND MITIGATION.....	24

ANNEXES

ANNEX 1: POLICY AND RESULTS MATRIX.....	25
ANNEX 2: LETTER OF DEVELOPMENT POLICY	28
ANNEX 3: FUND RELATIONS ANNEX.....	32
ANNEX 4: GOVERNMENT OF TONGA'S JOINT-POLICY REFORM MATRIX	34

TABLES

TABLE 1: SELECTED POVERTY AND INCOME DISTRIBUTION INDICATORS	2
TABLE 2: KEY MACROECONOMIC INDICATORS	5
TABLE 3: FINANCING THE BUDGET DEFICIT.....	6
TABLE 4: KEY FISCAL INDICATORS.....	7
TABLE 5: DPO PRIOR ACTIONS AND ANALYTICAL UNDERPINNINGS	18
TABLE 6: STANDARDIZED OPERATIONAL RISK-RATING TOOL	23

FIGURES

FIGURE 1: GINI COEFFICIENTS AND INCOME LEVELS	2
FIGURE 2: PUBLIC DEBT SUSTAINABILITY ANALYSIS	8
FIGURE 3: EXTERNAL DEBT SUSTAINABILITY ANALYSIS	8

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SUMMARY OF PROPOSED CREDIT/GRANT AND PROGRAM
Kingdom of Tonga
First Inclusive Growth Development Policy Operation

Borrower	Kingdom of Tonga
Implementation Agency	Ministry of Finance and National Planning
Financing Data	SDR 0.8 million (US\$1.0 million equivalent) IDA Grant and SDR 0.8 million (US\$1.0 million equivalent) IDA Credit Standard IDA credit terms for small island states of 40 years maturity including a grace period of 10 years.
Operation Type	The proposed operation is the first inclusive growth development policy operation in a programmatic series of three operations. It will be provided in a single tranche.
Pillars of the Operation And Program Development Objective(s)	The Program Development Objective is to: i) <u>Support fiscal resilience</u> by means of strengthened revenue mobilization and strategic fiscal and debt policies; ii) pursue <u>inclusiveness and government accountability</u> by improving compliance with public procurement regulations, improving budgetary classifications, improving the adequacy of responses to external audit, and introducing new regulatory frameworks into selected sectors; and iii) <u>support a more dynamic and inclusive economy</u> by adopting investor-friendly foreign investment legislation, extending coverage of the credit bureau, and improving oversight and private participation in public enterprises.
Result Indicators	<u>Under development objective (i):</u> 1) Increase in excise tax revenue as a proportion of GDP 2) Reduction in public wagebill as a proportion of domestic revenue over time 3) All new external debt taken on is highly concessional <u>Under development objective (ii):</u> 4) Increase in proportion of contracts above the small purchases threshold that are subject to open competition 5) Improvement in the proportion of audit recommendations acted on 6) Regular regulatory reports published for selected sectors 7) Basic labor market protections introduced <u>Under development objective (iii):</u> 8) Increase in applications for investment permits from potential foreign investors 9) Increase in number of Credit Bureau checks made for credit applications 10) Public enterprises reformed to increase private participation
Climate and disaster risks (required for IDA countries)	(i) Are there short and long term climate and disaster risks relevant to the operation (as identified as part of the SORT environmental and social risk rating)? Yes No X
Overall risk rating	Substantial
Operation ID	P155133

IDA PROGRAM DOCUMENT FOR A PROPOSED CREDIT AND GRANT TO TONGA

1. INTRODUCTION AND COUNTRY CONTEXT (INCLUDING POVERTY DEVELOPMENTS)

1. **This operation is the first in a new programmatic series of three operations to build fiscal resilience, support accountability and promote inclusive growth in Tonga.** The operation will consist of a US\$ 1.0 million equivalent credit and US\$ 1.0 million equivalent grant. Australia, through its Department of Foreign Affairs and Trade (DFAT), the Asian Development Bank (ADB) and the European Union (EU) are all expected to provide budget support this year against the same joint policy reform matrix (JPRM) supported by this operation¹.

2. **Tonga is a small Pacific island nation that has just undergone major democratic changes.** Tonga's population of 106,000 is dispersed across 36 of its 177² islands with around one quarter of the population based in the capital of Nuku'alofa. Its location makes Tonga the most geographically remote nation from major centers of economic activity in the world³. Tonga is a constitutional monarchy. Until 2010, the legislative assembly of 23 representatives consisted of 17 unelected noble representatives and 9 elected "people's" representatives. Major constitutional reforms in April 2010 saw the legislative assembly change to become majority democratically elected, with 17 elected representatives and 9 nobles. There have been two elections since the reforms. In November 2010, a party led by the nobles formed a government. The next election in November 2014 saw a hand-over of power to a party led by elected representatives for the first time in Tonga's history. Tonga's new Prime Minister, the Honorable 'Akilisi Pohiva, co-founded the first democratic party in Tonga and has been a leading figure in the call for democratic change.

3. **Tonga's economic growth potential is hindered by innate high cost structures and exposure to shocks, common to many of the small Pacific island nations.** Over the last twenty years, per capita GDP has grown by 1.1 percent on average, compared to 2.3 percent globally. While this is lower than the average of any other developing region, it is still better than the average for the group of small Pacific islands as a whole, which grew by 0.9 percent per year over the same period, illustrating the challenges faced by the region. In any given year, it is likely that Tonga is either hit by a major natural disaster, or is still recovering from the previous one. Small size and remoteness combine to push up the cost of economic activity in Tonga, limiting the competitiveness of its exports of goods and services in world markets. Small size and remoteness also push up the cost of providing public services. High dependence on imports combined with a lack of sufficient size for meaningful diversification makes Tonga highly vulnerable to external economic shocks. These factors combine to make growth, inclusive or otherwise, particularly elusive in Tonga.

4. **Extreme poverty is negligible, but Tonga is facing a serious challenge in securing prosperity for all and significant numbers live in situations of hardship.** While infrequent surveys mean the latest poverty data is over five years old⁴, the Bank has recently prepared internationally-comparable poverty estimates for Tonga and other Pacific islands for the first time⁵. These estimates show that the prevalence of extreme poverty is very low in Tonga, at 1.1 percent nationwide, which suggests there are fewer than 1,200 people in extreme poverty in the entire country. Poverty based on the \$3.10-a-day line is somewhat

¹ The Government of Tonga has invited New Zealand Ministry of Foreign Affairs and Trade (MFAT) to join the budget support framework but at present MFAT do not have any budget support commitments.

² A new island was created in March 2015 with the eruption of Hunga Tonga volcano.

³ Using a GDP-weighted measure of distance from all other countries, Tonga is the most remote developing country in the world. Only Australia and New Zealand are more remote, excluding their own sizeable domestic markets.

⁴ The latest Household Income and Expenditure (HIES) data available corresponds to 2009 data. A new HIES is underway but is not yet complete.

⁵ These estimates are not only the first time 'dollar-a-day' metrics have been calculated, but incorporate 2011 round ICP PPP price estimates, which for the first time are based on survey data for Tonga, rather than imputed values.

higher, at 8.2 percent of the population, with rural populations more likely to live in poverty than those in urban areas (9.1 percent compared to 4.9 percent). This is consistent with local views that while there are very few people in abject poverty in Tonga, “hardship” or lack of cash for basic goods, is significantly more widespread. The estimated Gini coefficient of 38.1 is in line with other countries in the East Asia Pacific (EAP) region, given their income levels (for example, Thailand, with a slightly higher household income, has a slightly higher Gini coefficient). Comparison of household survey results in 2001 and 2009 suggest that income growth of lowest deciles has only just kept pace with average income growth (with a negligible difference in growth rates). Although reliable data for more recent years is not available for most income and non-income measures, there are indications that material hardship remains a pressing problem for some. The 2011 Census revealed that since 2006, 1,950 people had left the subsistence agriculture sector, yet only 260 formal jobs had been created nationwide.

Table 1: Selected Poverty and Income Distribution Indicators

	Extreme Poverty (\$1.90 a day)	Poverty (\$3.10 a day)	Gini coefficient (0 – 100)
	<i>percentage of population below poverty line</i>		<i>where 100 is completely unequal</i>
National	1.1	8.2	38.1
Urban	-	4.9	39.1
Rural	-	9.1	37.0
Male-head hhlds	-	8.4	-
Female-head hhlds	-	7.5	-

Source: World Bank Staff estimates based on Tonga Department of Statistics data

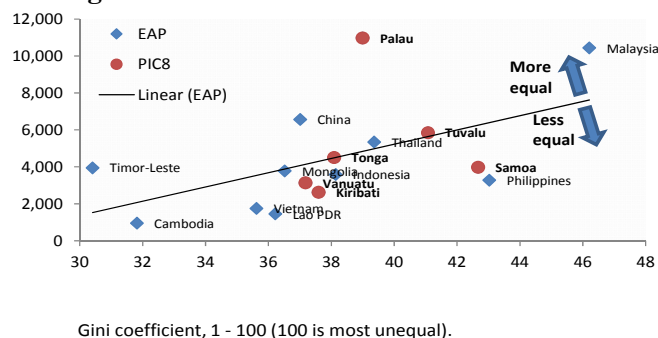
5. Social and human development indicators are amongst the strongest in the Pacific, but challenges remain and there are important gender disparities that adversely affect development outcomes for women. Primary and secondary school enrollments are high at 96 percent and 83 percent, respectively. The quality of education remains a challenge though, with children scoring poorly on early-grade reading assessments. Under-five mortality, at 12 per 1000, continues to decline, while 98 percent of births are attended by skilled health staff. However, the growing crisis of non-communicable diseases (NCDs) threatens to reverse improvements, with some evidence suggesting that life expectancy in Tonga is now falling as a result of NCDs. While women are not generally more likely to be poor in

Tonga and keep up and even outperform men in education participation at all levels, they face a number of serious challenges. Women are under-represented at senior levels of the labor force, for example, senior civil service positions⁶, and there are no female Members of Parliament. Forty percent of ever-partnered women aged 15-49 have experienced gender-based violence. Women have a higher non-communicable disease burden, and are 20 percent more likely to be obese than men and are almost 10 percent more likely to die prematurely.

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6. This operation will support the achievement of the twin goals by strengthening the inclusivity of growth to support shared prosperity, and improving economic prospects for women and vulnerable groups. This new engagement is a product of the Government of Tonga’s new inclusive growth program and the recently completed Systematic Country Diagnostic for the eight small Pacific islands (PIC8 SCD). It seeks to target the main constraints to achieving the twin goals under the selected pillars, and is based on a solid analytical basis and strong government ownership.

Figure 1: Gini coefficients and income levels



⁶ About 60 percent of top civil service positions are filled by men, although the second tier is predominantly women.

7. **This new programmatic engagement reflects a strong reform program under the new Government, and a continuation of the reform partnership with development partners.** This program builds on two previous two-year programs that immediately preceded it over the last four fiscal years. The previous development policy engagements supported domestic revenue mobilization and public financial management reforms while addressing private sector constraints. For the new programmatic engagement, the Bank has worked with the Government of Tonga (GoT) and development partners to elaborate key reform actions via the formulation of a Joint Policy Reform Matrix (JPRM) that outlines shared reform priorities, and is fully aligned with the Government's national development plan – the Tonga Strategic Development Framework 2015-2025 (TSDF) and the Budget priorities of the government⁷.

8. **The program supports objectives that are considered to be the most critical to setting the foundations for inclusive growth in Tonga.** The Program Development Objective is to: i) Support fiscal resilience by means of strengthened revenue mobilization and strategic fiscal and debt policies; ii) pursue inclusiveness and government accountability by improving compliance with public procurement regulations, improving budgetary classifications, improving the adequacy of responses to external audit, and introducing new regulatory frameworks into selected sectors; and iii) support a more dynamic and inclusive economy by adopting investor-friendly foreign investment legislation, extending coverage of the credit bureau, and improving oversight and private participation in public enterprises.

9. **Supported reforms will improve fiscal resilience, support a modern and accountable state and support a more dynamic and inclusive economy.** To support fiscal resilience, policy actions in this operation include strengthening of revenue collection through excise tax increases; the approval of Tonga's first medium-term debt strategy (MTDS); and the completion of a public sector remuneration review. To support an inclusive, modern and accountable state, this operation supports policy actions that introduce new procurement regulations; more robust systems to follow-up and address audit recommendations; and legislation to establish a new ICT regulator. To support a more dynamic and inclusive economy, the operation supports an action to streamline the Boards of Directors of Public Enterprises, with a number of further reform areas intending to commence in the second operation.

10. **The proposed operation carries substantial risk due to thin capacity in the public sector and vulnerability to external economic shocks and natural disasters.** The proposed operation faces two main risks. Firstly, Tonga experiences the thin capacity typical of public sectors in very small states, with a small number of qualified public servants called upon to implement the many tasks of a central government. This implies that program implementation can be directly affected by the performance or departure of a few officials. Secondly, macroeconomic stability is dependent on a continued sustainable fiscal position, and stable external financial flows including remittances and development assistance from donors. Macroeconomic disruption arising under several feasible shock scenarios, including natural disasters and any substantial scaling back of external assistance, would distract available capacity and resources from the implementation of actions supported by the program, as well as undermine the impact of these actions on growth and poverty-reduction. The World Bank, coordinated with other development partners, intends to continue its close economic and fiscal dialogue in support of reform as a primary means of managing risks related to limited capacity, and is also engaged at a policy and operational level to support Tonga to manage disaster risks.

⁷ The TSDF 2015-2025 was finalized in early 2015 and reflects the priorities of the Government that took office in late 2014.

2. MACROECONOMIC POLICY FRAMEWORK

2.1 RECENT ECONOMIC DEVELOPMENTS

11. **Tonga's economic growth has been low by global standards, and adversely affected by the frequent occurrence of shocks.** Similar to most other Pacific Island Countries (PICs), smallness and remoteness pose challenges to Tonga, pushing up the cost of economic activity, limiting competitiveness in global markets, and limiting scope for diversification in its sources of foreign exchange. Tonga is also highly vulnerable to external shocks, climatic conditions, and natural disasters. Average growth over the last five years has remained low at 1.2 percent⁸ and has been volatile, with short term public construction cycles driving temporarily heightened growth followed by 3.1 percent negative growth in FY2013. The economy then rebounded to 2.0 percent growth in FY2014 and is expected to grow moderately at 1.8 percent in FY2015.

12. **Over the medium term, income growth is most likely to arise from tourism-servicing sectors, overseas work opportunities and commercial agriculture and fisheries.** Over the last five years, agriculture and fisheries have outperformed other sectors, growing at 2.3 percent compared to growth in the secondary and tertiary sectors of 0.7 and 0.9 percent respectively. However, agricultural growth may not be sustained and the primary sector is estimated to have declined by 2.4 percent in FY2015 due to the severe impact of a drought that year. Over the last five years, total tourist arrivals in Tonga increased by 9.5 percent. Tourism receipts were equivalent to 10 percent of GDP in FY2014, up from 7 percent in FY2010. Remittances continue to be a critical income source, and recent years have seen improved remittance growth following the expansion of overseas worker programs such as the Australian Seasonal Worker Program and New Zealand Recognized Seasonal Workers Program. The transport and communications sector will be enhanced with the utilization of the fiber optic cable in the mainland and the extension to outer islands. Development of quality ICT improves Tonga's attractiveness as a tourism destination, as well as a location for investment more generally.

13. **Inflation has declined and remains subdued.** As commodity prices, particularly oil, have declined significantly and demand remains weak, inflation has fallen from a peak of 7.1 percent in FY2011 to 0.2 percent in FY2015, despite the Tongan Pa'anga depreciating against a number of major currencies in the last couple of years. The latest IMF Article IV report, published in 2015, assessed the level of the exchange rate as broadly in line with fundamentals, with estimates ranging between 6 percent undervaluation to 15 percent overvaluation. Since the time of that assessment, the exchange rate has depreciated further against a selection of currencies. Inflation is expected to remain low in the near term. This has allowed the National Reserve Bank of Tonga (NRBT) to maintain its current accommodative monetary policy stance.

14. **Private sector credit growth has started to grow after a long decline.** Tonga's banking system has gone through a prolonged period of balance sheet adjustment since the third quarter of 2008. Over 2004 to 2008, a bubble developed in the housing market and the stock of private credit doubled to 54 percent of GDP. The boom came to an abrupt end in late 2008 due to sharply deteriorating debt servicing capacities and moderating asset prices in the wake of the global crisis. Non-performing loans (NPLs) peaked at 20 percent in 2009. Private sector credit then fell by 34 percent the period FY09- FY14, including a drop by 20 percent in FY2010. Despite the National Reserve Bank of Tonga (NRBT)'s attempt to stem the decline in credit through aggressive injections of liquidity, banks continued to shrink their loan books and accumulate excess reserves leading to a liquidity overhang. Tight lending conditions, with NPLs remaining at uncomfortable levels and uncertain external conditions, limited competition in the banking sector during the period. With improvements in banks' capital and credit quality, NPL ratios have declined to less than 13 percent in FY2014. Supported by government initiatives, including a new subsidized lending scheme through the Tonga Development Bank, domestic private sector credit grew by 8.6 percent in FY2015. The

⁸ Although this marks an improvement in the last five years, average growth over the last ten years just 0.6 percent.

private credit-to-GDP ratio has returned to 30 percent, which is only slightly higher than the pre-crisis period.

Table 2: Key Macroeconomic Indicators

	FY2011	FY2012	FY2013	FY2014	FY2015	FY2016	FY2017
Real Economy							
	Annual percentage change, unless otherwise indicated						
GDP (nominal Pa'anga m)	774.8	800.6	779.3	803.6	828.1	860.9	894.9
Real GDP	2.7	0.9	-3.1	2.0	1.8	2.8	2.1
Per Capita GDP (in current US\$)	4,051	4,365	4,074	4,251	3,714	3,780	3,879
Exports, f.o.b.	36.3	65.4	-22.6	8.4	0.0	15.0	14.0
Imports, f.o.b.	17.0	17.6	-2.2	0.1	9.7	8.6	2.2
GDP deflator	5.8	2.4	0.5	1.1	1.2	1.1	1.9
CPI (eop)	7.1	2.3	0.2	1.5	0.2	1.7	2.0
Fiscal Accounts							
	Percent of GDP, unless otherwise indicated						
Expenditures	33.7	30.2	26.5	25.9	28.8	35.6	30.5
Revenues	26.3	27.4	25.3	28.6	29.0	30.7	27.8
General Government Balance	-7.4	-2.8	-1.3	2.7	0.2	-4.9	-2.7
PV of External PPG debt (% of GDP)	28.6	35.7	28.9	30.9	31.2	30.9	30.3
PV of public sector domestic debt (% of GDP)	5.5	4.6	3.7	3.6	5.5	5.3	5.0
Selected Monetary Accounts							
	Annual percentage change, unless otherwise indicated						
Base Money	3.3	7.2	6.1	7.2	9.0	8.0	9.9
Credit to Private Sector	-9.9	-5.2	-7.5	0.7	8.6	4.6	13.5
Balance of Payments							
	Percent of GDP, unless otherwise indicated						
Current Account Balance	-0.4	-1.2	-1.6	-1.8	-2.9	-7.1	-4.6
Exports	2.6	3.9	3.2	3.3	3.8	4.3	4.7
Imports	36.1	39.2	41.0	39.1	48.9	51.8	51.1
Foreign Direct Investment	4.8	1.1	3.6	2.6	2.7	2.9	3.0
Gross Reserves (in US\$ m, e.o.p.)	120.8	140.6	144.7	153.4	144.8	145.4	139.2
In months of next years imports	5.6	6.6	7.3	7.1	6.3	6.1	5.5
As % of short-term external debt	78.1	72.1	73.5	79.6	82.4	80.0	75.3
Exchange Rate (eop)	1.8	1.8	1.8	1.8	2.1	2.1	2.1
Other memo items							
GDP (nominal US\$ m)	422.9	457.5	428.2	448.9	394.3	404.2	418.2
Remittances (% of GDP)*				23.2	26.6	28.5	28.4
Tourism receipts (% of GDP)	7.9	8.3	9.7	10.0	10.9	12.5	14.0

**Due to methodological changes to the series, historical data is not available.*

Source: IMF and World Bank staff estimates.

15. **The current account deficit has widened slightly and remains largely financed by development grants and remittances.** The current account deficit (after grants) as a share of GDP increased from 0.4 percent in FY2011 to 2.9 percent in FY2015. The current account deficit has been adequately financed by capital inflows. Development assistance has helped the government to build up foreign reserves. Gross official foreign reserves in months of imports have increased to 7 months in FY2014 from 5.6 month in FY2011. FDI inflows remain low at around 3 percent of GDP.

16. **The fiscal balance has improved significantly thanks to prudent fiscal management, although it may worsen again in FY2016 and FY2017 mostly due to construction spending related to the upcoming South Pacific Games (SPG).** Despite a slight increase in expenditure, the government was able to narrow the overall deficit (after grants) from 7.4 percent of GDP in FY2011 to 1.3 percent in FY2013 and turned a small overall surplus in FY2014 by enhancing tax revenue and mobilizing grants. Domestic revenue (excluding grants) has increased by 3.9 percentage points of GDP over the three years to FY2015, as a series of revenue policy and administration reforms have been effected. Development expenditure, which includes donor-financed capital projects, has fallen since FY2011 as large debt-financed public building and roads projects have been completed, and this has supported an improving budget balance. Managing current expenditure pressures has been a challenge, as current expenditure increased by 2.9 percentage points of GDP from FY014 to FY2015, due in equal parts to increased staff costs (TOP9m), increased goods and services (TOP8m) and one-off monetization of pension commitments (TOP8m). The wage bill has been a big fiscal risk since 2006 when a large pay rise was granted in the wake of public service pressure and rioting. Although it was effectively kept under control up until FY2013, since then intensified pressure has led to two pay settlements of approximately 5 percent each in FY2014 and in the current fiscal year FY2016, highlighting the need for a more systematic approach to managing public service remuneration. However, the biggest factor moving the budget into deficit in FY2016 and FY2017 are large budget allocation for SPG investments, although there are strong indicators that in FY2016 at least, these costs may not materialize on the government budget⁹.

Table 3: Financing the budget deficit

	FY2016
	Tongan Pa'anga (millions)
Overall deficit (excluding grants)	111.5
Budget support grants	17.0
Of which World Bank	2.3
Asian Development Bank	4.8
Australia	5.1
European Union	4.8
Budget support credits	7.1
Of which World Bank	2.3
Asian Development Bank	4.8
Other grants	50.6
Other external financing	17.2
External debt amortization	6.4
External grants and financing	85.5
Domestic financing	26.0
Total grants and financing	111.5

Note: Donor financing are projections only, and are not binding on any party

Source: IMF Staff Estimates and World Bank Staff Estimates

2.2 MACROECONOMIC OUTLOOK AND DEBT SUSTAINABILITY

17. **Growth is expected to strengthen in the near term driven by heightened construction activity and a growth in tourism.** Cyclone Ian reconstruction, which has been mainly financed by development assistance, and construction work for the SPG are expected to be the main drivers of growth over the next three years. The economy is expected to grow moderately at 1.8 percent in FY2015 and strengthen further in FY2016 to an annual rate of 2.8 percent. Agriculture is expected to continue its recovery in FY2016 from negative growth due to a severe drought in FY2015. Due to resource depletion and the unfavorable investment climate, the outlook of fisheries is uncertain. The service sector is expected to drive higher growth and exports in FY2016 and FY2017 in large part due to tourism expansion with the new Tanoa

⁹ An allocation of TOP38 million is made in Budget FY2016 for SPG construction costs. However, it is understood that commitments received from development partners after presentation of the budget will be used to finance these expenses, and domestic resources will not be utilized for this budget line.

International Dateline Hotel expected to commence operations in FY2016.

Table 4: Key Fiscal Indicators

	FY2011	FY2012	FY2013	FY2014	FY2015	FY2016	FY2017
In percent of GDP, unless otherwise indicated							
Overall Balance	-7.4	-2.8	-1.3	2.7	0.2	-4.9	-2.7
Primary Balance	-4.6	-1.9	-0.4	3.6	1.0	-4.0	-1.9
Total Revenues and Grants	26.3	27.4	25.3	28.6	29.0	30.7	27.8
Domestic revenues	19.2	18.0	19.5	20.0	21.9	22.6	22.8
of which Sales and Consumption Taxes	10.6	11.0	11.2	11.8	12.5	13.1	13.3
of which Taxes on Income and Profits	4.9	3.2	3.6	3.2	3.6	0.0	0.0
of which Non-tax Revenue	2.1	2.2	2.5	2.7	3.2	3.2	3.2
Grants	6.8	9.4	5.6	8.6	7.1	8.1	5.0
Total Expenditures	33.7	30.2	26.5	25.9	28.8	35.6	30.5
Current Expenditure	22.7	23.5	24.9	23.6	26.5	31.9	28.1
Wages and Compensation	11.8	10.4	10.8	11.5	12.3	13.4	12.9
Goods and Services	6.6	8.3	9.8	6.7	7.5	10.9	8.3
Interest Payments	2.7	0.8	0.9	0.9	0.8	0.9	0.8
Current Transfers	2.2	3.0	2.0	3.3	4.2	4.4	4.6
Development expenditures	9.6	5.6	1.6	2.3	2.3	3.7	2.4
General Government Financing	7.4	2.8	1.3	-2.7	-0.2	4.9	2.7
External (net)	8.4	5.1	0.2	-0.8	0.6	1.9	0.7
Domestic (net)	-1.1	-2.4	1.0	-1.9	-0.7	3.0	2.0

Source: IMF staff estimates

18. **Inflation is expected to remain below three percent and the current account deficit will worsen as preparations for the SPG proceed.** Inflation is expected to rise slightly to around 2 percent, as private sector credit returns to positive growth following the bottoming out of the credit cycle and as commodity prices stabilize. The current account deficit is forecast to increase during FY2016 due to the commencement of imports of large amounts of construction-related materials for the SPG. Foreign reserves are expected to remain adequate, at more than 5 months of import cover through the forecast period.

19. **Continued close supervision of the budget and an appropriate fiscal strategy will support fiscal sustainability into the medium-term.** The fiscal surplus achieved in FY2014 is expected to continue in FY2015. External grants have remained around 7 percent of GDP over FY2015 while cyclone-recovery operations proceed, but are expected to fall back again by FY2017. Despite these improvements, Tonga faces large costs over the next few years, which need to be watched very carefully to make sure they do not undermine fiscal stability. Tonga will host the SPG in 2019 and intends to minimize the costs of new developments and refrain from debt financing, seeking to finance through domestic revenues, grants and corporate sponsorship. Cost overruns or funding shortfalls could rapidly undermine Tonga's hard-won fiscal discipline. While scope for significant fiscal consolidation on the expenditure side is limited given pressing service delivery needs, a gradual decline in wages and salaries will create space for other essential expenditure. Revenue is estimated to increase from new sources, such as increased excise tax on unhealthy foods and alcohol, excise tax increases on petrol, and improved revenue collection efficiency.

20. **Tonga is assessed to be at a moderate risk of debt distress, down from high risk two years ago, aided by continued vigilance of the authorities.** The government has been successful in lowering both external and domestic debt in recent years. Public and publically-guaranteed (PPG) external debt to GDP has gradually declined from 35.7 percent in FY2012 to 30.9 percent in FY2014. The 2015 Debt

Sustainability Analysis (DSA) indicates that Tonga remains at moderate risk of debt distress. The assessment has improved rapidly over recent years driven by a number of factors, both methodological and due to fundamentals. In 2013, Tonga's strengthening CPIA rating moved it up to a 'medium' performer and the associated higher debt thresholds. In 2014, changes to the Debt Sustainability Framework meant that capacity-to-repay indicators now factor in remittances, improving the assessment for Tonga, while changed market comparison rates increased the discount factor for concessional debt. As a result, WB and ADB financing is now available on half highly concessional credits-half grant terms. The government has successfully maintained a stance of avoiding any new non-concessional borrowing, and debt levels have been trending downwards. Despite the slight increase in external debt over the coming years, the government's ambition to finance the SPG using non-debt creating funds is considered to be prudent. The present value of debt is projected to remain below the benchmark, and steadily decreases to about 20 percent of GDP throughout the projection period (Figure 2). The external debt and debt service indicators remain under the thresholds (Figure 3). Debt service is forecast to increase from 2019 to 2029 reflecting mostly repayments of the two large external loans, which account for about 60 percent of the outstanding external debt.

Figure 2: Public Debt Sustainability Analysis

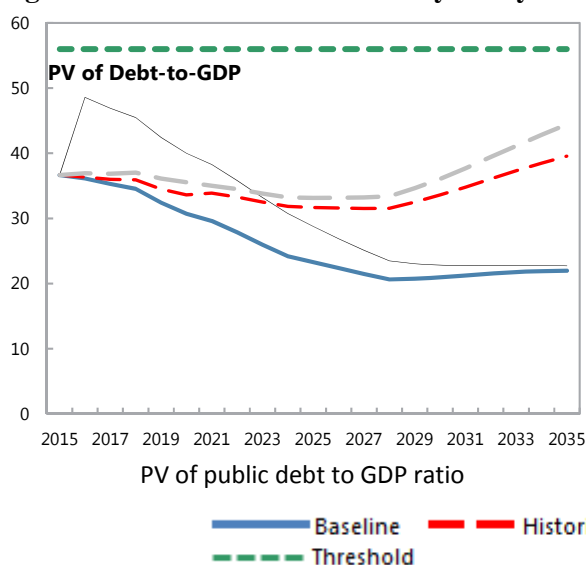
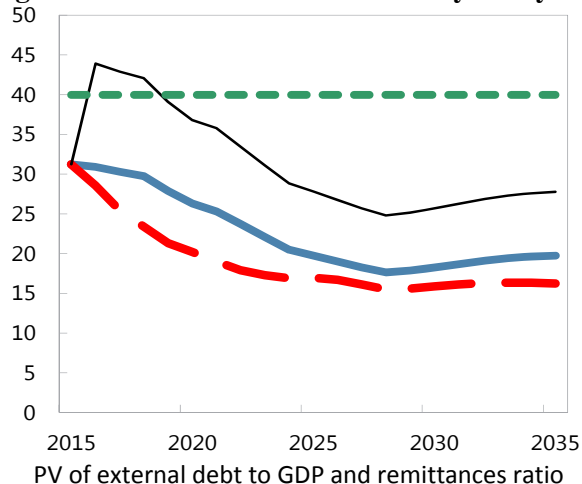


Figure 3: External Debt Sustainability Analysis



Source: IMF-World Bank Debt Sustainability Analysis for Tonga, 2015

21. **The current macroeconomic policy stance is adequate for the proposed program, but outcomes continue to remain subject to uncertainty and reliant on external linkages, including development assistance, remittances and commodity prices.** The latest IMF Article IV assessment notes that while risks remain, the fiscal position has improved, outlook for growth is moderately good and inflation is expected to remain muted, an assessment supported by the IMF assessment letter (Annex 3). There is a risk that growth could slow down with the ending of cyclone reconstruction projects and public projects for the SPG, without other private sector engines starting up. The large agriculture sector continues to be at risk of major crop losses, which continued El Niño activity over the next 6 to 12 months could exacerbate. Tonga is highly reliant on imports and a sharp rise in prices of imported commodities could undermine efforts to achieve inclusive growth and poverty reduction. Adverse shocks to employment and consumer demand in major partner countries would feed through to Tonga via reduced remittances and tourism receipts. The macroeconomic policy framework also depends on the continued availability of development assistance from development partners over the medium term. Finally, Tonga continues to be highly vulnerable to major natural disasters, which can devastate the local economy and create considerable fiscal pressure.

3. THE GOVERNMENT'S PROGRAM

22. **The new government has set out Tonga's national development strategy in the Tonga Strategic Development Framework (TSDF), 2015-2025.** This document, which was endorsed by the government in April 2015 sets out a medium term vision and directly builds on the preceding TSDF 2011-2014. It is underpinned by an extensive consultation process which involved all parts of government and intensive consultations with stakeholders and the public, including both civil society groups and private sector entities across the Tongan islands.

23. **The vision of the TSDF is for “a more progressive Tonga supporting a higher quality of life for all”.** This vision is translated into seven high-level National Outcomes to achieve over the next 10 years. The criticality of inclusivity and sustainability is emphasized in each of the seven outcomes. They aim to achieve: i) a more dynamic, knowledge-based economy; ii) more balanced urban-rural development; iii) more empowering human development and gender equality; iv) responsive and good governance, including law and order; v) successful provision and maintenance of infrastructure and technology; vi) effective land administration, environmental management and resilience to climate and risk; and vii) consistent advancement of Tonga's external interests, security and sovereignty.

24. **This new strategic framework includes a heightened emphasis on sustainability, good governance and shared prosperity.** The strategic priorities clearly emphasize the cross-cutting importance of sustainability and inclusivity issues when addressing all outcome areas. The importance of governance, both internally as effective public service provision and externally as international relations is a key area of focus for the new TSDF.

25. **The national outcomes are to be achieved via a set of 29 organizational outcomes, which together identify a set of key policy areas of focus.** The organizational outcomes are grouped under five pillars: economic institutions; social institutions; political institutions; infrastructure and technology inputs; and natural resource and environmental inputs.

4. THE PROPOSED OPERATION

4.1 LINK TO GOVERNMENT PROGRAM AND OPERATION DESCRIPTION

26. **The proposed new programmatic DPO series is designed to set the foundations for achievement of key national outcomes under the Government's TSDF 2015-2025.** The series as a whole will support national outcomes one to five enumerated in paragraph 23. Fiscal and economic management reforms under pillar one will support the government's inclusive development priority, and improve the identification and resourcing of key public service delivery. Pillar two will support more responsive and effective government systems and delivery of key utility and infrastructure services for all of Tonga. Pillar three will support the preconditions for more dynamic, inclusive and sustainable growth. These supported outcomes are those which are associated with the comparative advantage of development policy programming, while other outcomes are being supported by investment operations and technical assistance by the World Bank and by other development partner programs.

27. **The development objective of the operation reflects key constraints that the government is addressing as a matter of priority.** The reform program is expected to directly support poverty reduction and shared prosperity by supporting lower costs of basic goods through more effective regulation, reinforcing incentives for healthy living, and encouraging a more conducive business environment for more jobs and income-earning opportunities. Over the course of the program, reforms that will improve the inclusivity of growth will be brought in, notably supporting increased access to finance for smaller businesses in the second year and foundational labor rights introduced into domestic law in the third year.

28. **The proposed program builds on the foundations of the previous programmatic DPO.** The previously supported program strengthened contingency fund and sub-program virement budgetary controls, tax exemption rationalization, tax simplification and tax reforms designed to combat NCDs, as well as the establishment of a new business registry. Since the approval of the last DPO, significant progress has been made to ensure the sustainability of other supported reforms. The receivership bill has been passed into law, as has the extractive industries taxation bill. The Dateline Hotel, previously a public enterprise, has been taken over by the international Tanoa Group and is currently being completely renovated. It will soon be the largest hotel operating in Tonga.

29. **The proposed operation reflects key lessons learned from previous development policy operations that the Bank has undertaken in Tonga.** In Tonga, DPOs can be implemented relatively quickly to achieve good results in the context of solid government ownership, and can be a prime means for advancing economic and fiscal policy reforms. Adequate investment in policy dialogue is vital but resource intensive, and flexibility is important in the context of a limited-capacity and volatile environment, including the flexibility to significantly adjust indicative triggers. Project-level engagement can assist in identifying key priorities to be supported, and close coordination and engagement with other development partners in the identification of policy priorities is critical in sectors where the Bank has limited knowledge and engagement. Finally, coordinated management of fiscal needs and budget support can provide vital support to mitigate the impact of external shocks.

4.2 PRIOR ACTIONS, RESULTS AND ANALYTICAL UNDERPINNINGS

30. **The proposed program supports policy reforms under three pillars: i) Supporting fiscal resilience; ii) supporting an inclusive, modern and more accountable state; and iii) supporting a more dynamic and inclusive economy.** Under these three pillars, this operation consists of seven prior actions. To support fiscal resilience, policy actions include strengthening of revenue collection through excise tax increases; the approval of Tonga's first medium-term debt strategy; and the approval of a new remuneration framework. To support an inclusive, modern and accountable state, this operation supports policy actions that introduce new procurement regulations; more robust systems to follow-up and address audit recommendations; and the establishment of a new ICT regulator. To support a more dynamic and inclusive economy, the operation supports an action to streamline the Boards of Directors of Public Enterprises, with

a number of further reform areas intending to commence in the second operation.

Pillar I: Supporting Fiscal Resilience

31. **Getting the most out of domestic revenue sources, building fiscal buffers and careful management of the limited funds available are the best fiscal preparation for future shocks.** Fiscal and debt management policy are geared towards increasing the resilience of the public finances to shocks. The Government is committed to leveraging development policy financing (DPF) to strengthen fiscal resilience to future shocks by increasing domestic revenue mobilization through strengthened taxation settings and increasing the oversight of key sources of fiscal risk. Policy reforms will also be focused on increasing revenue efficiently from indirect tax sources, curtailing the scope for tax exemptions in law, addressing major expenditure items, including debt management and public service wagebill, in order to ensure the sustainability of public finances whilst supporting effective service delivery to the greatest extent possible. This reform area builds on previously supported reforms to improve policy settings for tax exemptions, introduce new tax regimes for small businesses and natural resources, and to stabilize wagebill costs through careful management of the establishment and remuneration policy.

Prior Action 1: Excise tax and import duty changes to support revenue mobilization and healthy lifestyles

32. **Specific duties serve a dual role in Tonga as the major source of domestic revenue and a policy lever to achieve behavioral change.** Global evidence and Bank-led regional work has shown that greater use of fiscal signals to promote healthy consumption choices is one of the top priorities to address the burgeoning Non-Communicable Diseases (NCD) epidemic. NCDs are a major threat to public health and public finances in Tonga. Life expectancy is already falling in Tonga as a result. Over one third of female and over one quarter of male premature deaths are caused by NCDs and 88 percent of adult Tongans are overweight or obese. Tonga is also in the top ten countries in the world for male rates of smoking.

33. **Historically, eighty percent of tax revenue is collected from consumption and trade taxes that were hard hit during the Global Food and Fuel Crises.** In a highly trade-dependent country with limited domestic value added and limited direct tax compliance capacity, import duties, consumption tax and excise duties form the mainstay of the revenue system. At the height of the Global Food and Fuel Crisis in FY2009, a series of changes were implemented in an attempt to mitigate the impact of price rises in basic commodities on household welfare. As a result, revenue from these sources dropped by 20 percent in a single year and has remained low. Recent falls in global oil prices have afforded an opportunity to reinstate these critical revenue sources without increasing the net price to consumers.

34. **As a prior action, the Recipient has increased the rate of fuel excise tax by TOP 0.06 per liter (an increase in the rate of 12%) and other excise tax and import duty rates in order to improve revenue mobilization and strengthen incentives to consume healthy foods, as evidenced through the Excise Amendment and the Customs Amendment.** The government has extended reforms put in place under the last DPO and increased the excise duty on tobacco, all kinds of alcohol, and implemented a new excise duty on instant noodles¹⁰ and increased the import duty rates on turkey tails to 15 percent. To encourage healthy choices and reduce the negative impact on household budgets, compensating reductions in the import duties of various fruit, vegetables and fish have been implemented. To support revenue mobilization, the excise duty on petroleum has been raised by 12 percent from TOP\$ 0.50 to TOP\$ 0.56 per liter. The results indicator for this reform area will target an increase in excise duty revenue as a proportion of GDP.

35. **Indicative triggers will strengthen the legislative framework for key tax heads, curtailing the scope for discretionary exemptions.** Reforms under previous development policy programs in Tonga have established a new policy and institutional framework to manage the granting of tax exemptions. As a next

¹⁰ Duty on cigarettes increases by TOP\$5 per 1,000 sticks; duty on beer increases by TOP\$5 per liter of alcohol (LAL) and duty on spirits increases by TOP\$4 per LAL.

step, the DPO series will support the review of consumption and corporation tax legislation in order to make explicit the purposes of tax exemptions and reduce ambiguity and the scope for loosely-targeted or discretionary exemptions. These reforms will extend further domestic revenue mobilization efforts and reduce the risk of tax base erosion in future years by restricting the legal scope for exemptions.

Prior Action 2: Medium-term debt strategy

36. **Tonga's small economic base means that expenditure is highly constrained and the capacity for the public sector to service debt is extremely limited.** The government of Tonga suffers from an acute lack of economies of scale, whereby revenues from a small population are required to finance the fixed costs of a full set of public goods and services comparable to a country many times Tonga's size. This means that pressure on the public purse is particularly acute in Tonga. However, in a context where resources for debt-servicing are very small and the prospects for economic growth in many cases risky and uncertain, the government can only service a relatively small debt portfolio, and the case for borrowing must be very carefully considered.

37. **Over the past four years Tonga has effectively refrained from new borrowing in order to bring its debt portfolio to manageable levels.** Two loans contracted in the late 2000s (one to rebuild commercial buildings destroyed in the 2006 riots, another to upgrade major roads in the capital city) were sufficient to push the country into a high risk of debt distress. Total public debt rose from 28 percent of GDP in FY2008 to 45 percent of GDP in FY2012. To ensure existing debts are properly managed and prospective new loans sufficiently analyzed, the Ministry of Finance and National Planning (MFNP) established and staffed a dedicated Debt Unit and introduced a 'no new debt' policy that was consistently adhered to while Tonga was classified as in high risk of debt distress. As a result of strengthening policy frameworks and continued control of debt, the joint IMF – World Bank Debt Sustainability Analysis found that Tonga now faces a reduced risk of debt distress (down from high to moderate).

38. **As a prior action for this operation, the Cabinet has approved a new Medium-Term Debt Strategy (MTDS), which has been made public.** Now that Tonga has re-established a moderate capacity for new debt, the Government has agreed that it is imperative that any new loans contracted are subjected to rigorous assessment to ensure they maximize the benefits to the country and maintain low portfolio risk. The MTDS creates a new policy framework under which to manage debt, and provides a set of conditions under which debt may be contracted. The MTDS contains detailed analysis of the existing debt portfolio, risk analysis and appraisal of various borrowing strategies, with recommended strategies identified. The results indicator for this reform area will target the adherence to key MTDS policy objectives of contracting only high concessionality debt.

39. **Indicative triggers will establish a robust medium-term fiscal framework.** Tonga faces significant fiscal stresses from year to year as a result of large, discrete shocks, both externally and internally-derived. In an inherently volatile fiscal context, a medium-term framework which identifies appropriate targets and strategies to get there will support sustainability and increase fiscal resilience. Such a framework would parsimoniously combine rules to support maintaining fiscal buffers (debt target), rebuilding buffers (deficit target) and maintaining space for service delivery (wage target). This framework will support the government to bring together its MTDS, expenditure policies and revenue mobilization efforts into a comprehensive framework.

Prior Action 3: Public sector remuneration review

40. **Public sector remuneration has for years been a major fiscal challenge in Tonga, and reform is highly contentious, given the importance of public service salaries for much of the population.** The public sector wage bill, which constitutes around 60 percent of domestic revenue, is high even when compared similar economies in the Pacific. Following an aborted reform of the public service remuneration program which was met with public service strikes and public outcry, a large pay settlement left horizontal inequities in the remuneration system and poor performance management systems unaddressed.

41. **The Government has independently initiated a detailed remuneration review in order to move towards a more equitable and functional public remuneration framework.** For the first time since the 2000s, the Government, led jointly by the Public Service Commission (PSC) and the Remuneration Authority (RA) has initiated a review of current remuneration carried out by an industry-leading international consultancy firm. This review has considered the pay and job descriptions of all public servants – those subject to the PSC payscales and those agencies and bodies that have their own remuneration scales as overseen by the RA.

42. **As a prior action (a) The Recipient's Remuneration Authority has completed a remuneration review of the public service in order to ensure equitable, competitive and fiscally-sustainable remuneration and submitted its recommendations to Cabinet; and (b) the Recipient's Cabinet has reviewed the said recommendations.** The new remuneration framework will set a solid foundation for equitable and performance-related pay by ensuring that similar jobs receive commensurate remuneration across the public service. It will help to address sustainability issues by removing the de-facto automatic increments of the current system, which contribute to an expectation for continual, substantial pay rises year-on-year irrespective of performance. The proposed changes will achieve cost savings by reducing wage growth from these large automatic progressions, and relieve pressure for universal pay settlements from the many civil servants that are currently stuck at the top of their pay banks. Substantial work over nearly two years has gone into assessing each position in the public sector (using the Hay 'job-sizing' methodology) and proposing a new framework and mapping off all current employees and posts to that new framework. Cabinet has received and discussed the Remuneration Review and has instructed that the reform proceed with detailed consultation across government to ensure all staff are sensitized on the new framework and have an opportunity to raise concerns. While this is a significant step forward, substantial further work is needed to ensure that improvements in the remuneration system are embedded across government and complementary reforms are brought in. Indicative triggers in this policy area will support further implementation of the public sector reform program including the implementation of the remuneration framework and the development of a reformed public service performance management and reward system. The results indicator for the policy area will target improved public sector wagebill affordability, measured as a reduction in public remuneration as a proportion of domestic revenue. This target will be met by improved control of wage bill growth, both by making sure that universal pay settlements are affordable and earned, and by reducing the prevalence of rapid in-grade salary increases which are not linked to good performance. It is important to note that the reform does not include any plans to reduce the number of positions, nor are there any plans to reduce the level of wages to any public servant.

Pillar II: Supporting a modern and accountable state

43. **The new government of Tonga came in on a platform of good governance, and while effective fiscal management is part of this, a key priority is to ensure the democratic mandate is extended across government and to entrench a culture of transparency, audit and accountability.** The proposed program supports key steps under the new government that will strengthen accountability and oversight frameworks within both the public sector and in private markets. Policy areas supported under the pillar of the program include: Improved procurement and IFMIS systems; increased effectiveness of external audit recommendations; regulation of sectors that provide basic services; and labor market reform to improve the quality of jobs and narrow gender disparities. Reforms in this area build on previous DPO reforms including improvements in the preparation of public accounts, transparency of budget execution information, contingency fund controls, and previous stages of the procurement reform program. Previously supported reforms also include regulatory reform of the petroleum sector, and electricity tariff reform.

Transparency and control of use of public funds

44. **The Government has launched a new PFM Reform Roadmap (PFMRP) that will support effective control and accountability of public funds, transparency and efficient service delivery.** Binding capacity constraints in the public service, particularly for professionals such as accountants mean that the Government faces a challenge in ensuring that PFM systems are effective whilst compatible with

the capacity-scarce environment. The PFMRP, which was extensively consulted on and approved by Cabinet in late 2014, sets out a comprehensive and whole-of-government plan for the next five years. This development policy program selectively supports critical reforms under the PFMRP.

Prior Action 4: Public procurement reform

45. **The Government is mid-way through a major public procurement reform program that will address weaknesses in the system, improve accountability and help assure value-for-money.** The previous DPO program supported the initiation of a new procurement reform program to address deficiencies identified in the latest Public Expenditure and Financial Accountability (PEFA) report and other recent reviews of procurement activity, including a lack of usable records for auditing, low levels of compliance with rules and a chronic lack of procurement capacity in most ministries. Improving compliance with procurement regulations that support competitive and value-for-money public sector tendering is a key priority for Government. Steps already taken include the launch of a Procurement Reform Action Plan, the establishment of a new Central Procurement Unit (CPU) in MFNP and a Treasury instruction to mandate oversight of sizeable procurements by the CPU. The CPU is now fully operational and is overseeing all public procurement, whilst also providing capacity building for procurement officers in line ministries.

46. **As a prior action for this operation, the Recipient's Cabinet has approved a revised set of Procurement Regulations, and prepared standard bidding documents and procurement manuals in support of the Regulations.** The Procurement Review of 2013 highlighted a number of failings in the then regulatory framework for public procurement. A revised set of Procurement Regulations has been prepared which has consolidated a broader and in some cases inconsistent set of regulations, rules and procedures. For example, under the previous framework there were a large number of thresholds to trigger different procurement methods. This has been consolidated to 6 non-overlapping thresholds to cover all procurement methods from direct procurement for items under TOP 3,000 to international competitive bidding for large items. These Procurement Regulations, along with supporting manuals and standard bidding documents have been approved by the Cabinet and endorsed by the Government Procurement Committee and are now being implemented with the leadership of the CPU. The results indicator for this area will target an increase in usage of competitive tender methods for procurements above the small tender threshold.

47. **Indicative triggers in this area will support reform of the government's financial management information systems, in order to ensure appropriate and timely financing of government activities, and clear reporting.** Further reform in this area targets other core systems in MFNP, with a view to improve their functionality and reduce capacity requirements to improve the overall effectiveness of financial management in government. Indicative triggers for each of the next two years will support reforms that will improve the clarity of reporting of budgetary information through a Chart of Accounts that captures standard economic classifications (based on Government Financial Statistics guidelines) and an improved Financial Management Information System (FMIS) which will reduce the capacity burden of budget monitoring and reporting, and support greater integration and efficiency of treasury and cash management systems.

Accountability and control of corruption reform

Prior Action 5: External audit reform

48. **External audit of public accounts is an important accountability mechanism and one which to date has not been utilized effectively in Tonga.** Tonga's 2010 PEFA assessment identified a number of serious short-comings in the performance of the external audit functions, which have been supported by more recently assessments such as the 2014 PEFA self-assessment and Australia's 2015 Assessment of National Systems (ANS). The timeliness of audit reports has in the past been compromised by delays in annual financial statements, although this has improved in recent years. However, once audit reports have been prepared, there are often long delays in formal responses being prepared and the reports being tabled by the Public Accounts Committee (PAC) in the Legislative Assembly. There is little evidence of follow-

up on audit recommendations, with formal responses not detailed and delivered with long delays.

49. **As a prior action for this operation, a new biannual report of audit recommendations and actions for all ministries and agencies of government has been prepared, and a new Audit Oversight Committee of Cabinet established and tasked with ensuring timely and thorough follow-up of audit recommendations.** A new 'Report on Status of Audit Recommendations and Management Responses and Actions by Auditees' will be prepared for all GoT entities on a regular basis, led by the Cabinet Audit Oversight Committee (CAOC), with the Chief Internal Auditor of the Ministry of Finance and National Planning reforming secretariat functions. The recommendations arising from CAOC will be discussed in Cabinet and Cabinet decision issued as appropriate for the action of relevant ministries. The results indicator for this policy area will target the proportion of audit recommendations that are considered to have been adequately address as a proportion of all audit recommendation made in the last five years.

Utility regulation and competition

Prior action 6: ICT regulator

50. **Sector reforms are needed to ensure adequate regulation of markets with limited or no competition, mindful of very limited capacity for regulatory functions.** Analysis such as the Systematic Country Diagnostic for eight Pacific Island Countries (PIC8 SCD) has shown that all the small Pacific islands face elevated cost structures due to the marginal nature of many domestic markets and a lack of economies of scale. As a result of the small size of markets, there is little scope for competition and in its absence, lack of pressure from competing firms can lead to even more inflated consumer prices. While institutional reform should aim to minimize additional capacity requirements, this needs to be balanced against the advantages of maintaining a separation of ownership and regulation of firms and ensuring an effective and transparent regulatory framework. In Tonga, the information and communication technology (ICT) sector is regulated by the Government through the Minister of Information. However, the Government is also the owner of a wholesale operator, Tonga Cable Limited (TCL) and a retail operator, Tonga Communications Corporation (TCC), which creates a potential or perceived conflict of interest. In terms of transparency, predictability and accountability, the regulatory powers under the Communications Act are broad and there are no guidelines or regulations to specify how regulation will be exercised, which combined with capacity constraints makes it difficult for the Government to ensure regulatory decisions are made predictably and transparently.

51. **As a prior action for this operation, the Recipient's Legislative Assembly has approved a new Communications Commission Act that will establish an independent regulator.** The Communications Commission Act establishes the Communications Commission with powers under the amended Communications Act which include regulation of communication services, management of license issuance, fee setting, monitoring and communication and consultation with the public. The Commission will act in a capacity to advise the responsible Minister on matters of communication policy and to provide guidance to firms on how to comply with existing rules and regulations. The results indicator in this area will target the effective regulation of regulated areas, measured as regulatory monitoring reports being prepared.

52. **Indicative triggers in this area will support the establishment of a multi-sector regulator for utilities, and the introduction of a new competition policy.** While ICT is a competitive industry a number of utility sectors are either natural monopolies or have no direct competition for customers. The government will expand on their experience of establishing an energy regulator to develop a multi-sector regulator that will oversee energy, water and other utility sectors with limited competition. By establishing these two regulators, the government will introduce a new regulatory framework for most infrastructure and communication services. To support the expansion of services and the reduction of cost, a new energy bill will, inter alia, enable increased competition in the energy sector by facilitating the entry into the market of Independent Power Providers (IPPs).

Ensuring basic labor rights

53. **Tonga is one of the few countries in the region that lacks any form of labor regulation that governs the private sector, which is recognized as a serious risk in ensuring salaries and conditions for workers are fairly set.** Tonga has never been a member of the International Labor Organization (ILO) and Tonga lacks any legislation that would otherwise address most of the key basic protections that are considered standard globally including rights to leave from work, non-discrimination, rights for fair dismissal and redundancy, etc¹¹. Lack of minimally-attractive working conditions in the private sector may contribute to a reduced willingness to commit to long-term careers in the private sector, especially for women who require more flexible working conditions and, especially, maternity leave. Broad measures of inactivity show that 43 percent of women and 23 percent of men are inactive. The recent World Bank Study on Women, Business, and the Law 2016 showed the Tonga has lagged behind in promoting gender equity in business. Tonga is the only country in EAP that does not entitle parents to any kind of leave, paid or unpaid when a child is born.

54. **The Recipient's Cabinet has approved Tonga's membership in the ILO, and signed up to its key principles.** The new Government has taken a strong position to support context-appropriate legislation for Tonga's labor market. As a first step, the Cabinet has approved the application to join the ILO, a landmark step, which will kick off a process of review of Tonga's labor market legislation and dialogue on reform. The Government has indicated its' support for ILO's core principles including the elimination of forced labor, abolition of the worst forms of child labor, equal opportunity and non-discrimination in employment and freedom of association and the right to collective bargaining. This area of reform will be an ongoing area of engagement under this program, cumulating in an indicative trigger of the approval of foundational employment legislation in Tonga that is consistent with these principles and will support women's participation and safeguard employee rights. The results indicator in this policy area will target the enshrinement of selected basic labor rights in domestic law, as described in the results framework in Annex 1.

Pillar III: Supporting a more dynamic and inclusive economy

55. **Reform of key legislative frameworks and business-supporting services is essential to set the foundations to fully exploit future growth opportunities.** Over the past four years, the authorities have implemented a series of business-supporting reforms under previous DPO programs, including a new, simpler business registration system, a new legislative framework for receiverships and a clear governance framework for natural resources. In the area of public enterprise reform, they have also supported substantial PPPs and improved governance. In the 2015 Doing Business Survey, Tonga ranks 78th in the world and is the top ranked Pacific developing nation, above Fiji and Samoa. However, a series of assessments combined with ongoing dialogue has identified a number of critical gaps. This three-operation program identified key actions to address the most critical problems, phased to account for very limited implementation capacity.

56. **Building on past and ongoing reforms, the government has committed to providing a more supportive environment for private sector development, which enhances inclusive growth.** This pillar consists of four reform areas: Foreign investment regulatory reform to promote growth and job creation; financial sector reform, which increase access and affordability of finance; and business law reform, which reduce risks and costs of doing business.

57. **A lack of foreign direct investment has been a constraint for growth and job creation which has been recognized by the government through a new foreign investment policy framework.** Foreign direct investment in Tonga has remained very low for some time and is currently 3 percent of GDP. Overly burdensome and complex legislation is frequently mentioned by potential investors as an impediment that prevents foreign investors from taking advantage of business opportunities, and leads to an acute shortage

¹¹ There are specific provisions under the Public Service Act which establish rights for public servants, but private sector employees are not covered.

of capital and learning in the economy. In addition, uneven enforcement of laws has created uncertainty and prevented potential foreign investors from investing and starting business in Tonga. Analytical studies and consultations carried out with support from ADB and the WBG have helped the government to recognize the importance of regulatory reform to enhance FDI, which is vital for private sector development. Supported under the previous DPL program, the government has approved a framework for a new foreign investment policy and legislative environment.

58. **An indicative trigger under this program will support the approval of revised Foreign Investment Act and complementary changes to the Immigration Act.** This reform is expected to generate increased interest from foreign investors both as a signal that the government is serious about cutting red tape and to directly improve the experience of investing in Tonga, including rationalized restrictions on investment and accelerated paths to gain work visas for key staff. In the final operation, the preparation of new contract law is envisaged, as part of a broader program of business environment reforms underway. The results indicator in this policy area measures the increase in vetted applications from foreign investors.

59. **Under-developed financial sector regulation and systems have impeded development of well-functioning domestic financial markets.** The establishment of a credit bureau is a key step in developing national systems that provide comprehensive, reliable credit information and thereby radically lowering the cost of extending credit to new customers. Such a system will especially benefit smaller customers including small start-ups and women who typically lack property as collateral, as high fixed costs of manual credit checks make these customers unviable for banks. Legislative gaps in the areas of receivership (insolvency) and bankruptcy have also contributed to uncertainty around lending and increased risks for banks, reflected in poor assessments in this area of the Doing Business Survey. Tonga ranks at 133th in the global ranking in Resolving Insolvency in Doing Business 2015.

60. **Indicative triggers under this reform will support improved access to credit for SMEs and women, providing the resources for improved economic prospects and a more dynamic economy.** While the credit bureau is operational, credit records are not comprehensively reported by banks, and other credit-extending companies do not participate. The program will support mandating reports to ensure all bank credit is recorded and extend the bureau to cover positive reporting to more comprehensively cover credit records which will help people to build up their credit records and access affordable finance. As a result of these reforms, overall credit bureau coverage of the population is expected to increase. This will be reflected in improved distance to frontier scores for Getting Credit in the Doing Business Survey. Gender-disaggregated credit record data will also show active and increasing participation of women (as individuals and partners), particularly for smaller loans. The results indicator in this policy area targets the number of credit checks for new credit being carried out, disaggregated by gender.

61. **The Cabinet has approved the Public Enterprise Reform Policy.** The new government has signaled its intent to continue and deepen the reforms in this area by preparing a comprehensive PE Reform Policy which sets out their principles for the sector and reforms steps that will be taken. The policy is based around the principles of divestment where it is viable and in the public interest to do so, and improved governance and other forms of private sector participation where companies should stay in public hands. The policy includes a detailed assessment of each PE, and proposed actions to take for each PE, whether it be an asset considered ready for privatization, another form of PPP, or an asset that should remain in government hands. The framework will help to guide subsequent steps to implement the PE commercialization program.

Table 5: DPO Prior Actions and Analytical Underpinnings

Prior actions	Analytical Underpinnings
Pillar I: Supporting fiscal resilience	
The Recipient has increased the rate of fuel excise tax by TOP 0.06 per liter (an increase in the rate of 12%) and other excise tax and import duty rates in order to improve revenue mobilization and strengthen incentives to consume healthy foods, as evidenced through the Excise Amendment and the Customs Amendment	2012 WB Financing Options for the Health Sector in Tonga and 2014 WB NCD Roadmap outlined the scale of the NCD epidemic facing Tonga and recommended to reinforce positive behavioral change with taxes on risk factor goods like tobacco and unhealthy food and drink as part of a broader package of reforms. NCDs are a priority for action in the WB Country Gender Action Plan for Tonga. The 2013 IFC/WB Investment Incentive Report provides specific recommendations to reform the tax exemption system to reduce cost, improve transparency and better target investment incentives. IMF Article IV 2014 & 2015 consultations point out the importance of broadening the tax base for increasing fiscal space with the estimation that tax exemption and zero rating accounts for 4 percent of GDP.
The Cabinet has approved a new Medium-Term Debt Strategy, which has been made public	IMF/World Bank Debt Sustainability Analysis 2013 & 2014 noted the progress in reducing risk of debt distress and highlighted the importance of developing medium-term and comprehensive debt management strategy. WB 2015 World Bank Tonga Medium Term Debt Strategy Aide Memoire and IMF Article IV 2015 consultations emphasized that medium-term fiscal consolidation should be supported by effective strategies and strong debt management. TSDF 2015-2015 noted the improvement in debt management and the importance of fiscal sustainability with prudent public debt.
(a) The Recipient's Remuneration Authority has completed a remuneration review of the public service in order to ensure equitable, competitive and fiscally-sustainable remuneration and submitted its recommendations to Cabinet; and (b) the Recipient's Cabinet has reviewed the said recommendations.	ADB Tonga Economic Update Outlook 2012 raised a steady reduction in the size of the public service with performance assessment and results-linked remuneration for more effective public spending as the top priority of fiscal sustainability. 2015 Government of Tonga Remuneration Review suggests that the current salary structure, which initiated in the 1980s, needs to be revised in line with the current circumstance in the public and private sector and the evolvement of various positions in the government organizational structure.
Pillar II: Supporting a modern and accountable state	
The Recipient's Cabinet has approved and introduced a revised set of Procurement Regulations, and prepared standard bidding documents and procurement manuals in support of the Regulations	The 2010 Public Expenditure and Financial Accountability (PEFA) Assessment noted significant weaknesses in procurement processes and rated them overall as 'C'. 2014 PEFA self-assessment reported that the performance on public procurement have been deteriorated from "C" to "D" since the 2010 PEFA assessment and suggests the government to improve procurement as a priority GoT/AusAID Public Procurement System Review 2013; GoT/DFAT Procurement Regulation Review 2014 identified a number of failings in the regulatory framework for public procurement and recommended various reforms including clarification of bidding documents.
A new biannual report of audit recommendations and actions for all ministries and agencies of government has been prepared, and a new Audit Oversight Committee of Cabinet established tasked with ensuring timely and thorough follow-up of audit recommendations	The 2010 PEFA rated that the overall fiduciary risk as "High" and indicated areas of weaknesses in accounting, recording and reporting and in external scrutiny and audit.
The recipient's Legislative Assembly has approved a new Communications Commission Act that will establish an independent regulator	Regulatory assessments carried out as part of the World Bank's Pacific Regional Connectivity Program identified constraints in the current framework and actions that could be taken to address them.
Pillar III: Supporting a dynamic and inclusive economy	

Prior actions	Analytical Underpinnings
The Recipient's Cabinet has approved the appointment of shared boards of directors 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	ADB Tonga Economic Update Outlook 2012, ADB Finding Balance 2014, and GoT Public Enterprise Reform Strategy show the inefficiency and poor performance of PEs and suggest to impose stronger commercial disciplines on PEs and to enhance accountability and transparency.

Prior action 7: Shared boards PE governance reform

62. **As a prior action for this operation, the Recipient's Cabinet has approved the appointment of shared boards of directors 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.** In accordance with the Public Enterprise Act, each PE is required to be overseen by a board of directors, which may not include Government officials. In a small very small country with fifteen PEs, identifying suitable candidates for all these positions is a substantial challenge. In order to support increased professionalism of boards, the Government is creating new 'shared boards' in which the same Board of Directors will serve for multiple PEs in a similar field. The two shared boards to be created will span utilities, covering Tonga Power Limited, Tonga Water Board and Waste Authority Limited and ICT covering Tonga Broadcasting Corporation, Tonga Communications Corporation, Tonga Post and Fast Print Ltd. The board members for both of these boards have been appointments as approved by Cabinet.

63. **Indicative triggers for public enterprise reform target the continued implementation of Tonga's program to increase private sector participation in the PE portfolio.** Tonga's long-standing PE reform program has already delivered significant new opportunities for the private sector and reduced fiscal risks for the government. A series of PEs have already been privatized or substantially restructured to increase private sector participation including Leiola Group Ltd duty free retailer, the International Dateline Hotel and most recently this year Tonga Water Board which contracted out all its plumbing works to the private sector on a long-term contract. Looking ahead, the new government has launched a renewed effort to ensure its PE portfolio is appropriate and supportive of private sector development. Indicative triggers target the cabinet approval of reform to two PEs in each year – via sale, outsourcing or other form of PPP, which will lead to the completion of these deals as a result of the program with the government's pipeline of transactions guided by the Public Enterprise Reform Policy.

4.3 LINK TO CPF, OTHER BANK OPERATIONS AND THE WBG STRATEGY

64. **The World Bank Group's Country Assistance Strategy (CAS) for the Kingdom of Tonga is built around three themes of reform, integration and resilience.** The first theme is supporting policy reform to strengthen economic growth prospects and to improve service delivery. The second theme is generating opportunities through greater global and regional integration. The third theme is building resilience against shocks. The proposed operation contributes to the first theme of engaging with the Government on policy reforms to strengthen growth performance and improve service delivery and to the third theme of building resilience. The policy framework strengthens the policy and legal framework to support improved opportunities for growth, while also supporting strengthened fiscal policy that will help to build fiscal buffers and improve the resilience of the government to shocks from any source.

65. **The proposed operation builds on a number of technical assistance projects of both the Bank and development partners.** Energy sector reform complements and benefits from extended engagement of the World Bank (WB) Tonga Energy Road Map project. ICT regulatory reform has been facilitated by a joint operational engagement between WB and ADB. Health-promoting fiscal reform is a product of a broader regional engagement led by the World Bank on addressing non-communicable diseases in coordination with partners, as well as substantial in-country engagement on NCD policy dialogue led by DFAT. Reform to the credit bureau builds on an ongoing engagement by IFC on this area. Tax exemptions

and investment incentive technical assistance has been provided jointly by IDA and IFC. Debt management reform has been supported by technical assistance by the World Bank, as well as Commonwealth Secretariat.

4.4 CONSULTATIONS, COLLABORATION WITH DEVELOPMENT PARTNERS

66. **The new series, and this operation, have been developed through an extensive and high-level process of consultation with all relevant authorities and stakeholders, both within the central government and at the sector level over the course of a year.** The proposed operation has been developed through established consultative processes in place for the last four years, including quarterly meetings of the Budget Support Management Committee (BSMC) chaired by the Ministry of Finance and National Planning and with representation from all budget support donors and government stakeholders. The program has also been informed by a broader Government-led consultation which engaged all ministries, agencies and non-government stakeholders. A Policy Reform retreat was held over two days in September 2015 in which key priorities for consideration under the JPRM were discussed by Chief Executive Officers of ministries, their teams, and development partners. This retreat was completed with a presentation and consultation with Cabinet Ministers, and a summary document submitted to and approved by Cabinet that outlined the proposed areas for reform under the JPRM.

67. **The proposed operation is the product of close collaboration with other development partners, and is part of a coordinated budget support framework.** The World Bank and IMF collaborate closely and Bank staff have participated in each of the last six Article IV missions and jointly prepare Debt Sustainability Analysis (DSA) for Tonga. Based on this cooperation, the Bank and IMF share a common view about Tonga's macroeconomic and structural reform priorities. The World Bank leads development partner representation at the BSMC, which is the key mechanism for coordinated dialogue to select actions and monitor progress. DFAT budget support of AU\$3 million, ADB budget support of US\$ 5 million equivalent and EU budget support of Euro 2 million is expected to be mobilized for the same policy actions. The Bank cooperates closely with key development partners in the provision of analytical work and technical assistance to Tonga, including coordinated needs assessment and programming, cross-organization peer review of analytical outputs and regular discussion in the budget support management committee framework. ADB, DFAT, EU and PFTAC are all providing assistance to the achievement of the proposed program of policy reforms.

5. OTHER DESIGN AND APPRAISAL ISSUES

5.1 POVERTY AND SOCIAL IMPACT

68. **Extreme poverty is rare in Tonga but there are significant levels of material deprivation, particularly in rural areas.** While traditional systems of support have typically provided some protection to poor and vulnerable households, economic shocks, urbanization and social change have put pressure on these informal risk-sharing mechanisms. Statistics based on the 2009 Household Income and Expenditure Survey (HIES) show that about one in ten rural households lives below the \$3.10 a day poverty line.

69. **Reforms supported by the program are expected to help reduce poverty and boost shared prosperity via market-based protection and shared proceeds from growth.** The public sector is a key provider of infrastructure and services that low-income households need to improve their opportunities. This operation will lay the foundations of a more ample and efficient public resource through increased resource mobilization and improved procurement and financial systems. NCDs are a major cause of mortality, morbidity and economic inactivity in Tonga, all of which are drivers of poverty. Although some households may pay more in the short-term for the three goods being taxed, offsetting reductions in duty for more healthy foods should minimize any short-term increase in costs, while substitution towards readily-available alternatives will provide much greater health and financial benefits over their lifetime. The reforms under Pillar B of the program are focused on increasing the level of private sector activity which is expected to bring jobs and opportunities to Tonga. But the reforms support inclusive growth by setting standards in the labor market which will make sure that jobs created are good quality and without discrimination, which will particularly benefit women. Financial market reforms to extend the credit bureau and introduce new bankruptcy law will cut the cost and risk of extending credit to small-scale businesses and entrepreneurs, thereby extending access and opportunity to those from lower-income groups. Finally, the third pillar aims to directly address poverty by minimizing the cost of basic goods and services through ensuring effective regulation and private sector competition.

70. **Supported reforms have been designed to not have a negative impact on the poor, and the poverty impacts of the program will be monitored as it proceeds.** Based on household expenditure data, poor households do not heavily consume any of the food items for which tax has been increased, with chicken, mutton flaps¹², manioke, bread and taro constituting over 40 percent of their expenditures. Although this aggregate analysis cannot rule out that some poor households may face higher costs, others will benefit from the tax reduction on healthy foods such as tinned fish and vegetables, and the reduction in price of healthy foods will support substitution towards these goods. Public enterprise reforms will address possible short-term negative impacts by using poverty and social impact assessments to identify any groups that might have been affected and include measures to make sure negative impacts are mitigated.

5.2 ENVIRONMENTAL ASPECTS

71. **The policy actions supported under the operation are not expected to have a significant impact on Tonga's environment, natural resources or forests.** Based on the expectation that very limited, if any, green field development would result from the Program, it is considered that adequate protection would be provided by the existing legal and administrative frameworks for environmental assessment and land management in Tonga.

72. **Tonga has a well-established environmental impact assessment (EIA) process administered by the Ministry of Environment and Climate Change.** It is noted that the Transport Sector Consolidation Project (TSCP) has been implemented using the Tongan legislation and to date, the project is being implemented effectively and no environmental issues have been identified. Legislation includes firstly the

¹² Mutton flaps are considered to be a risk for NCDs due to their high fat content. However the government has as yet not implemented NCD-supporting taxes on this foodstuff for the reason that it would may hit the poor if they do not reduce their consumption of it.

Environmental Impact Assessment Act 2003 to provide for the application of environmental impact assessment to the planning of development in Tonga. The Act is structured in five parts, starting with definitions of key terms in Part I and clarifying functions and powers in Part II. Part III outlines the EIA process. Part IV deals with cases of non-compliance with the previous provisions and Part V contains further miscellaneous provisions. Secondly, the Environmental Impact Assessment Regulations 2010 to regulate major development projects and the applications of notification consistent with the EIA Act 2003. Finally, the Environment Management Act 2010 to establish the Ministry of Environment & Climate Change which is now the principal Ministry responsible for the protection and proper management of the environment and the promotion of sustainable development.

5.3 PFM, DISBURSEMENT AND AUDITING ASPECTS

73. **Reflecting reform efforts over the recent years, Tonga’s CPIA rating has increased from 2.9 to 3.5 in the last 10 years, with Tonga’s policy and institutional performance now above average for IDA countries.** The 2010 PEFA showed that the legal and regulatory framework for PFM in Tonga provides a solid basis for budgeting, spending and accountability, but indicated areas of weaknesses in accounting, recording and reporting and in external scrutiny and audit. Satisfactory ratings were received on all indicators and sub-indicators pertaining to the credibility of the budget and on comprehensiveness and transparency. The annual budget, as approved by Parliament, is publicly disclosed and available on the Ministry of Finance website. Within the area of accounting, recording and reporting, unsatisfactory ratings were issued on the availability of information on resources received by service delivery units and the quality and timeliness of Annual Financial Statements (AFS). Other weaknesses were identified in external scrutiny and audit: the scope, nature and follow-up of external audit; legislative scrutiny of the annual budget law; and legislative scrutiny of external audit reports. A number of these failures have since been addressed, supported by the budget support program.

74. **There is no current IMF Safeguards Assessment of the NRBT, as Tonga has not accessed IMF funds.** The NRBT publishes its annual report together with the audited accounts and the report of the independent auditors on those accounts. The FY2011/12 annual report has been published and the audited financial accounts were unqualified. The NRBT has an established Revaluation Reserve Account, which provides an additional buffer for any foreign exchange losses and maintains foreign reserves composed of a basket of currencies reducing the sensitivity to exchange rate risk as movements of these currencies generally offset each other.

75. **There is no indication of substantial issues within the foreign exchange environment.** Until an IMF Safeguards Assessment is concluded, however, there is insufficient information available to draw any substantiated conclusions, so while country-level financial management risk for Tonga is generally rated as Moderate, the lack of an IMF Safeguards Assessment does not provide the required insights regarding the Central Bank’s foreign currency management environment. The Fiduciary risk for this specific operation is therefore assessed as “Substantial” due to the lack of an IMF Safeguards Assessment.

76. **The disbursement measures proposed are to ensure that the grant and credit funds disbursed by the Bank are deposited in a dedicated account of the NRBT, and then an amount equivalent to the grant and credit is credited to an account of the government available to finance budgeted expenditures.** IDA financing will be disbursed according to IDA disbursement procedures for development policy operations. The full amount of the grant and credit (each US\$ 1 million equivalent) will be disbursed against satisfactory completion of the specified policy actions as listed in Table 5, an adequate macroeconomic framework and the Government agreement as summarized in the Letter of the Development Policy, and is not tied to any specific purchases. Once the grant and credit are approved by the Board and become effective, the proceeds of the grant and credit will be deposited by IDA in one tranche, at the request of the Recipient, into a dedicated Foreign Currency Deposit Account at the NRBT, which will form part of Tonga’s foreign exchange reserves.

77. **Flow of funds (including foreign exchange) is subject to normal Financial Management**

processes. It is not possible to track the ultimate use of the foreign exchange provided by the development policy operation proceeds, but grant and credit proceeds will, within 30 days of the IDA disbursement, flow into a dedicated Foreign Currency Deposit Account at the NRBT and from it to the budget of the Government, and are thus subject to normal PFM processes and NRBT procedures. The Government will provide confirmation to the Bank when the grant and credit amount has been credited to a Local Currency Deposit Account used to finance budgeted expenditures by way of a letter within 30 days of the crediting of the funds into a Local Currency Deposit Account.

78. **The Bank will retain the right to request the Government to arrange a special audit of the dedicated Foreign Currency Deposit Account established in the NRBT.** The audit should cover the following: (i) the accuracy of the summary of the transactions of this account, including accuracy of exchange rate conversions; (ii) that this account was only used for the purposes of the operation and that no other amounts were deposited into this account, including confirmation from corresponding bank(s) involved in the funds flow; and (iii) that payments from this dedicated Foreign Currency Deposit Account were in a timely manner (normally within 30 days of disbursement) transferred to a Local Currency Deposit Account available to finance budgeted expenditure. The audit, if requested in writing by the Bank, will be provided to the Bank as soon as available, but not later than six months after the last disbursement from the Association, and will be made publicly available in a timely fashion.

5.4 MONITORING, EVALUATION AND ACCOUNTABILITY

79. **The existing institutional structure for aid management in Tonga will be used to implement and monitor the policy actions supported by the operation.** Through the Budget Support Management Committee, the MFNP will provide overall guidance for the budget support program, and will assume overall responsibility for coordinating the implementation, monitoring and evaluation of the operation. The MFNP will also be ultimately responsible for reporting progress and coordinating actions among other concerned government agencies.

80. **Specific indicators that the Bank will monitor for each of the policy areas supported by the proposed operation are set out in Annex 1.** The Bank will work with the Government to assess the progress of implementation of the policy actions supported by the proposed operation. The Bank will also work with the Government to monitor the specific indicators associated with each of the policy areas supported by the proposed operation. The Bank will play a coordinating role among development partners to ensure that there is a single, agreed assessment of the implementation of the policy actions and a single, agreed evaluation of the monitoring indicators. This will reduce the administrative burden on Government.

81. **Grievance Redress.** Communities and individuals who believe that they are adversely affected by specific country policies supported as prior actions or tranche release conditions under a World Bank Development Policy Operation may submit complaints to the responsible country authorities, appropriate local/national grievance redress mechanisms, or the WB's Grievance Redress Service (GRS). The GRS ensures that complaints received are promptly reviewed in order to address pertinent concerns. Affected communities and individuals may submit their complaint to the WB's independent Inspection Panel which determines whether harm occurred, or could occur, as a result of WB non-compliance with its policies and procedures. Complaints may be submitted at any time after concerns have been brought directly to the World Bank's attention, and Bank Management has been given an opportunity to respond. For information on how to submit complaints to the World Bank's corporate Grievance Redress Service (GRS), please visit <http://www.worldbank.org/GRS>. For information on how to submit complaints to the World Bank Inspection Panel, please visit www.inspectionpanel.org.

6. SUMMARY OF RISKS AND MITIGATION

The overall risk level for the proposed program is substantial.

82. **Very limited institutional capacity for implementation and sustainability present risks to the results of the operation.** Tonga suffers from the thin capacity typical of public sectors in very small states, with a small number of public servants called upon to implement the many tasks of a central government. The limited number of staff with the required technical qualifications and experience to undertake supported reforms means that poor performance or departure of staff working on the program can directly affect the speed and quality of implementation of the reform program. The availability of data is much more limited than in larger countries where the fixed costs of preparing statistics are lower. This risk is being mitigated by strong dialogue through which the Government and the Bank have carefully selected a limited number of policy actions that are key priorities for the Government. The Government and the Bank have also discussed the implementation requirements for each action at length, to ensure that expectations regarding the timeframes for implementation are realistic. Limited capacity is also being mitigated through the provision of dedicated technical assistance from various development partners to the achievement of nearly all specified actions, while the development of the results framework takes into account the limitations of what data is available.

83. **Macroeconomic shocks occur relatively frequently, can be destabilizing, and temporarily divert attention from medium-term reforms.** Potential shocks, including natural disasters, a deterioration of economic conditions in other countries, commodity price shocks or a reduction in external assistance pose risks to the maintenance of macroeconomic stability. Ongoing macroeconomic stability is highly

Table 6: Standardized Operational Risk-Rating Tool	
Risk Categories	Rating (H, S, M or L)
1. Political and governance	M
2. Macroeconomic	H
3. Sector strategies and policies	M
4. Technical design of project or program	M
5. Institutional capacity for implementation and sustainability	H
6. Fiduciary	S
7. Environment and social	L
8. Stakeholders	S
Overall	S

dependent on external factors, including sources of remittances and external demand, development assistance from donors and imported commodity prices. Remittance flows will be largely determined by economic conditions in the US, New Zealand and Australia, which are the major sources of remittances. Similarly, Tonga's economic outlook remains heavily dependent on the timely provision of budget support grants from development partners. A shortfall or substantial delay in the provision of budget support would undermine cash

management and disrupt service delivery. Macroeconomic disruption arising under several feasible scenarios would distract available capacity and resources from implementation of actions supported by the program, and undermine the impact of these actions on shared prosperity. Risks associated with these various external vulnerabilities are being mitigated through: i) conservative fiscal management; ii) accumulation of cash reserves and foreign exchange reserves to manage shocks; and iii) the Bank's dialogue with Government on appropriate ways to approach and manage expenditure or revenue shocks and pressures.

ANNEX 1: POLICY AND RESULTS MATRIX

Prior actions and triggers			Results
Prior Actions under DPO 1	Triggers for DPO 2	Triggers for DPO 3	
Pillar I – Supporting fiscal resilience			
The Recipient has increased the rate of fuel excise tax by TOP 0.06 per liter (an increase in the rate of 12%) and other excise tax and import duty rates in order to improve revenue mobilization and strengthen incentives to consume healthy foods, as evidenced through the Excise Amendment and the Customs Amendment ¹³	Implement recommendations of a review of consumption tax legislation to reduce exemptions The Recipient’s Cabinet has approved a transparent, target-based fiscal anchor system and monitoring framework	Implement recommendations of a review of corporate tax legislation to reduce exemptions	<u>Outcome: Excise duty revenue as a proportion of GDP increases</u> Indicator: Excise duty revenue as a proportion of GDP Baseline (average FY11-FY14): 4.2 percent Target (FY18): increase of 0.5 percentage points of GDP
The Cabinet has approved a new Medium-Term Debt Strategy which has been made public			<u>Outcome: Proportion on borrowing that is highly concessional</u> Indicator: External borrowing that is above 35 percent concessionality as a proportion of all external borrowing Baseline (FY13-FY15): 100 percent Target (FY16-FY18): 100 percent
(a) The Recipient’s Remuneration Authority has completed a remuneration review of the public service in order to ensure equitable, competitive and fiscally-sustainable remuneration and submitted its recommendations to Cabinet; and (b) the Recipient’s Cabinet has reviewed the said recommendations.	Cabinet approval 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.	Cabinet approval of a new public service performance management framework which provides for credible performance assessments and performance-based pay progression	<u>Outcome: Improve wagebill affordability</u> Indicator: Public wagebill as a proportion of domestic revenue Baseline (FY14): 57 percent Target (FY18): 53 percent or lower
Pillar II – Supporting an inclusive, modern and accountable state			

¹³ 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 fish decreased.

Prior actions and triggers			Results
Prior Actions under DPO 1	Triggers for DPO 2	Triggers for DPO 3	
Pillar I – Supporting fiscal resilience			
The Recipient’s Cabinet has approved a revised set of Procurement Regulations, and prepared standard bidding documents and procurement manuals in support of the Regulations A new biannual report of audit recommendations and actions for all ministries and agencies has been prepared, and a new Audit Oversight Committee of Cabinet established and tasked with ensuring timely and thorough follow-up of audit recommendations	Implementation of revised Chart of Accounts to improve reporting for line ministries	Activate and add key IFMIS modules, such as budget preparation, sales and receipts, cash management	<u>Outcome: Increased compliance with requirements for public procurement</u> Indicator: Proportion of contracts above the small purchases threshold that are subject to open competition ¹⁴ . Baseline (FY14): 35 percent of contracts subject to open competition Target (FY18): At least 50 percent of contracts subject to open competition <u>Outcome: External audit recommendations acted upon</u> Indicator: Proportion of outstanding audit recommendations 12 months after submission of the audit report to the Legislative Assembly ¹⁵ Baseline (FY15): 85 percent (115 of 136) Target (FY18): 50 percent
The Recipient’s Legislative Assembly has approved a new Communications Commission Act that will establish an independent regulator	Cabinet approval for submission to Parliament of legislation to establish a multi-sector regulator and finalization of institutional structure	Cabinet approval of a competition policy	<u>Outcome: Effective oversight of regulated sectors</u> Indicator: Monitoring reports for regulated sectors published on a regular basis Baseline (2015): No baseline report Target (2018): Reporting issued by regulators that covers all sector under their oversight

¹⁴ Aligned with the definition of PEFA Dimension PI-19(i) based on M2 scoring methodology as set out in 2011 Public Financial Management Performance Measurement Framework.

¹⁵ Where an outstanding audit recommendation is one which has not been adequately addressed as determined by the Auditor General in his Audit Report. The baseline for this indicator is based on audit recommendations made in all management reports for FY2011 and FY2012 which are outstanding as stated in the Tonga Audit Office Annual Report for FY2012. These are 36 recommendations in FY2012 and 112 recommendations in FY2011, of which it has received 33 responses. The baseline and target for this indicator will be reviewed and updated as information from more recent audit reports becomes available.

Prior actions and triggers			Results
Prior Actions under DPO 1	Triggers for DPO 2	Triggers for DPO 3	
Pillar I – Supporting fiscal resilience			
		Employment Relations Bill that, among others, reduces gender disparities approved by Cabinet for submission to Parliament	<u>Outcome: Key labor market protections are in place</u> Indicator: Number of basic labor rights enshrined in domestic legislation ¹⁶ Baseline (2015): None of eight in place Target (2018): At least six of eight in place
Pillar III – Supporting a more dynamic and inclusive economy			
	Foreign investment legislation approved by Cabinet for submission to Parliament and Cabinet approval of work permit rules	A Contract Bill has been approved by Cabinet that codifies common law on contracts	<u>Outcome: Increase in interest from foreign investors</u> Indicator: Vetted applications from foreign investors Baseline (FY15): 21 applications Target (FY18): 30 applications or greater
	Issuance of central bank directive to mandate credit bureau reporting in order to reduce costs of due diligence and support access to finance for SMEs and individuals	Extension of credit bureau coverage to non-bank credit providers, such as utilities	<u>Outcome: Increased utilization of credit bureau for credit checking</u> Indicator: Number of credit checks for new loan requests for; i) sole male applicants; ii) female applicants or joint applications Baseline (FY15): i) 636; ii) 588 Target (FY18): i) 800 or more; ii) 750 or more
The Recipient’s Cabinet has approved the appointment of shared boards of directors 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	Cabinet has approved the reform of two PEs in accordance with the PE Reform Plan, where ‘reformed’ may consist of privatization, liquidation, substantial restructuring, outsourcing or another form of public-private partnership ¹⁷	Cabinet has approved the reform of an additional two PEs reformed in accordance with the PE Reform Plan, where ‘reformed’ may consist of privatization, liquidation, substantial restructuring, outsourcing or another form of public-private partnership	<u>Outcome: Public enterprises reformed to introduce private sector participation</u> Indicator: Number of private enterprises that have been reformed Baseline (FY2015): None Target (FY18): At least four

¹⁶ Where the basic rights consist of: As measured in the annual WBG Ease of Doing Business index. The 8 basic labor rights measured are: i) paid annual leave; ii) notice period for redundancy; iii) severance pay for redundancy; iv) equal remuneration for equal work; v) gender non-discrimination; vi) right to maternity leave; vii) paid sick leave; viii) right to unionize

¹⁷ The formulation of the two indicative triggers in this area will be made more specific when they become prior actions.

ANNEX 2: LETTER OF DEVELOPMENT POLICY

**OFFICE OF THE MINISTER FOR
FINANCE & NATIONAL PLANNING**

Reference: 69G/05



**MINISTRY OF FINANCE &
NATIONAL PLANNING
NUKU'ALOFA
TONGA**

20th January 2016

Mr Jim Yong Kim
President
The World Bank
Washington, DC, 20433
USA.

Dear President Kim

Re: Letter of Development Policy

In its recent past and present, the Kingdom of Tonga has been experiencing 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 high 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 elections 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 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 dynamic 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 toward 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 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 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 rationalization 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 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.

On our quest to promote more efficient and effective public spending, we are further reviewing expenditure of ministries and agencies to redirect spending on non-productive programs and 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 achieving 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.

Yours sincerely,



Aisake Valu Eke

Minister for Finance and National Planning



ANNEX 3: FUND RELATIONS ANNEX

Tonga—Assessment Letter for the World Bank December 8, 2015

1. **Economic activity and headline inflation in 2014/15 has largely evolved as expected in the last Article IV consultation.** Growth has slowed marginally to 1.8 percent in 2014/15 (on preliminary data) from 2 percent in 2013/14 on account of slow implementation of government projects and a moderate drought caused by El Niño, but is expected to accelerate in the coming years to close to 3 percent owing to intensified construction works in the aftermath of the Cyclone Ian (2014) and in preparation for the South Pacific Games (2019). Inflation remained low at 0.1 percent in FY2014/15, but is expected to increase gradually in the medium term to around 3.5 percent, reflecting stronger demand generated by the South Pacific Games and assuming stable global commodity prices. Both the external and fiscal positions deteriorated somewhat, reflecting increased government spending.
2. **The balance of risks is tilted to the downside.** Spillovers from a protracted period of slower growth in advanced and emerging economies could weigh on Tonga, mainly due to its close ties with Australia and New Zealand through aid, remittances, trade, and tourism. On the domestic front, slippages in delivering on policy reforms could affect the level of development partners' budget support, leading to lower aid inflows. Cost overruns relating to the South Pacific Games could make it necessary to mobilize additional resources, potentially resorting to new borrowing, which would undermine debt sustainability. Natural disasters similar to recent cyclones could again take a toll on the economy. On the upside, Tonga would benefit as a net commodity importer if oil and food prices remain low for an extended period of time.
3. **After improving in 2013/14, the fiscal position weakened in 2014/15 (on preliminary data), and risks to debt sustainability increased.** The overall balance declined to 0.2 percent in 2014/15, from a 2.7 percent surplus in the previous year. The overall balance will likely revert to a deficit in 2015/16 to factor in (i) cyclone-related reconstruction work; (ii) wage pressures from the civil servants; and (iii) preparations for the South Pacific Games. Public debt increased from about 47 percent of GDP to 58 percent of GDP reflecting also depreciation of Tongan pa'anga.
4. **It is therefore imperative to build a sound fiscal position to bolster resilience to shocks and protect debt sustainability.** Staff estimates that over the medium term, a primary surplus of one percent of GDP would be needed to put the fiscal position on a more sustainable path and bring down external public debt to 40 percent of GDP, while keeping domestic public debt at around 10 percent of GDP. Measures to create such primary surplus should include: (i) improving tax administration on consumption tax; (ii) restraining the wage bill in line with the authorities' target; and (iii) improving the quality and efficiency of spending through ongoing public financial management reforms. The government's conservative policy of no external commercial borrowing and only limited concessional borrowing is a welcome step. Additionally, finalizing the overall debt management strategy would be critical to lay a solid foundation for prudent debt management.

5. **The current monetary stance is appropriate.** The National Reserve Bank of Tonga's (NRBT) easy monetary policy stance has led to higher bank lending. Credit growth to the private sector increased to 8.6 percent in FY2014/15 from 0.7 percent in the previous year, indicating a turn in the credit cycle. Low lending rates and the government's managed fund scheme will continue to support credit growth. However, the NRBT should be vigilant and stand ready to mop up excess liquidity if inflation picks up strongly and the external position comes under pressure. Inflation is expected to rise in the coming years closer to the medium-term trend of 3.5 percent. However, a weak transmission mechanism of monetary policy and Tonga's sensitivity to external price shocks complicate the task of controlling inflation.

6. **Progress has been made in repairing banks' balance sheets and strengthening the legal framework, however, challenges to financial stability remain.** Most of Tonga's banks recently improved their capital positions and the banking system remains highly liquid. Efforts have rightly focused on strengthening regulations including amending the National Reserve Bank of Tonga Act and the Financial Institutions Act. Financial sector risks can be mitigated through active liquidity management, the introduction of macro-prudential tools, and improved bank supervision.

7. **The external position remains comfortable.** International reserves declined slightly during 2014/15 to US\$145 million in August 2015 (equivalent to six months of imports) from US\$ 153 million in 2013/14, reflecting increased imports. The current account deficit is expected to expand by 2–3 percent in the medium term, with the financing coming mostly from foreign grants and concessional loans.

8. **Tonga remains at a moderate risk of debt distress, with its external debt sustainability being susceptible to external shocks.** The present value of both public and external debt is expected to steadily decline over the medium term reflecting (i) rescheduling of repayment of two large external loans from China EXIM bank with an additional 5-year grace period, and (ii) prudent government's borrowing policy. Under the baseline scenario, both external and public debt and debt service indicators remain below the thresholds.

9. **Raising potential growth remains a key challenge.** In the absence of reform measures over the medium term, longer-term growth would revert to its historical average of around 1¾ percent, once cyclone reconstruction work and South Pacific Games-related activities are completed. The government has adopted several initiatives to raise Tonga's growth potential, but these efforts have yet to bear fruit, and need to overcome key bottlenecks for private sector development. In this regard, business-enabling structural reforms to promote private sector development remain crucial.

ANNEX 4: GOVERNMENT OF TONGA'S JOINT-POLICY REFORM MATRIX

Joint Policy Reform Matrix, 2015/16-2017/18

Reform area	FY2015/16 Actions	FY2016/17 Actions	FY2017/18 Actions	Results indicators
I. SUPPORTING FISCAL RESILIENCE				
Fiscal strategy Gov't lead: MFNP Partners: ADB, IMF, PFTAC, WB		1. Cabinet has approved a transparent, target-based fiscal anchor system and monitoring framework [Tongan Gov't, ADB, DFAT, WB]		
Revenue Gov't lead: Ministry of Revenue and Customs Services Partners: PFTAC (lead), WB	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 foods ¹ [Tongan Gov't, ADB, DFAT, WB] 2. Develop and begin to implement a new risk-based compliance strategy in order to improve tax collection efficiency and recover tax arrears [Tongan Gov't]	2. Implement recommendations of a review of consumption tax legislation to reduce exemptions [Tongan Gov't, ADB, DFAT, WB]	1. Implement recommendations of a review of corporate tax legislation to reduce exemptions [Tongan Gov't, ADB, DFAT, WB]	<u>Domestic revenues as a proportion of GDP increases</u> Indicator: Tax revenue as a proportion of GDP Baseline (avg FY11-FY14): 17.3 percent Target (avg FY16-FY18): 18.3 percent or higher
Debt Gov't lead: MFNP (Debt unit, senior management) Partners: WB	3. Cabinet has approved a new Medium-Term Debt Strategy which has been made public [Tongan Gov't, ADB, DFAT, WB]			<u>Proportion on borrowing that is highly concessional</u> Indicator: Borrowing that is above 35 percent concessionality as a proportion of all borrowing Baseline (FY13-FY15): 100 percent Target (FY16-FY18): 100 percent
Public service management reform Gov't lead: MFNP Other gov't agencies: Remuneration Authority, PSC Partners: ADB, WB (lead)	4. 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 [Tongan Gov't, ADB, DFAT, WB]	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 [Tongan Gov't, ADB, DFAT, WB]	2. Cabinet approval of a new public service performance management framework which provides for credible performance assessments and performance-based pay progression [Tongan Gov't, ADB, DFAT, WB]	<u>Improve wage bill affordability</u> Indicator: Public wage bill as a proportion of domestic revenue Baseline (FY14): 57 percent Target (FY18): 53 percent or lower

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.

Reform area	FY2015/16 Actions	FY2016/17 Actions	FY2017/18 Actions	Results indicators
II. SUPPORTING AN INCLUSIVE, MODERN AND ACCOUNTABLE STATE				
Procurement Gov't lead: MFNP (Procurement Unit) Partners: DFAT (lead), WB	5. Cabinet has approved a revised set of Procurement Regulations, and prepared standard bidding documents and procurement manuals in support of the Regulations [Tongan Gov't, ADB, DFAT, WB]	4. Implementation of new procurement tracking database and identification of a small number of compliance and performance indicators and associated targets [Tongan Gov't]		Increased compliance with requirements for public procurement Indicator: Proportion of contracts above the small purchases threshold that are subject to open competition ² . Baseline (FY14): 35 percent of contracts subject to open competition Target (FY18): At least 50 percent of contracts subject to open competition
Financial management, accounting, reporting and audit Gov't lead: MFNP (Treasury, budget) Partners: ADB, DFAT, PFTAC (lead)	6. A new biannual report of audit recommendations and actions for all ministries and agencies has been prepared, and a new Audit Oversight Committee of Cabinet established and tasked with ensuring timely and thorough follow-up of audit recommendations [Tongan Gov't, ADB, DFAT, WB]	5. Implementation of revised Chart of Accounts to improve reporting for line ministries [Tongan Gov't, ADB, DFAT, WB] 6. Enhancement of purchasing and reporting modules in the IFMIS system to make fully operational commitment control functionality and provide enhanced budgetary reporting functionality [Tongan Gov't]	3. Activate and add key IFMIS modules, such as budget preparation, sales and receipts, cash management [Tongan Gov't, ADB, DFAT, WB]	External audit recommendations acted upon Indicator: Proportion of outstanding audit recommendations 12 months after submission of the audit report to the Legislative Assembly ³ Baseline (FY15): 85 percent (115 of 136) Target (FY18): 50 percent
Anti-corruption Gov't lead: Ministry of Justice Partners: TBD		7. Appointment of the Anti-Corruption Commissioner to establish the Commission [Tongan Gov't]		

² Aligned with the definition of PEFA Dimension PI-19(i) based on M2 scoring methodology as set out in 2011 Public Financial Management Performance Measurement Framework.

³ Where an outstanding audit recommendation is one which has not been adequately addressed as determined by the Auditor General in his Audit Report. The baseline for this indicator is based on audit recommendations made in all management reports for FY2011 and FY2012 which are outstanding as stated in the Tonga Audit Office Annual Report for FY2012. These are 36 recommendations in FY2012 and 112 recommendations in FY2011, of which it has received 33 responses. The baseline and target for this indicator will be reviewed and updated as information from more recent audit reports becomes available.

Reform area	FY2015/16 Actions	FY2016/17 Actions	FY2017/18 Actions	Results indicators
Utility and service regulation Gov't lead: Deputy Prime Minister Partners: ADB, WB	7. Parliament has approved a new Communications Act and a Communications Commission Act that will establish an independent regulator [Tongan Gov't, ADB, DFAT, WB]	8. Cabinet approval for submission to Parliament of legislation to establish a multi-sector regulator and finalization of institutional structure [Tongan Gov't, ADB, DFAT, WB]	4. Cabinet approval of a competition policy [Tongan Gov't, ADB, DFAT, WB]	Effective oversight of regulated sectors Indicator: Monitoring reports for regulated sectors published on a regular basis Baseline (2015): No baseline report Target (2018): Reporting issued by regulators that covers all sector under their oversight
Labour market Gov't lead: MCL Partners: ADB, ILO (lead), WB	8. Cabinet has approved membership of the ILO and adherence to core principles of rights at work and decent employment opportunities [Tongan Gov't]		5. Employment Relations Bill that, among others, reduces gender disparities approved by Cabinet for submission to Parliament [Tongan Gov't, ADB, DFAT, WB]	Key labour market protections are in place Indicator: Number of basic labour rights enshrined in domestic legislation ⁴ Baseline (2015): None of eight in place Target (2018): At least six of eight in place
III. SUPPORTING A MORE DYNAMIC AND INCLUSIVE ECONOMY				
Private sector development strategy Gov't lead: MCL Partners: ADB		9. Cabinet approval of a prioritized and sequenced private sector development strategy that supports inclusive growth and economic participation of women, youth and disabled [Tongan Gov't, ADB]		

⁴ Where the basic rights consist of: As measured in the annual WBG Ease of Doing Business index. The 8 basic ~~labor~~ rights measured are: i) paid annual leave; ii) notice period for redundancy; iii) severance pay for redundancy; iv) equal remuneration for equal work; v) gender non-discrimination; vi) right to maternity leave; vii) paid sick leave; viii) right to unionize.

Reform area	FY2015/16 Actions	FY2016/17 Actions	FY2017/18 Actions	Results indicators
Financial sector development Gov't lead: MCL Partners: ADB, PFTAC, WB		10. 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 [Tongan Gov't, ADB, DFAT, WB]	6. Extension of credit bureau coverage to non-bank credit providers, such as utilities [Tongan Gov't, ADB, DFAT, WB]	<u>Increased utilization of credit bureau for credit checking</u> Indicator: Number of credit checks for new loan requests for; i) sole male applicants; ii) female applicants or joint applications Baseline (FY15): i) 636; ii) 588 Target (FY18): i) 800 or more; ii) 750 or more
Business law reform, including foreign investment Gov't lead: MCL Partners: ADB		11. Foreign investment legislation approved by Cabinet for submission to Parliament and Cabinet approval of work permit rules [Tongan Gov't, ADB, DFAT, WB] 12. Cabinet approval of a policy on bankruptcy [Tongan Gov't, ADB]	7. Cabinet approval of a Contract Bill that codifies common law on contracts [Tongan Gov't, ADB, DFAT, WB] 8. Bankruptcy legislation approved by Cabinet for submission to Parliament [Tongan Gov't, ADB] 9. 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 [Tongan Gov't, ADB]	<u>Increase in interest from foreign investors</u> Indicator: Vetted application from foreign investors Baseline (FY15): 21 applications Target (FY18): 30 applications or greater

Reform area	FY2015/16 Actions	FY2016/17 Actions	FY2017/18 Actions	Results indicators
Energy Gov't lead: Partners: ADB, EU (lead), WB		13. Cabinet approval for submission to Parliament of a new National Energy Act to, among others, facilitate competition in the power generation sector [Tongan Gov't, ADB, EU]		<p>Increased proportion of renewable electricity generation Indicator: Share of renewable electricity in total electricity generation Baseline (FY15): 6.4% Targets: FY17-9% ; FY18-12%; FY19-16%</p> <p>Improvement in generation efficiency Indicator: Fuel consumption per kWh electricity generated Baseline (FY16): 4.04kWh/L Targets: FY17-4.06kWh/L ; FY18-4.08kWh/L; FY19-4.10kWh/L</p>
Public enterprise reform Gov't lead: MPE Partners: ADB	9. Cabinet tasks MPE to implement the Reform Plan of the new PE Ownership, Performance Improvement and Divestment Policy [Tongan Gov't, ADB] 10. Cabinet has approved the appointment of shared boards of directors 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 [Tongan Gov't, ADB, DFAT, WB] 11. Tonga Water Board concluded contract with a private sector business to outsource asset maintenance and pipe-laying services [Tongan Gov't, ADB]	14. 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 [Tongan Gov't, ADB, DFAT, WB]	10. 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 [Tongan Gov't, ADB, DFAT, WB]	<p>Increased private participation in PE portfolio Indicator: Number of private enterprises that have been reformed Baseline (FY2015): None Target (FY18): At least four</p>

ADB = Asian Development Bank; DFAT = Australian Department of Foreign Affairs and Trade; EU = European Union; FY = fiscal year; gov't = government; IFMIS = integrated financial management information system; ILO = International Labour Organization; kWh = kilowatt hour; L = liter; MCL = Ministry of Commerce and Labour; MFNP = Ministry of Finance and National Planning; MPE = Ministry of Public Enterprises; PE = public enterprise; PEFA = public expenditure and financial accountability; PFTAC = Pacific Financial Technical Assistance Centre; TBD = to be determined; TOP = Tongan Pa'anga; WB = World Bank.