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INTERNATIONAL DEVELOPMENT ASSOCIATION

PROGRAM DOCUMENT

FOR A PROPOSED DEVELOPMENT POLICY GRANT

IN THE AMOUNT OF SDR 1.2 MILLION (EQUIVALENT TO US$ 1.65 MILLION)

AND A PROPOSED DEVELOPMENT POLICY CREDIT

IN THE AMOUNT OF SDR 2.5 MILLION (EQUIVALENT TO US$ 3.35 MILLION)

TO THE

KINGDOM OF TONGA

FOR THE

SECOND INCLUSIVE GROWTH DEVELOPMENT POLICY OPERATION

April 27, 2017

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
February 28, 2017)

Currency Unit	Tongan Pa'anga
US$ 1.00	TOP$ 2.17
SDR 1.00	US$ 1.35389

ABBREVIATIONS AND ACRONYMS

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

Regional Vice President: Victoria Kwakwa
Country Director: Michel Kerf
Global Practice Director: John Panzer
Global Practice Manager: Ndiame Diop
Program Leader: Robert Utz
Task Team Leaders: David Knight and Kim Edwards

KINGDOM OF TONGA

SECOND INCLUSIVE GROWTH DEVELOPMENT POLICY OPERATION

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The First Inclusive Growth Development Policy Operation was prepared by a World Bank Group team consisting of: David Knight (TTL, GMF10); Kim Edwards (TTL, GMF10), Carlos Romero Orton (GMF10); Virginia Horscroft (GMF10); Duangarat Laohapakakul (LEGES); Loren Atkins (LEGES); Donna Andrews (GGO14); Robert Gilfoyle (GGODR); Stephen Hartung (GGODR); Saia Faletau (EACNF); Tatafu Moeaki (EACNF); Quincy Austriaco (WFALN); Samantha Evans (EACNF). The team received valuable contributions from Jesse Doyle (GSPDR), Lasse Melgaard (EACNF); James Neuman (GEEDR); Natasha Beschcorner (GTI09); Sean Michaels (GTI02); Imogen Halstead (GPV02); Ross Butler (GSU02); Pene Ferguson (GENDR); Cristiano Nunes (GGODR); Deva De Silva (CEASY) and John Vivian (GFM02). The team was supervised by Robert Utz (EACNF). Overall guidance was provided by Ndiame Diop (GMF10), Mona Sur (EACNF) and Michel Kerf (EACNF). Peer reviewers were Imogen Halstead (GPV02), and Jurgen Blum (GGO14).

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

Borrower	Kingdom of Tonga
Implementation Agency	Ministry of Finance and National Planning
Financing Data	SDR 1.2 million (US$ 1.65 million equivalent) IDA Grant and SDR 2.5 million (US$ 3.35 million equivalent) IDA Credit. Standard IDA grant and 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 second 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) Support fiscal resilience by means of strengthened revenue mobilization and strategic fiscal and debt policies; ii) support improved government accountability and private sector regulation 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, improving oversight and private participation in public enterprises, and introducing regulation to private sector labor markets.
Result Indicators	Under development objective (i): 1) Increase in excise tax revenue as a proportion of domestic revenue 2) Analysis of relationship between current fiscal outcomes, budget projections, and the path toward fixed medium-term fiscal targets conducted as part of Budget preparations 3) Reduction in public wagebill as a proportion of domestic revenue over time 4) All new external debt taken on is highly concessional Under development objective (ii): 5) Increase in proportion of contracts above the small purchases threshold that are subject to open competition 6) Improvement in the proportion of audit recommendations acted on 7) Regular regulatory reports published for selected sectors Under development objective (iii): 8) Basic labor market protections introduced 9) Increase in applications for investment permits from potential foreign investors 10) Increase in number of Credit Bureau checks made for credit applications 11) Public enterprises reformed to increase private participation
Overall risk rating	Substantial
Climate and disaster risks *(required for IDA countries)*	There are short and long term climate and disaster risks relevant to the operation (as identified as part of the SORT environmental and social risk rating)
Operation ID	P159262
Closing date	December 31, 2018

IDA PROGRAM DOCUMENT FOR A PROPOSED *CREDIT AND GRANT*
TO *THE KINGDOM OF TONGA*

1. INTRODUCTION AND COUNTRY CONTEXT (INCLUDING POVERTY DEVELOPMENTS)

1. **This operation is the second in a programmatic series of three operations designed to build fiscal resilience, support accountability and promote inclusive growth in Tonga.** The operation will consist of a US$ 1.65 million equivalent grant and a US$ 3.35 million equivalent credit. Australia, through its Department of Foreign Affairs and Trade (DFAT), New Zealand, through its Ministry of Foreign Affairs and Trade (MFAT), 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 operation.

2. **Over the last six years, annual development policy operations have helped Tonga move out of crisis, strengthen the fiscal position and improve private sector prospects.** The current operation marks the sixth annual development policy operation delivered in Tonga. Over this period revenue mobilization has increased rapidly, borrowing has been constrained and expenditure risks contained. Continued public enterprise reforms mean that Tonga now has one of the best performing public enterprise portfolios in the Pacific and the strongest governance framework.

3. **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 177 islands with around one quarter of the population based in the capital of Nuku'alofa. Tonga is a constitutional monarchy. Until 2010, the legislative assembly of 26 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 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 current 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.

4. **Like many other small Pacific island nations, Tonga's economic growth potential is constrained by structurally high costs and exposure to economic and environmental shocks.** Its location makes Tonga the most geographically remote nation from major centers of economic activity in the world[1]. 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 faster than the small Pacific islands average (0.9 percent), illustrating the challenges faced by the region. In any given year, it is likely that Tonga is either hit by or recovering from a major natural disaster. 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 and reducing the potential to realize economies of scale. 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.

5. **Only a small fraction of the population experiences extreme poverty, but Tonga is facing a serious challenge in securing prosperity for all and significant numbers live in situations of hardship.** While

[1] 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.

infrequent surveys mean the latest poverty data is over five years old[2], the Bank has recently prepared internationally-comparable poverty estimates for Tonga and other Pacific Island countries (PICs) for the first time[3]. 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 (Table 1). Poverty based on the $3.10-a-day line is somewhat 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, controlling for income (Figure 1). Comparison of household survey results in 2001 and 2009 suggest that income growth of the lowest deciles has only just kept pace with average income growth. Although reliable data for more recent years are 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.

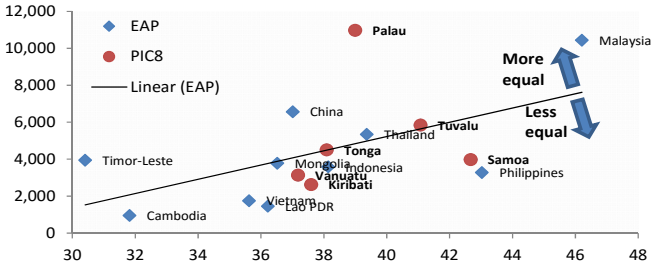
Table 1: Selected Poverty and Income Distribution Indicators

	Extreme Poverty ($1.90 a day)	Poverty ($3.10 a day)	Gini coefficient (0 – 100)
	percentage of population below poverty line		*where 100 is completely unequal*
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

6. **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 generally are not more likely to be poor in Tonga, they outperform men in education participation at all levels. Women are relatively well represented in senior management levels[4]. At the same time, they face a number of serious challenges. Whilst candidature for women are open in Tonga, they are under-represented at leadership levels for example, cabinet and Parliament as there is no

Figure 1: Gini coefficients and income levels



Gini coefficient, 1 - 100 (100 is most unequal).

[2] The latest Household Income and Expenditure (HIES) data available corresponds to 2009. A new HIES has been completed but the data is not yet available.

[3] These estimates are not only the first time 'dollar-a-day' metrics have been calculated, but incorporate 2011 round International Comparison Project purchasing-power parity price estimates, which for the first time are based on survey data for Tonga, rather than imputed values.

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

female in Cabinet and only one Member of Parliament at the current session. 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.

7. **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 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.

8. **This 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 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 this 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 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 government[5].

9. **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) support improved government accountability and private sector regulation 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, improving oversight and private participation in public enterprises, and introducing regulation to private sector labor markets.

10. **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 include the adoption of a new rules-based fiscal strategy; strengthening of revenue collection through further excise tax increases; and the implementation of a new public sector remuneration framework. To support improved government accountability and private sector regulation, this operation supports policy actions that introduce a new procurement monitoring system; and legislation to establish a multi-sector energy regulator. To support a more dynamic and inclusive economy, the operation supports the submission of a revised Foreign Investment Bill to the Legislative Assembly; and the commercialization of two public enterprises.

11. **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. Despite the

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

focus of this policy program on building fiscal resilience, relatively large sources of possible risk remain, including a high public wagebill, a large, regional sporting event being held and repayment of sizeable existing loans. Policy slippages or macroeconomic disruption arising under several feasible shock scenarios, including a natural disaster or a substantial scaling back of external assistance, could divert available capacity and resources from the implementation of actions supported by the program and/or increase the size of the budget deficit. To mitigate these risks, the World Bank 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 in its management of disaster risks. In the event of unexpectedly larger fiscal deficits, the government is expected to rely on additional support from development partners or short-term domestic financing.

2. MACROECONOMIC POLICY FRAMEWORK

2.1 RECENT ECONOMIC DEVELOPMENTS

12. **Tonga's economic growth has been low by global standards, and adversely affected by the frequent occurrence of natural disasters and external price shocks.** Similar to most other PICs, smallness and remoteness pose challenges to Tonga, pushing up the cost of economic activity, limiting competitiveness in global markets, and limiting the scope for diversification. Tonga is also highly vulnerable to external shocks, climatic conditions, and natural disasters. Average growth over the last five years has thus remained low, averaging 1.2 percent[6] annually, and has been volatile, with short term public construction cycles driving temporarily faster growth followed by a 3.1 percent contraction in FY2013. Economic growth then rebounded to 2.1 percent in FY2014, and accelerated to 3.7 percent in FY2015, largely reflecting a pick-up in construction activity, strong remittances, and strong private sector credit growth.

13. **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 FY2010-FY2015 period, growth in the primary sector (average 1.3 percent annually) was driven primarily by agricultural production (despite a severe drought in FY2015 resulting in a 5.9 percent year-on-year decline), and to a lesser extent fisheries. The secondary sector expanded by 0.6 percent on average annually, hampered by a 29.9 percent decline in construction activity between FY2012 and FY2013. The services sector grew at an average annual growth rate of 1.2 percent, with both wholesale and retail trade, and transport and communications contributing strongly to growth. Between FY2012 and FY2015, tourist receipts in Tonga grew from 8.3 to 10 percent of GDP but have since remained around that level, adversely affected by Tropical Cyclone Ian which hit Tonga in FY2014. 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 the New Zealand Recognized Seasonal Employers Program. The transport and communications sector will be further enhanced with the utilization of the fiber optic cable in the mainland and the extension to outer islands. Development of quality information and communication technology (ICT) improves Tonga's attractiveness as a tourism destination, as well as a location for investment more generally.

[6] This marks a marginal improvement in the last five years, with average growth over the last ten years just 0.6 percent.

Table 2: Key Macroeconomic Indicators

					Est.	Proj.		
	FY2012	FY2013	FY2014	FY2015	FY2016	FY2017	FY2018	FY2019
Real Economy	Annual percentage change, unless otherwise indicated							
GDP (nominal Pa'anga m)	800.6	779.3	803.6	846.1	881.9	910.7	948.4	1004.9
Real GDP	0.9	-3.1	2.1	3.7	3.1	2.3	2.5	2.9
Per Capita GDP (in current US$)	4,507	4,277	4,199	4,101	3,950	4,105	4,598	4,827
Exports, f.o.b.	22.8	-10.2	19.3	0.0	-8.9	-0.6	2.5	3.0
Imports, f.o.b.	0.0	-7.9	0.1	8.6	-9.8	10.8	14.2	9.8
GDP deflator	2.4	0.5	1.0	1.5	1.1	0.9	1.6	3.0
CPI (eop)	2.3	0.2	1.5	0.2	-0.9	0.1	3.0	3.0
Fiscal Accounts	Percent of GDP, unless otherwise indicated							
Expenditures	30.2	26.5	25.7	29.2	29.1	29.4	29.3	29.6
Revenues	27.4	25.2	27.5	28.2	27.0	27.2	28.5	26.0
General Government Balance	-2.8	-1.3	1.7	-1.0	-2.0	-2.3	-0.8	-0.7
PV of External PPG debt (%of GDP)	35.7	28.9	30.9	34.1	33.5	33.0	33.1	31.7
PV of public sector domestic debt (% of GDP)	4.6	3.7	3.6	1.8	5.6	5.8	5.5	5.2
Selected Monetary Accounts	Annual percentage change, unless otherwise indicated							
Base Money	7.2	6.1	7.2	9.0	10.6	8.8	..	..
Credit to Private Sector	-5.2	-7.5	0.7	8.6	9.4	12.5	..	..
Balance of Payments	Percent of GDP, unless otherwise indicated							
Current Account Balance	-12.4	-4.5	-7.9	-11.8	-3.1	-7.1	-10.5	-10.1
Exports	3.5	3.3	4.0	4.1	3.9	3.7	3.3	3.2
Imports	43.1	41.7	42.3	46.8	43.5	46.0	46.5	48.2
Foreign Direct Investment	-0.3	1.2	2.6	2.9	2.9	3.0	2.7	2.7
Capital and Financial Account	14.7	17.8	5.1	6.9	7.9	6.9	7.9	8.9
Gross Reserves (in US$ m, e.o.p.)	145.2	147.6	158.7	142.5	158.6	162.0	158.2	147.4
In months of next years imports	6.5	7.1	6.9	6.2	6.2	5.7	5.3	5.3
As % of short-term external debt	75.9	76.1	83.9	80.1	86.5	85.7	73.6	66.6
Exchange Rate (eop)	1.8	1.8	1.8	2.1	2.1	..	..	..
Other memo items								
GDP (nominal US$ m)	472.3	449.5	443.4	435.4	422.3	442.5	500.1	529.9
Remittances (% of GDP)*	..	..	..	..	34.3	33.3	30.6	30.0
Tourism receipts (% of GDP)	8.3	9.7	10.0	8.9	9.8	10.1	..	..

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

Source: IMF and World Bank staff estimates.

14. **Headline 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 -0.3 percent at end-February 2016, despite the Tongan Pa'anga depreciating against a number of major currencies over the last couple of years. The latest IMF Article IV report, published in May 2016, assessed the level of the exchange rate as broadly in line with medium-term fundamentals. 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. The NRBT is considering moving towards a new indicative inflation reference rate that is more in line with the medium-term inflation outlook.

15. **Private sector credit growth is now recovering after a long period of decline.** Tonga's banking system has gone through a prolonged period of balance sheet adjustment since 2008. From 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 financial crisis. Non-performing loans (NPLs) peaked at 20 percent in 2009. Private sector credit fell cumulatively by 34 percent over the period FY2009 to FY2014. Since then, the NRBT has implemented a number of macro-prudential and regulatory reforms, including a new set of legislation governing the central bank, the banking sector, and the non-bank financial sector. With recent improvements in banks' capital and credit quality, NPL ratios have declined, and stood at 7.6 percent in February 2016. Supported by government initiatives, including a new subsidized lending scheme through the Tonga Development Bank, growth in domestic private sector credit increased to 14.6 percent in the year to February 2016, from 8.6 percent in FY15. The private credit-to-GDP ratio currently stands at 31.1 percent, which is only slightly higher than the pre-crisis period.

16. **The current account deficit is driven by construction cycles and largely financed by development grants and remittances.** The current account deficit (after grants) as a share of GDP has varied between 3 percent and 12 percent of GDP in the last five years, peaking in years of large public sector construction works (FY2012 and FY2015). The current account deficit has been adequately financed by capital inflows. Development assistance has helped the government to build up foreign reserves, which remain at adequate levels despite a slight decline from 6.9 months of imports in FY2014 to 6.2 months in FY2016. Although still low, foreign direct investment (FDI) has been picking up in recent years, reaching 2.9 percent of GDP in FY2015.

17. **The government's fiscal position weakened slightly in the last two years, but remains robust thanks to strong domestic revenue performance.** Following previous years of prudent fiscal management the overall deficit (after grants) shrank from 7.4 percent of GDP in FY2011 to record a modest surplus (1.7 percent) in FY2014. Driven by expenditure growth in the following years, including a 5 percent public sector pay settlement in FY2016, coupled with weakening grant funding, the fiscal position returned to a deficit of 2.0 percent of GDP in FY2016. Despite strengthened domestic revenue collections, total revenue and grants weakened in FY2016 as World Bank and Asian Development Bank moved from full grant to half grant-half credit financing. Development expenditure, which includes donor-financed capital projects, has fallen from its peak in FY2011 as large debt-financed public building and roads projects have been completed. Overall, the management of the government budget (excluding grants) has been strong with an average growth of government commitments of 7.5 percent per year over the four years to FY2016 outpaced by 12.7 percent domestic revenue growth, which has caused the budget deficit excluding grants to decline from 12.1 percent to 5.6 percent.

Table 3: Financing the budget deficit

	FY2017
Tongan Pa'anga (millions)	
Overall balance (excluding grants)	**-51.1**
Budget support grants	**21.3**
Of which World Bank	3.1
Asian Development Bank	4.7
Australia	6.5
European Union	6.1
New Zealand	0.8
Budget support credits	**11.1**
Of which World Bank	6.4
Asian Development Bank	4.7
Other grants	9.3
Other external financing (net)	5.8
External grants and financing	**47.5**
Domestic financing (net)	3.6
Total grants and financing	**51.1**

Note: Donor financing are projections only, and are not binding on any party
Source: IMF and World Bank Staff Estimates

18. **Nevertheless, the public sector wage bill remains an ongoing fiscal risk, as it has been 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, more recent pressure has led to two pay increase settlements of 6 percent and 5 percent in FY2014 and FY2016

respectively, highlighting the need for a more systematic approach to managing public service remuneration, as supported by this program. One-off transition costs associated with the implementation of the new remuneration framework are expected to increase the wage bill as a percentage of GDP from 12.7 percent in FY2016 to 13.7 percent in FY2017, but the new framework will act to contain growth in the wage bill thereafter.

Table 4: Key Fiscal Indicators

					Est.	Proj.		
	FY2012	**FY2013**	**FY2014**	**FY2015**	**FY2016**	**FY2017**	**FY2018**	**FY2019**
	In percent of GDP, unless otherwise indicated							
Overall Balance (including grants)	-2.8	-1.3	1.7	-1.0	-2.0	-2.3	-0.8	-0.7
Overall Balance (excluding grants)	-12.1	-6.9	-5.7	-7.7	-5.6	-5.6	-4.8	-4.8
Primary Balance	-2.0	-0.4	2.6	-0.3	-1.4	-1.6	-0.1	-0.1
Total Revenues and Grants 1/	**27.4**	**25.2**	**27.5**	**28.2**	**27.0**	**27.2**	**28.5**	**28.9**
Domestic revenues	18.0	19.5	20.0	21.4	23.4	23.7	24.5	24.7
of which Goods and Services Taxes	11.0	11.1	11.8	12.2	14.0	14.1	14.2	..
of which Taxes on Income and Profits	3.2	3.9	3.6	4.1	4.0	4.0	4.0	..
of which Non-tax Revenue	2.2	2.5	2.7	3.1	3.2	3.3	3.7	..
Grants (in cash)	9.4	5.6	7.5	6.7	3.6	3.4	4.0	4.1
Total Expenditures 1/	**30.2**	**26.5**	**25.7**	**29.2**	**29.1**	**29.4**	**29.3**	**29.6**
Current Expenditure	19.2	21.2	23.3	24.0	24.9	25.0	24.7	26.0
Wages and Compensation	10.4	10.8	11.5	12.0	12.7	13.7	13.5	13.1
Goods and Services	4.0	6.0	6.4	6.2	5.8	5.8	5.8	7.6
Interest Payments	0.8	0.9	0.9	0.8	0.7	0.7	0.7	0.7
Current Transfers 2/	3.9	3.4	4.5	5.0	5.8	4.8	4.8	4.6
Development expenditures	9.8	5.4	2.6	4.0	3.3	3.6	3.8	4.5
General Government Financing	**2.8**	**1.3**	**-1.7**	**1.1**	**3.1**	**1.7**	**-0.8**	**-0.7**
External (net)	5.1	0.2	0.3	0.6	1.4	1.3	2.1	0.8
Domestic (net)	-2.4	1.0	-2.0	0.5	1.7	0.4	-2.9	-1.5
Memorandum Items:								
Wages and Compensation								
as % domestic revenue	58.0	55.5	57.5	56.2	54.3	57.8	55.2	52.8
as % current expenditures	44.5	43.5	46.0	46.9	48.0	52.4	52.1	50.3

1/ Excludes in-kind development grants and expenditures

2/ Includes employer contributions to defined-contribution pension scheme

Source: IMF and World Bank staff estimates

2.2 MACROECONOMIC OUTLOOK AND DEBT SUSTAINABILITY

19. **Growth is expected to remain relatively strong in the near term driven by heightened construction activity and continued growth in the tourism sector.** A recovery in agricultural production, following a severe drought in 2015, coupled with construction activity in preparation for the South Pacific Games (SPG) in 2019, is estimated to have resulted in strong growth of 3.1 percent in FY2016. Over the next three years, continued SPG-related construction activity and tourism are expected to be the main drivers of growth. The recent depreciation of the Tongan Pa'anga against a number of major currencies over the last couple of years should improve external competitiveness, with the operation of major new tourism infrastructure such as the Tanoa International Dateline Hotel also likely to boost the tourism sector in particular. On the other hand, goods export values are forecast to decline, with the price of commodity exports stabilizing at relatively low levels. Economic growth is expected to fluctuate between 2.3 and 3 percent over the medium term, before converging to its historical average of 1.8 percent by FY2021.

20. **Inflation is expected to increase to around 3 percent by 2019 and the current account deficit is expected to expand as preparations for the SPG proceed.** Inflation is expected to rise as private sector credit continues to grow following the bottoming out of the credit cycle and as commodity prices stabilize. The current account deficit is forecast to expand from 3.1 percent in FY2016 to just over 10 percent in the years leading up to the 2019 SPG as construction-related imports peak, and then fall markedly from FY2020. The deficit is expected to be financed by inward FDI and portfolio investment, and highly concessional development partner financing. Foreign reserves are expected to remain adequate, at more than 5 months of import cover through the forecast period. Prospects for inbound remittances are uncertain, and growth will hinge on expansion of both short-term (e.g. seasonal) and long-term migration programs for Tongans wishing to work overseas. While de-risking of global banks has not yet led to significant adverse impacts on remittance flows, some money transfer operators have closed, particularly at the cost-competitive end of the market, increasing the cost of sending and receiving remittances.

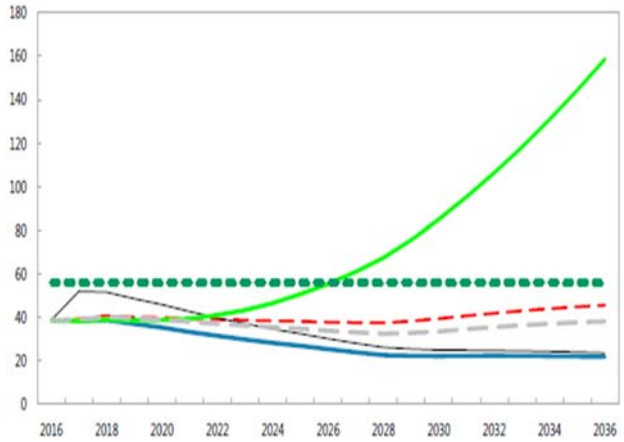
21. **Continued close supervision of the budget and an appropriate fiscal strategy will support fiscal sustainability in the medium-term.** Growing domestic revenues, a moratorium on non-concessional debt and limited expenditure growth have enabled Tonga to improve the health of its public finances, but the country faces large costs over the next few years, which need to be watched carefully to make sure they do not undermine newly-won fiscal stability. Improving the management of the wagebill, including through reforms supported by this program will be important. The FY2017 budget includes provision for approximately 10 percent wagebill growth to accommodate the cost of transitioning to a new remuneration structure, but following that transition wage growth should be contained to a sustainable level. Indeed, following the transition to the new remuneration framework in FY2017, wages as a ratio to GDP are expected to gradually decline, while the government's target of wagebill affordability – wages as a ratio to domestic expenditure is expected to fall to its lowest level in eight years by FY2019. Tonga will host the SPG in 2019 and intends to minimize the costs of new developments and refrain from debt financing, seeking to finance the SPG through domestic revenues, grants, corporate sponsorship, and a controversial levy on the purchase and sale of foreign currency[7]. An estimated operational cost of TOP 20m is factored into the forward

[7] A new tax, the "Foreign Exchange Levy" was approved by Parliament in 2015. Its implementation was delayed by a year following requests for clarification on its operation by banks and in 2016, Foreign Exchange Levy Regulations were published. The levy was announced as a one seniti levy per Pa'anga of value of foreign exchange transactions (or one percent of the value of the transaction) in the banking system. Following pressure from banks, the levy was halved later in 2016 to half a seniti per Pa'anga bought or sold for foreign currency. It is not clear how much revenue this levy is likely to raise, and it may induce behavioral responses, including by incentivizing remittance-senders to use other, more informal channels.

projections and overall capital costs are expected to be between TOP 78 and 93 million, of which over half has been secured in grant commitments so far[8]. Cost overruns or funding shortfalls could rapidly undermine Tonga's hard-won fiscal discipline, although to date the government has shown considerable forward-planning and discipline in planning for the SPG. While scope for significant fiscal consolidation on the expenditure side is limited given pressing service delivery needs, a gradual decline in wages and salaries as a proportion of spending 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.

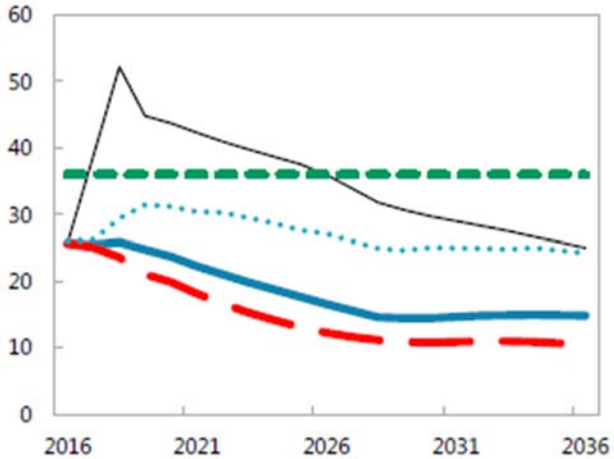
22. **Tonga is assessed to continue to be at a moderate risk of debt distress, aided by the continued vigilance of the authorities.** Public and publically-guaranteed (PPG) external debt to GDP declined from 35.7 percent in FY2012 to 30.9 percent in FY2014, before increasing to 34.1 percent of GDP in FY2015, due to a substantial depreciation in the Pa'anga, as well as the WB and ADB moving to 50 percent concessional credit financing. The 2016 Debt Sustainability Analysis (DSA) indicates that Tonga remains at moderate risk of debt distress. The government has successfully maintained a stance of avoiding any new non-concessional borrowing, and the government's ambition to finance the SPG using non-debt creating funds is considered to be prudent. The present value of public debt is projected to remain below the benchmark, and steadily decreases to around 20 percent of GDP through the projection period. However, in the scenarios in which the primary balance remains at the level of 2016 throughout the projection period, or the public wage bill grows at the average rate of the past three years (7 percent) during the projection period, public debt becomes unsustainable (Figure 2). The external debt and debt service indicators remain under the thresholds in the baseline scenario, although a 'combined shock' to GDP, exports, inflation and non-debt creating inflows leads to a breach in debt and debt service ratios (Figure 3). Even in the baseline, debt service ratios are forecast to increase from 2019 to 2029, mainly reflecting repayments of two large external loans, which account for about 60 percent of the outstanding external debt.

Figure 2: Public Debt Sustainability Analysis



Present Value (PV) of public debt to GDP ratio

Figure 3: External Debt Sustainability Analysis



PV of external debt to GDP and remittances ratio

Baseline
Historical scenario
Fix Primary Balance
Public debt benchmark
Most extreme shock 1/
High wages

Source: IMF-World Bank DSA for Tonga, 2016

[8] In mid-2016, Tonga agreed a grant with China of approximately TOP50m to finance two outdoor swimming pools, an indoor gymnasium, an outdoor rugby field, four outdoor netball fields, one lawn bowling field and ancillary facilities. Infrastructure yet to be financed are the main stadium and a golf course. While yet to be confirmed, the Government of Papua New Guinea has also made a commitment to provide financial support (http://spto.org/news/item/4275-papua-new-guinea-offers-to-assist-tonga-prepare-for-the-2019-pacific-games).

23. **The current macroeconomic policy stance is adequate for the proposed program, but outcomes remain subject to uncertainty and are contingent on external drivers including development assistance, remittances and commodity prices.** The latest IMF Article IV assessment (May 2016) notes that despite a weakening of the fiscal position in FY2016, the deficit remains moderate and is expected to improve gradually over the medium-term. The outlook for growth is relatively good and inflation is expected to remain contained, an assessment supported by the IMF (Annex 3). Key risks to the growth outlook are i) a protracted period of slower growth in advanced and emerging economies which could affect Tonga via reduced remittances and tourism receipts ii) natural disasters, which can devastate the local economy and create considerable fiscal pressure, and iii) fiscal pressure arising from continued growth in government wages or cost overruns for the SPG. Further, 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. Nevertheless, these risks are mitigated by the government's willingness to closely monitor the fiscal situation and build fiscal space to respond to shocks by mobilizing domestic revenues and containing expenditures. Development partners are also likely to continue to provide financial and technical assistance in support of these aims over the medium-term.

3. THE GOVERNMENT'S PROGRAM

24. **The 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 as well as intensive consultations with stakeholders and the public, including both civil society groups and private sector entities across Tonga.

25. **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. Inclusivity and sustainability are emphasized in each of the seven outcomes: 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.

26. **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. The importance of governance, both internally as effective public service provision and externally as international relations, is also a key area of focus for the new TSDF.

27. **The national outcomes are to be achieved via a set of 29 organizational outcomes, which together identify a set of key policy areas.** 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

28. **This programmatic development policy operation (DPO) series is designed to set the foundations for the achievement of key national outcomes under the Government's TSDF 2015-2025.** The series as a whole will support National Outcomes one to five as outlined above. 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. The supported outcomes are those which are consistent with the comparative advantage of development policy programming, while other outcomes are being supported by investment operations and with technical assistance from the World Bank and other development partner programs.

29. **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 and services through more effective regulation, reinforcing incentives for healthy living, encouraging a more conducive business environment and facilitating access to credit especially for smaller customers (which should help create jobs and income-earning opportunities), and boosting government resources for inclusive service delivery. In this operation, the wording of one of the pillars, or components of the development objective, has been slightly amended to more clearly specify the intended impacts. The originally phrased pillar ii) of "pursue inclusiveness and government accountability" has been amended to "support improved government accountability and private sector regulation". While the reforms supported under this pillar continue to support "inclusiveness", the new formulation clarifies the mechanism by which this is expected to occur, to ensure consistent reference to the term "inclusiveness" to mean specifically improvement against the twin goals. In line with this change, the indicative trigger on labor market reform has been moved to pillar iii).

30. **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 an important means of advancing economic and fiscal policy reforms. Adequate investment in policy dialogue is vital but resource intensive. Given the thin capacity, dependence on technical assistance for many reforms and high exposure to external shocks, flexibility to adjust the reform program (including the flexibility to adjust indicative triggers) is important to ensure multi-year reform programs remain relevant and informed by the latest evidence. 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.

31. **Previous operations under this and preceding development policy programs have supported a range of reforms focused on fiscal consolidation, public finance management (PFM) strengthening and improving the business environment.** Actions have included new policy and procedures to crack down on ad-hoc tax exemptions, the strengthening of core revenue mobilization and the introduction of behavioral incentives in the tax system. Previous operations have helped to stabilize wage bill growth and introduce a new debt management law. Budgetary processes have been improved through tightened contingency fund controls, and linking of budget allocations to corporate deliverables. A major public procurement reform program has been supported, as have other PFM improvements such as improved audit follow-up

procedures. Business environment reforms have included business license simplification, passage of a Receivership Bill and public enterprise governance and commercialization measures.

4.2 PRIOR ACTIONS, RESULTS AND ANALYTICAL UNDERPINNINGS

32. **The proposed program supports policy reforms under three pillars: i) Supporting fiscal resilience; ii) supporting improved government accountability and private sector regulation; and iii) supporting a more dynamic and inclusive economy.** Under these three pillars, the government's commitment to the implementation of the reform program is reflected in the completion of the prior actions set out. To support fiscal resilience, policy actions include the adoption of a new rule-based fiscal strategy; strengthening of revenue collection through further excise tax increases; and the implementation of a new remuneration framework. To support government accountability and private sector regulation, this operation supports policy actions that introduce a new procurement monitoring system; and legislation to establish a multi-sector energy regulator. To support a more dynamic and inclusive economy, the operation supports submission of a revised Foreign Investment Bill to the Legislative Assembly (LA); and the commercialization of two public enterprises (PEs).

Pillar I: Supporting Fiscal Resilience

33. **Building fiscal buffers through domestic revenue mobilization and careful management of spending is the best way to support fiscal resilience to 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, while increasing domestic revenue mobilization through strengthened taxation settings and improving the oversight of key sources of fiscal risk. The reforms being progressed in this area continue an ongoing engagement from two previous DPO programs, and are focused on increasing revenue efficiently from indirect tax sources; addressing major expenditure items, including the public service wagebill, in order to ensure the sustainability of public finances; and supporting effective service delivery. Tax measures aimed at supporting more healthy lifestyles are also expected to reduce the pressure on health spending over the longer-term, in a country that has a very high non-communicable disease burden.

34. **The actions supported in this operation build on actions completed in the previous operation, which included tax increases on petroleum products and unhealthy foods (offset by reductions in taxes on healthy alternatives), Tonga's first Medium-term Debt Management Strategy, and the completion of a Public Sector Remuneration Review.** The government raised excise duty on tobacco and all kinds of alcohol, implemented a new excise duty on instant noodles, increased the import duty rates on turkey tails to 15 percent, and reduced import duty on various fruit, vegetables and fish products. To support revenue mobilization, the excise duty on petroleum was raised by 12 percent (Table 5). Cabinet approved and made public a new Medium-Term Debt Strategy (MTDS), to ensure that Tonga's borrowing strategy is clearly defined and new loans are subject to rigorous assessment to ensure they maximize the benefits to the country and maintain low portfolio risk.

Prior Action 1: The Recipient has increased the rate of fuel excise tax by TOP 0.09 per liter (an increase in the rate of 16%) 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.

35. **Historically in Tonga, eighty percent of tax revenue has been collected from consumption and trade taxes that were hard hit during the Global Food and Fuel Crisis.** In a highly trade-dependent country with limited domestic value added and limited capacity to ensure direct tax compliance, 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 remained low. Recent falls in global oil prices have afforded an opportunity to reinstate these critical revenue sources without raising the net price to consumers.

Table 5: Summary of selected excise tax and import duty changes

	FY2014	FY2015	FY2016	FY2017
Excise tax on:	*(Tongan Pa'anga)*			
Fuel (liter)	50	50	56	65
Imported cigarettes (1000 sticks)	210	250	255	380
Local cigarettes (1000 sticks)	200	238	240	280
Imported alcohol (liter alcohol)	21	21	25	25
Local alcohol (liter alcohol)	42	42	50	50
Fizzy drinks, sweetened (liter)	0	0.50	0.50	1.00
Lard and drippings (kg)	0	1.00	1.00	2.00
Chicken leg (kg)	0	0	0	0.40
Turkey tail (kg)	0	0	0	1.50
Mayonnaise (kg)	0	0	0	2.00
Ice cream (liter)	0	0	0	1.50
Instant noodles (kg)	0	0	1.00	2.00
Import duties on:	*Ad-valorem rate (percentage)*			
Turkey tails	0	0	15%	15%
Lamb breast	0	0	0%	15%
Lamb flaps	0	0	0%	15%
Mayonnaise	0	0	0%	15%
Fresh, frozen or preserved fish	5%	5%	0	0
Fresh fruit (except coconuts)	15%	15%	0	0
Fresh legumes & vegetables (except potatoes	20%	20%	0	0
Potatoes	20%	20%	15%	15%
Beer	15%	15%	0	0

36. **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.

37. **As a prior action, tThe Recipient has increased the rate of fuel excise tax by TOP 0.09 per liter (an increase in the rate of 16%) 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 continued the reforms supported by the current and previous DPO programs[9] by revising a series of excise and import duties rates in order to increase the positive behavioral incentives in the tax system while also increasing revenue mobilization. The impact of the measures in DPO-1 are estimated to have raised excise tax and import duty revenue collections by TOP 7.5m (0.9 percent of GDP) in FY2016 and onwards. A key reform is a further increase in the fuel excise duty by 9c (equivalent to a 16% increase in the rate), tobacco, all kinds of alcohol, and on unhealthy foods

[9] The previous increase in excise tax on fuel was TOP 0.06 (12%).

Table 6: Indicative triggers and prior actions for the second operation

Indicative trigger for this second operation (as presented in the program document for the first operation in this series	Second operation prior action	Explanation / Status
Pillar I – Supporting fiscal resilience		
Implement recommendations of a review of consumption tax legislation to reduce exemptions.	The Recipient has increased the rate of fuel excise tax by TOP 0.09 per liter (an increase in the rate of 16%) 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 decided to further reforms supported in DPO-1 (fuel excise tax increase of another 9c, compared to 6c last year, and other new NCD-targeting taxes) instead of prioritizing the proposed trigger. The trigger is supported in the medium-term, but is not currently seen as critical as policy and institutional reforms supported by a previous DPO mean ad-hoc exemptions remain very low at present.
The Recipient's Cabinet has approved a transparent, target-based fiscal anchor system and monitoring framework.	The Recipient's Cabinet has approved a transparent, target-based fiscal anchor system and monitoring framework that supports medium-term fiscal sustainability and a more efficient mix of public spending.	Minor adjustment to more clearly specify the purpose of the action.
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.	The Recipient's Cabinet has approved and begun to implement a new public service remuneration structure and performance management system to ensure effective public service delivery, adequate pay, and consistency with fiscal sustainability.	Trigger has been completed and prior action strengthened to include more rapid progress on reform, with the indicative trigger for DPO-3 already completed this year. Reformulation to reflect this rapid progress.
Pillar II – Government accountability and private sector regulation		
Implementation of revised Chart of Accounts to improve reporting for line ministries	The Recipient has implemented a new procurement tracking database and adopted compliance and performance indicators and associated targets.	Recent technical assistance to the reform area has recommended a reprioritization of reforms in this area. Trigger to be delayed to DPO-3, and DPO-2 reflects the completion of prioritized PFM reform that supports procurement reform under DPO-1.

Cabinet approval for submission to Parliament of legislation to establish a multi-sector regulator and finalization of institutional structure	The Recipient's Cabinet has approved for public consultation a National Energy Bill, which includes provisions for multi-sector regulation for all energy sub-sectors (electricity, gas, petroleum).	Reformulation to reflect more precise description of reform, in line with recommendation of World Bank TA. The prior action marks a concrete step in establishing new and consolidated multi-sector regulation. Reform to other sectors envisaged in the indicative trigger (waste and water) will be pursued separately and subsequent to energy sector reform.
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	The Recipient's Cabinet has approved the Foreign Investment Bill for submission to the Recipient's parliament, which includes provisions to facilitate foreign investment in the Recipient's territory.	Minor change to wording.
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		Trigger delayed until DPO-3 as proposed reform is no longer feasible, for reasons beyond Tonga's control. The Tonga Credit Bureau, operated by a company housed in Fiji, was affected by the new law passed in Fiji relating to credit information. As a result, the operator has decided to close down the Tongan Bureau. The central bank is working with IFC TA to identify a viable alternative, which will be supported under DPO-3.
Cabinet has approved the reform of two PEs in accordance with the public enterprise (PE) Reform Plan, where 'reformed' may consist of privatization, liquidation, substantial restructuring, outsourcing or another form of public-private partnership	The Recipient's Cabinet has directed the Ministry of Public Enterprises to proceed with a sale of shares in Tonga Cable Ltd.	Scope of trigger was considered too ambitious, given the considerable technical work required to adequately prepare a commercialization. Therefore, the trigger has been amended to reflect the completion of one, specified, transaction, rather than two.

such as lamb flaps and turkey tails. Duties for other commodities have either been reduced or left at zero, such as education materials, sporting goods, fruits, vegetables and construction materials. The indicative trigger for this policy area targeted consumption tax legislation reform to enshrine in law gains already made in reducing tax exemptions supported under the previous DPO program. However, given pressing revenue mobilization and health needs, the government decided to delay this reform in lieu of excise duty reforms. Preliminary estimates suggest that in addition to strengthening health policy, the set of revenue measures supported under DPO-2 will increase import duty and excise tax revenues by a further TOP 10.2 million a year (1.1% of GDP)[10]. The results indicator for this reform area will target an increase in excise duty revenue as a proportion of domestic revenue.

38. **The indicative trigger for the next operation in the series is to revise the Revenue Administration Services Act to set more realistic penalties and introduce more avenues for revenue recovery**. This is considered by the government to be a more pressing reform area than the previously envisaged indicative trigger, which was to reduce corporate tax exemptions, although this also remains on the government's agenda, as do improvements to customs legislation.

Prior Action 2: The Recipient's Cabinet has approved a transparent, target-based fiscal anchor system and monitoring framework that supports medium-term fiscal sustainability and a more efficient mix of public spending

39. **Over the past four years Tonga has been able to stabilize its public finances but looking ahead spending pressures will remain including the prospect of major exogenous fiscal shocks.** Prudent fiscal management has enabled the government to limit budget deficits and debt accumulation. However, past experience in Tonga as well as in neighboring small Pacific islands shows how quickly these gains can be unwound. 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. In the mid-2000s a very large public service wage rise, of around 60 percent in one year, tipped the recurrent budget immediately into unsustainable territory. The Government of Tonga already prepares an annual budget strategy which informs budget preparation. However, fiscal strategies and targets tend to be short-term in nature, and change significantly from year to year – making it less clear what the medium-term constraints for the budget are.

40. **As a prior action for this operation, The Recipient's Cabinet has approved a transparent, target-based fiscal anchor system and monitoring framework that supports medium-term fiscal sustainability and a more efficient mix of public spending.** 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, annual budget planning is often dominated by urgent needs, and a robust medium-term fiscal strategy can be a valuable tool to provide a stable anchor across years. The new fiscal strategy has been developed using the recently developed Tonga Macroeconomic Model, along with a new volatility model, which applies historically-calibrated stochastic shocks to key macro-fiscal variables over the course of the forecast period. The volatility model indicates that the proposed fiscal strategy and targets are internally consistent and have an acceptable probability of being resilient to economic volatility similar to that Tonga has faced in the past. The key components of the fiscal strategy bring together: i) a debt target – to maintain external debt below 50 percent, only contracting highly concessional debt; ii) a revenue target – to maintain domestic revenues at or above 22 percent of GDP; and a wagebill affordability target – to maintain public remuneration below

[10] The majority of revenue rises in each year are due to excise tax. Estimates are based on forecasts for the whole tax head in the year prior to the policy change compared to year it is announced, so are net of any other change in the forecast of that tax head.

53 percent of domestic revenues, moving towards 50 percent over time[11]. These targets represent central government objectives to support sustainable public service provision over the medium-term, and will be complemented from year to year with short-term budget targets.

41. **The results indicators for this prior action monitor whether new borrowing is contracted on highly concessional terms, as well as the extent to which the medium-term fiscal anchors are used in Budget planning and published documentation**. The concessionality of any new debt will have a critical impact on the sustainability of the public debt burden and the government's ability to meet its debt target over the medium to long term. It is also important that these anchors are consistently used in budget formulation and that a clear plan to either move toward or maintain the targets over the medium-term is set out in the government's budget documents each year.

Prior Action 3: The Recipient's Cabinet has approved and begun to implement a new public service remuneration structure and performance management system to ensure effective public service delivery, adequate pay, and consistency with fiscal sustainability

42. **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 with 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 in 2005 left horizontal inequities in the remuneration system and poor performance management systems unaddressed.

43. **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) carried out a review of the existing remuneration framework and options for reform, in partnership with an industry-leading international consultancy firm in 2014 and 2015. This review considered the pay and job descriptions of all public servants – those subject to the PSC pay scales and those agencies and bodies that have their own remuneration scales as overseen by the RA.

44. **Building on the Remuneration Review that has been completed, the Government is implementing a systematic program of reform to the public sector remuneration system.** The critical components of the reform program are: i) a revision of the individual payscales, to reflect competitive returns for skills and experience using a robust and fair methodology; ii) a new individual performance management framework that includes competitive and fair performance assessments as a basis for in-grade pay progression; iii) a policy framework to ensure that the individual remuneration framework (parts i and ii) are consistent with broader fiscal sustainability and allocative efficiency which will, among other things, determine the available funding for performance rewards.

45. **As a prior action, The Recipient's Cabinet has approved and begun to implement a new public service remuneration structure and performance management system to ensure effective public service delivery, adequate pay, and consistency with fiscal sustainability.** The complete introduction of a reformed public service performance management system will take place over a number of years, and progressive steps are supported under each operation of this programmatic series. The Cabinet approval and introduction of the new framework this year marks the formal revision of the payscales for the public sector and is reflected in the GoT's payroll management system. The new payscales and other aspects of the remuneration framework have been extensively consulted on in Tonga, and the final adopted payscales reflect an agreement between the Government and public servants. Public servants will be progressively

[11] Including employer social security contributions.

moved to the new payscales.[12]

46. **The new performance management system provides the framework to implement the performance-pay system.** Under the newly approved system, pay increments are no longer available solely at the manager and Chief Executive Officer (CEO's) discretion, but performance-based rewards will be decided following a new moderated performance assessment process starting in mid-2017. No increments have been available to staff during FY2017. The PSC has been undertaking significant training for both employees and managers to ensure effective implementation of the performance management process. To enhance the transparency and rigor of the performance assessment process and mitigate the risk of poor implementation, the PSC is establishing moderation processes for all ministries including a central moderation committee. The PSC has proposed the establishment of a working group consisting of a small number of CEOs together with the RA and Solicitor General that will recommend a monetary figure that be allocated in the budget to fund annual performance rewards. This recommendation is to be informed by the short and long term financial situation of Tonga's economy and the impact on the Government's overall wagebill. This recommendation will complement an annual salary scale review which will be undertaken by the RA.

47. **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 of continual, substantial pay rises year-on-year irrespective of performance. The proposed changes will achieve cost savings by ending 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 bands. While there will be transitional costs in FY2017 in moving to the new framework[13], these should be limited and since the new framework will not involve large-scale annual increments or unjustified cost of living adjustments, costs will be more effectively controlled and consolidated than under the previous system. 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. The indicative trigger for the next operation is for Cabinet to approve draft legislation to institutionalize a transparent reward and pay-setting mechanism to support improved control of the wagebill and effective performance and motivation of public servants. While significant changes have already been made to remuneration frameworks and the surrounding implementation arrangements, new and improved public sector management frameworks could be further institutionalized by introducing them in legislation. The World Bank, in coordination with other development partners, will provide TA to support the continued implementation of this reform program, include to assist the government to ensure that the new framework is appropriately designed to achieve the intended results.

48. **Results indicators under this pillar target improvements in indicators of fiscal resilience.** Results indicators for this pillar target adherence to Government the objective of contracting only high concessionality debt, improved public sector wagebill affordability, measured as a reduction in public remuneration as a proportion of domestic revenue and increased excise duty revenues.

Pillar II: Government accountability and private sector regulation

[12] Staff below CEO grade who remain on the same or higher salary point under the new system will be immediately transitioned. Staff whose existing salary point is currently above the band for their new grade will remain on the existing payscales. Such positions will be remapped to the new payscales as they are vacated and re-advertised. CEOs will move during the course of FY2017 to the new payscales.

[13] The net cost of remapping positions is understood to be no more than TOP 5m, and a transitional annual reward is likely to be required until there is an operational performance-based reward system in place.

49. **The new government of Tonga came in on a platform of good governance, and 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 that will strengthen accountability and oversight frameworks within the public sector and in private markets. Policy areas supported under this pillar of the program include: improved procurement systems; increased effectiveness of external audit recommendations; improved regulation of sectors that provide basic services; and labor market reform to improve the quality of jobs and narrow gender disparities.

50. **Actions completed in the previous operation under this pillar include revised procurement regulations, new procedures to ensure follow up of audit recommendations and the creation of a new multi-sectoral ICT regulator.** A revised set of Procurement Regulations was introduced which rationalized a previously complex set of procurement rules. Supporting manuals and standard bidding documents were also approved by Cabinet and the Government Procurement Committee and implemented alongside the regulations. 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.

Prior Action 4: The Recipient has implemented a new procurement tracking database and adopted compliance and performance indicators and associated targets

51. **The Government has already made substantial progress in introducing and implementing a major reform of public procurement, but has lacked adequate capacity to systematically record and monitor procurement activity centrally.** Each of the last three DPO operations have supported progressive steps in a major 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 Ministry of Finance and National Planning (MFNP), new Treasury instructions on procurement, and procurement regulations. The CPU is now fully operational and is overseeing all major public procurements, whilst also providing capacity building for procurement officers in line ministries.

52. **As a prior action for this operation, The Recipient has implemented a new procurement tracking database and adopted compliance and performance indicators and associated targets.** This database establishes an institutional mechanism to enable MFNP, through its Central Procurement Agency, to maintain a detailed record of all procurements above the small item threshold (TOP 7,500). The operation of the procurement tracking database will allow the Government to monitor key performance indicators on procurement and to maintain a historical record of past procurement. Key performance indicators to be monitored include the proportion of procurement that uses competitive methods, and the average number of days taken for the procurement process. The results indicator for this area will target an increase in usage of competitive tender methods for procurements above the small tender threshold.

53. **The indicative trigger for this policy area was a revision to the Chart of Accounts, in order to standardize the classification of expenditures in the Government budget system.** However, further technical assistance (from IMF-PFTAC) indicated that further analytical work should be done before this – including the development of a comprehensive government accounting framework, and finalization of a planned financial management system upgrade. As a result, the trigger on Chart of Account revision has been pushed back to the next operation, in lieu of the previous indicative trigger on adding IFMIS modules. Similarly to the procurement reforms supported by the current operation, Chart of Account revisions should also assist the GoT to more systematically monitor its spending across the budget.

Prior action 5: The Recipient's Cabinet has approved for public consultation a National Energy Bill, which includes provisions for multi-sector regulation for all energy sub-sectors (electricity, gas, petroleum)

54. **Sector reforms in the PICs are often needed to ensure adequate regulation of markets with limited or no competition, but these reforms need to account for 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.

55. **At present, regulation of the energy sector involves a patchwork of different arrangements.** The primary legislation governing the energy sector includes the Energy Act 2007, the Renewable Energy Act 2008 and the Petroleum Act 1959. The Tonga Competent Authority regulates petroleum prices under the Price and Wages Control Act. The Fire Commission monitors compliance with the Petroleum Regulations. The Ports Authority monitors maritime petroleum safety measures. The two privately-operated fuel depots are in practice self-regulating. On-grid generation, distribution and supply is regulated by the Electricity Commission, an independent regulator. Off-grid renewable electricity is regulated by the Government of Tonga's Energy Department, while off-grid, non-renewable electricity is unregulated in law.

56. **As a prior action for this operation, The Recipient's Cabinet has approved for public consultation a National Energy Bill, which includes provisions for multi-sector regulation for all energy sub-sectors (electricity, gas, petroleum).** An important provision of the new bill to establish a combined energy sector regulator will merge the responsibilities of the Electricity Commission and the Tonga Competent Authority for energy products, and clarify regulatory responsibilities in other areas. The new regulator will have a greater level of independence from government than previously. This reform also brings together price and non-price regulation of the sector under the same entity, supporting the ability of the regulator to make informed regulatory decisions in view of trade-offs faced by market actors. The results indicator in this area will target the effective regulation of regulated areas, measured as regulatory monitoring reports being prepared on at least an annual basis. This prior action has been revised from the indicative trigger to increase the level of precision, given the completion of ongoing analytical work (led by the World Bank). As a draft bill, the prior action represents further progress than the indicative trigger, while it more narrowly addresses energy sub-sectors, rather than other utilities such as water and waste which will be addressed subsequently to the completion of energy sector regulatory reform.

57. **The indicative trigger for the third operation in the series is that the Cabinet has approved the National Energy Bill for submission to Parliament.** While the provisions in the National Energy Bill have been approved in-principle by Cabinet, Cabinet also recommended that the legislation in the current Petroleum, Electricity, and Renewable Energy Acts be integrated into the Energy Bill. Compared with its predecessor (Cabinet approval of a new competition policy), this trigger is a clearer continuation of existing reforms in this area and avoids opening up a new area of reform in the last operation of the series. It is also more clearly tied to the results indicator, given that the regulatory monitoring reports will be an important part of the implementation of this Bill.

Pillar III: Supporting a more dynamic and inclusive economy

58. **Improving the business environment and supporting private sector development 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 the establishment of public-private partnerships (PPPs) and improved governance. In the 2017 Doing Business Survey, Tonga ranked 85th in the world and was 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 program identifies key actions to address the most critical problems, phased to account for very limited implementation capacity.

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

Prior action 6: The Recipient's Cabinet has approved the Foreign Investment Bill for submission to the Recipient's parliament, which includes provisions to facilitate foreign investment in the Recipient's territory.

60. **While foreign direct investment is a critical catalyst for private sector development, FDI inflows to Tonga are very modest, in part due to overly burdensome legislation that is unevenly enforced.** FDI 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, leading to an acute shortage 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 businesses 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.

61. **As a prior action, The Recipient's Cabinet has approved the Foreign Investment Bill for submission to the Recipient's parliament, which includes provisions to facilitate foreign investment in the Recipient's territory.** This reflects the culmination of work that has been ongoing for the last three years, with the previous DPO program supporting the development of a new investment policy that was a preliminary step towards new legislation. The new Foreign Investment Bill will replace the previous Foreign Investment Act (2002). The new Foreign Investment Bill implements a number of key recommendations to make it easier for foreigners to invest in Tonga. The Bill includes: a clearer definition of what constitutes foreign investment; new principles and procedures to manage reserved and restricted lists; more transparent procedures for vetting potential investments; and a requirement for foreign investors to report annually on the status of their investments. By rationalizing restrictions on investment, 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 by directly improving the experience of investing in Tonga. Due to the large amount of technical and consultative work in this complex and sensitive area, the approval of new work permit rules envisaged in the indicative trigger for this policy area will be addressed in the next operation, alongside completion of regulations to the new Foreign Investment Bill including new restricted and reserved lists. For the final operation, the preparation of new contract law was previously envisaged as a trigger, but the abovementioned work permit rules and regulations implementing the Foreign Investment Bill are a clearer continuation of the required reforms in this area and are explicitly linked to the results indicator, which measures the increase in vetted applications from foreign investors. They are hence a more appropriate trigger for the next DPO in the series.

Table 7: 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 0.09 per liter (an increase in the rate of 16%) 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. 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 Recipient's Cabinet has approved a transparent, target-based fiscal anchor system and monitoring framework that supports medium-term fiscal sustainability and a more efficient mix of public spending	The World Bank has provided technical assistance to the Government on modelling of appropriate fiscal anchors in the context of Tonga's risk profile.
The Recipient's Cabinet has approved and begun to implement a new public service remuneration structure and performance management system to ensure effective public service delivery, adequate pay, and consistency with fiscal sustainability	Government of Tonga Remuneration Review (2015) indicated that the current salary structure, in place since the 1980s, needs to be revised in line with the current circumstance in the public and private sector and the changes in various positions in the government organizational structure. World Bank has been providing TA to the Government to support the development of the reform program.
Pillar II: Democratic and government accountability	
The Recipient has implemented a new procurement tracking database and adopted compliance and performance indicators and associated targets	The 2010 PEFA Assessment noted significant weaknesses in procurement processes and rated them overall as 'C'. Noted in this report and highlighted in the AusAid Public Procurement System Review 2013 was the lack of any comprehensive non-manual system of procurement recording, which means that procurement information must be checked against individual documents. The establishment of a computerized tracking system was prioritized as part of the overall public procurement reform program.
The Recipient's Cabinet has approved for public consultation a National Energy Bill, which includes provisions for multi-sector regulation for all energy sub-sectors (electricity, gas, petroleum)	Energy Regulation options paper prepared for the GoT with support provided by the World Bank's Tonga Energy Road Map program identified shortcomings in regulation of non-electricity energy sectors and supported the preparation of a National Energy Bill which proposes to extend the regulatory remit of the electricity regulator.
Pillar III: Supporting a dynamic and inclusive economy	
The Recipient's Cabinet has approved the Foreign Investment Bill for submission to the Recipient's parliament, which includes provisions to facilitate foreign investment in the Recipient's territory	Following up from the 2012 ADB Private Sector Assessment, the 2014 Foreign Investment Policy Review conducted with ADB support identified issues with the foreign investment registration process that unnecessarily restricts access in sectors including tourism, fisheries and agriculture. The review recommended legislative and regulatory changes to the Investment Act regime.
The Recipient's Cabinet has directed the Ministry of Public Enterprises to proceed with a sale of shares in Tonga Cable Ltd	ADB Tonga Economic Update Outlook 2012, ADB Finding Balance 2016, and GoT PE 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.

62. **New and more restrictive credit reporting laws in Fiji have led to a setback in the operation of the Tonga credit bureau, requiring the National Reserve Bank of Tonga to reassess its credit reporting framework.** A planned indicative trigger under this operation was for NRBT to issue a regulation to mandate credit reporting under the already-operational Tonga credit bureau, operated out of Fiji. However, new laws requiring a higher level of credit data disclosure to the national (Fijian) authorities have caused the provider to cease operation of the Tonga credit bureau. Therefore, the planned trigger is no longer an appropriate reform. The WBG is supporting NRBT to identify alternative means of establishing a credit bureau, and steps to establish a sustainable solution could be supported under the next operation in this series, although it should be noted that there remains substantial uncertainty around potential outcomes in this area and hence some flexibility on this indicative trigger may be required. The intended results indicator in this policy area would target a substantial increase in credit checks for new loan applications, disaggregated by gender.

Prior action 7: The Recipient's Cabinet has directed the Ministry of Public Enterprises to proceed with a sale of shares in Tonga Cable Ltd.

63. **The Government is continuing a successful public enterprise (PE) reform program. The new Government approved a Public Enterprise Reform Policy which marked a continuation and reinvigoration of the previous reform program.** The policy encourages divestment where it is viable and in the public interest to do so, and improved governance and other forms of private sector participation in those cases where it is determined that the enterprise should remain publicly owned. Under the last operation, the Government consolidated PE boards to boost oversight and reduce management costs. 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 Tonga Water Board.

64. **As a prior action for this operation, The Recipient's Cabinet has directed the Ministry of Public Enterprises to proceed with a sale of shares in Tonga Cable Ltd.** Tonga Cable Limited (TCL) was established in 2009 to own and operate the Fiji-Tonga Cable which became commercially operational in August 2013. The Government of Tonga currently holds 82 percent of TCL shares, and the Tonga Communications Corporation (TCC), another PE, holds the remaining 18 percent. The government has approved the sale of 18 percent of its TCL share to Digicel, a private sector telecommunications operator in Tonga. The sale will result in increased private sector participation in the company, with an additional Digicel-appointed director on the TCL board. This transaction is expected to support the continued roll-out of high-speed internet across Tonga, ensuring a competitive, level playing field for telecommunications operators and hence competitive pricing. It is also expected to support improvements in access, with plans to use the proceeds of the sale of shares to connect outer islands via a domestic cable extension. Indicative triggers for PE reform target the continued implementation of Tonga's program to increase private sector participation in its PE portfolio – via sale, outsourcing or some other form of PPP – with the government's pipeline of transactions guided by the Public Enterprise Reform Policy.

65. **Tonga is one of the few countries in the region that lacks any form of labor regulation for the private sector, which is recognized as a serious risk in ensuring salaries and conditions for workers are fairly set.** Tonga lacks legislation to ensure 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, etc[14]. 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,

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

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. Under the program the government is taking steps to address this legislative gap, and has recently became a member of the International Labor Organization (ILO). An indicative trigger for the final operation in the series will be the approval of foundational employment legislation in Tonga that 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.

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

66. **The World Bank Group's Regional Partnership Framework (RPF) for nine PICs, including the Kingdom of Tonga, is built around four focus areas.** These are: first, fully exploiting the available economic opportunities (including in fisheries, agriculture, and tourism); second, enhancing access to employment opportunities (including by broadening opportunities for labor mobility and improving education outcomes); third, protecting incomes and livelihoods (including through strengthening resilience to natural disasters and climate change, and addressing NCDs); and fourth, strengthening the enablers of growth and opportunities (macro-economic management, infrastructure and addressing knowledge gaps). The proposed operation contributes to the first theme of exploiting economic opportunities through public enterprise reform and by making it easier to invest in Tonga, and the third and fourth focus areas by strengthening fiscal policy so as to build fiscal buffers and improve the resilience of the government to shocks, increasing taxes on alcohol, tobacco, and unhealthy foods and drinks to combat NCDs, and strengthening the regulatory environment for the energy sector.

67. **The proposed operation builds on a number of technical assistance projects of the World Bank and other development partners.** The World Bank (WB), in coordination with ADB and DFAT have provided guidance to the development of an implementation plan and reforms to public service remuneration reform, in addition to other assistance the GoT has received. WB has provided analytical support to the government in building an evidence base for its new fiscal strategy. Development of a procurement tracking database has been supported by WB, complementing considerable ongoing existing TA from DFAT to the public procurement framework. Energy sector reform has been supported by WB. 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. Foreign Investment legislation has been developed with support of the Private Sector Development Initiative program managed by ADB (ADB-PSDI). Public enterprise transactions have been aided by sectoral engagements by MFAT in forestry and WB in telecommunications, with overall TA to the PE reform program led by ADB-PSDI.

4.4 CONSULTATIONS, COLLABORATION WITH DEVELOPMENT PARTNERS

68. **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 the last 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 MFNP 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

concluded 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.

69. **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 all recent Article IV missions and jointly prepare 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$ 4 million, ADB budget support of US$ 6 million equivalent, MFAT budget support of approximately NZ$ 0.5 million and EU budget support of Euro 2.5 million is expected to be mobilized for the same policy actions, with New Zealand joining the budget support framework in FY2016 in response to the launch of this new development policy program. 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 facilitate the achievement of the proposed program of policy reforms.

5. OTHER DESIGN AND APPRAISAL ISSUES

5.1 POVERTY AND SOCIAL IMPACT

70. **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 international $3.10 a day poverty line.

71. **Reforms supported by the program are expected to help reduce poverty and boost shared prosperity via market-based protections 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. By supporting fiscal resilience, the reforms under Pillar 1 of the program will help ensure that the government has the fiscal space to respond to future economic shocks and natural disasters (which tend to have a particularly adverse impact on the poor) while maintaining critical health, education, and community services on which the bottom 40 per cent are particularly dependent. In particular, households with a public service employee tend to be better off, with 19 percent of basic needs poor households having a member working in government, compared with 28 percent of non-poor households. Hence ensuring that the public wage bill grows in an affordable fashion is potentially a pro-poor measure that will allow more space for essential spending on service delivery. The reforms under Pillar 2 of the program are focused on increasing the level of government accountability and ensuring effective regulation and private sector competition, which should also help to minimize the costs of basic goods and services. Given the lack of competition in the energy sector, the program's support for more effective regulation should ultimately support lower prices and improved service delivery in the sector (relative to the status quo). This in turn has potentially important implications for the basic-needs poor, which have less access to electricity and for whom electricity costs are a substantial burden. Pillar 2 reforms also support inclusive growth by setting standards in the labor market which will improve the quality of jobs and narrow gender disparities. Finally, the third

pillar aims to address poverty by improving the environment for private sector activity, which would help bring jobs and opportunities to Tonga.

72. **Supported reforms have been designed to minimize potential negative impacts on the poor, and the poverty impacts of the program will be monitored as it proceeds.** Reforms to excise and import duties increase the taxation level on a number of goods that have negative health impacts, including those that are consumed by poorer households. HIES data indicate that the poorer quintiles and those that live on the outer islands tend to spend less on transport, both in level terms and as a percentage of the total household budget, suggesting that fuel excise increases could be pro-poor if the revenue was used to finance services benefitting these groups. At the same time, poorer and more remote households' limited spending on transport probably partly reflects access inequities (resulting from to financial constraints—limited resources and/or high costs), and these may be exacerbated by the higher fuel excise at the margin. Nevertheless, the substantial fall in oil prices in recent years means that the cost to the consumer remains lower than previously, despite the rise in excise, with retail petrol prices in Tonga down 24 percent from their peak in early 2013 (as of Q3 2016). As a share of total expenditure, spending on alcohol and tobacco is roughly constant across the income distribution, averaging around 4 percent of the household budget for the approximately half of poor and non-poor households reporting non-zero expenditure on these items. Initial estimates suggest that the excise and duty increases for these households would constitute around 1.5 percent of the cost of the basic needs consumption basket, with potentially larger impacts for poorer households in the absence of any reduction in tobacco and alcohol consumption. On the other hand, the 2014 NCD Roadmap study notes that over the medium term, the poor benefit significantly more than the rich in terms of improved health outcomes, and bear less of the tax burden, because they are more likely to stop smoking or not take it up in the first place. Similarly, increased duties on unhealthy foods such as lamb flaps, turkey tails and instant noodles would increase food costs in the absence of a behavioral response, although the corresponding reduction in duties on fruits and vegetables may act as a positive incentive in this regard. Overall, any potential negative budget effects are judged to be outweighed by the potential positive health effects of lowering consumption (and as noted above the use of such taxes is supported by various pieces of analytical work including e.g. the 2014 NCD Roadmap). 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

73. **The policy actions supported under the operation are not expected to have a significant impact on Tonga's environment.** 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.

74. **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. Nevertheless, although the legal framework is reasonably sound, capacity for monitoring and enforcement is relatively thin and the quality of EIAs can be variable. Legislation includes the Environmental Impact Assessment Act 2003 which provides 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 regulates major development projects and the application of notifications consistent with the EIA Act 2003. Finally, the Environment Management Act 2010 established 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

75. **Reflecting reform efforts over the recent years, Tonga's policy and institutional performance is 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 MFNP 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.

76. **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 FY2014/15 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.

77. **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 inadequate knowledge of the foreign exchange control environment.

78. **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 will be disbursed against: (i) satisfactory completion of the specified policy actions as listed in Table 6; (ii) an adequate macroeconomic framework and; (iii)the Government agreement, as summarized in the Letter of the Development Policy. It 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.

79. **Flow of funds (including foreign exchange) is subject to Tonga's regular 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. The Recipient shall ensure that upon deposit of an amount of the Financing into the Foreign Currency Deposit Account, an equivalent amount in Tonga Pa'anga is accounted for in the Recipient's budget management system, in a manner acceptable to the

Association. The Government will provide confirmation to the Bank when an amount equivalent to 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. The proceeds of the operation would not be used to finance expenditures excluded under the Agreement. If, after being deposited in a government deposit account, the proceeds of the operation are used for ineligible purposes as defined in the legal agreements, IDA will require the Recipient to refund the amount directly to IDA. Any such amounts refunded to IDA shall be cancelled.

80. **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

81. **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.

82. **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.

83. **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.

84. **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. 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. Complex reform areas such as public service remuneration that require ongoing consultation and continued commitment have a higher level of implementation risk, but are mitigated via the gradual, phased approach and an upfront investment in analytical design and consensus-building.

Table 8: Standardized Operational Risk-Rating Tool

Risk Categories	Rating (H, S, M or L)
1. Political and governance	M
2. Macroeconomic	S
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	M
8. Stakeholders	S
Overall	S

85. **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 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 by: 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.

86. **The policy framework includes major reforms that may meet with opposition from vested interests.** A focus of this program is to strengthen inclusive institutions, and policy reforms focused on increasing domestic competition via foreign investment, implementing effective, independent sector

regulation and supporting controlled and earned public pay increases may give rise to opposition from individuals that benefit from existing systems. This risk is mitigated through an extensive public consultation process on these reforms led by the Government of Tonga, and by retaining flexibility in the policy program by change or delay indicative triggers when needed to allow extra time to ensure an agreement is reached.

87. **There is a substantial risk that policy actions could have unintended, negative environmental and social impacts for some groups.** As noted in the appraisal above, some measures may have negative impacts on certain groups of over certain time periods. For instance, tax increases on tobacco, alcohol and unhealthy foods may lead to some people who consume these goods being worse off as a result. However, the long-term health benefits are expected to outweigh these negative impacts over time for the same group of people.

ANNEX 1: POLICY AND RESULTS MATRIX

Completed actions, prior actions and triggers			Results
Actions completed under DPO 1	**Prior actions 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[15]	The Recipient has increased the rate of fuel excise tax by TOP 0.09 per liter (an increase in the rate of 16%) 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[16]	Revise the Revenue Administration Services Act to set more realistic penalties and introduce more avenues for revenue recovery	**Outcome: Excise duty revenue as a proportion of domestic revenue increases** Indicator: Excise duty revenue as a proportion of domestic revenue Baseline (average FY11-FY14): 19.0 percent Target (FY19): increase of 0.5 percentage points of domestic revenue
The Cabinet has approved a new Medium-Term Debt Strategy which has been made public	The Recipient's Cabinet has approved a transparent, target-based fiscal anchor system and monitoring framework that supports medium-term fiscal sustainability and a more efficient mix of public spending		**Outcome: Analysis of the relationship between current fiscal outcomes, budget projections, and the path toward fixed medium-term fiscal targets conducted as part of Budget preparations** Baseline (FY13-FY17): No such analysis in Budget documents Target: (FY18-FY20): Analysis included in Budget documents **Outcome: Proportion on borrowing that is highly concessional** Indicator: External borrowing that is above 35 percent concessionality as a proportion of all external borrowing Baseline (FY13-FY15): 100 percent Target (FY16-FY19): 100 percent

[15] 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.

[16] Excise duty on alcohol and tobacco has been increased, import duty on lamp flags increased to 15% and import duties on education materials, construction materials, sports materials, fruits and vegetables decreased.

Completed actions, prior actions and triggers			Results
Actions completed under DPO 1	**Prior actions DPO 2**	**Triggers for DPO 3**	
(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 Recipient's Cabinet has approved and begun to implement a new public service remuneration structure and performance management system to ensure effective public service delivery, adequate pay, and consistency with fiscal sustainability	Cabinet has approved draft legislation to institutionalize a transparent reward and pay-setting mechanism to support improved control of the wagebill and effective performance and motivation of public servants	**Outcome: Improve wagebill affordability** Indicator: Public wagebill as a proportion of domestic revenue Baseline (FY14): 57 percent Target (FY19): 53 percent or lower
Pillar II – Democratic and government accountability			
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	The Recipient has implemented a new procurement tracking database and adopted compliance and performance indicators and associated targets for monitoring system performance, to be publically disseminated	Approval of a Chart of Account revision in order to accurately reflect standard economic classifications in the Government budget system	**Outcome: Increased compliance with requirements for public procurement** Indicator: Proportion of contracts above the small purchases threshold that are subject to open competition[17]. Baseline (FY14): 35 percent of contracts subject to open competition Target (FY19): At least 50 percent of contracts subject to open competition **Outcome: External audit recommendations acted upon** Indicator: Proportion of outstanding audit recommendations 12 months after submission of the audit report to the Legislative Assembly[18] Baseline (FY15): 85 percent (115 of 136) Target (FY19): 50 percent
The Recipient's Legislative Assembly has approved a new Communications Commission Act that will establish an independent regulator	The Recipient's Cabinet has approved for public consultation a National Energy Bill, which includes provisions for multi-sector regulation for all energy sub-sectors (electricity, gas,	The Recipient's Cabinet has approved the National Energy Bill for submission to Parliament	**Outcome: Effective oversight of regulated sectors** Indicator: Monitoring reports for regulated sectors published on at least an annual basis Baseline (2015): No baseline report

[17] 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.
[18] 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.

Completed actions, prior actions and triggers			Results
Actions completed under DPO 1	**Prior actions DPO 2**	**Triggers for DPO 3**	
	petroleum)		Target (2018): Reporting issued by regulators that covers all sectors under their oversight
Pillar III – Supporting a more dynamic and inclusive economy			
		Employment Relations Bill that, among others, reduces gender disparities approved by Cabinet for submission to Parliament	**Outcome: Key labor market protections are in place** Indicator: Number of basic labor rights enshrined in domestic legislation[19] Baseline (2015): None of eight in place Target (2018): At least six of eight in place
	The Recipient's Cabinet has approved the Foreign Investment Bill for submission to the Recipient's parliament, which includes provisions to facilitate foreign investment in the Recipient's territory	Cabinet approval of revised foreign investment regulations, including reserved and restricted lists, and work permit rules	**Outcome: Increase in interest from foreign investors** Indicator: Vetted applications from foreign investors Baseline (FY15): 21 applications Target (FY19): 30 applications or greater
		The Recipient's Central Bank has issued a directive to mandate credit bureau reporting in order to reduce costs of due diligence and support access to finance for SMEs and individuals	**Outcome: Increased utilization of credit bureau for credit checking** 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 (FY19): 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	The Recipient's Cabinet has directed the Ministry of Public Enterprises to proceed with a sale of shares in Tonga Cable Ltd	Cabinet has approved the reform of an additional PE 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	**Outcome: Public enterprises reformed to introduce private sector participation** Indicator: Number of private enterprises that have been reformed Baseline (FY2015): None Target (FY19): At least two

[19] 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

ANNEX 2: LETTER OF DEVELOPMENT POLICY

OFFICE OF THE MINISTER FOR
FINANCE & NATIONAL PLANNING

MINISTRY OF FINANCE &
NATIONAL PLANNING
NUKU'ALOFA
TONGA

Reference: MF.178/29/40

2nd March 2017

President Jim Kim
World Bank Group
The World Bank
1818 H Street NW
Washington DC 20433
USA

President Takehiko Nakao
Asian Development Bank
6 ADB Avenue
Mandaluyong City
1550 Metro Manila
PHILIPPINES

Dear President Kim and President Nakao,

Re: Tonga Letter of Development Policy

The Kingdom of Tonga is one of the first nations in the world to see in the new dawn each day, and we are similarly committed to being on the forefront of good governance, despite the challenging external environment we are faced with. Tonga, along with many of its Pacific neighbors is increasingly rocked by natural disasters of an unprecedented scale and regularity, and major risks to our land and way of life through seawater incursion and other dangerous effects of climate change. Tonga is also a place of economic dichotomy. We are one of the most distant places on earth from other centres of economic activity, yet strive to be part of global economic community and maintain open borders for trade and goods. As a result, despite its distance, Tonga is one of the most trade-intensive countries in the world.

In place since December 2014, this 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, under the political reforms, 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. Reforms implemented to date have strengthened our public financial management systems, increased tax collections and improved public enterprise performance. Through the reforms, our debt position has stabilized, the allocation of public resources is more strategic and their use more efficient. Efforts to establish a more business-friendly environment have already led to tremendous improvements in the ease of doing business and further improvements to the investment climate are underway. Successive governments have been persistent in reform implementation, which led to substantial achievements despite volatile policy-making and administrative capacity in our small country.

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

While on this path, we are prepared to encounter and overcome numerous challenges and setbacks. A combination of external factors that include exposure to natural disasters and economic shocks, our extreme remoteness from major markets, limited natural resources, a small population, and wide dispersion of population and land present a constant weight on our shoulders. While we have been able to cope with frequent external shocks in the past, these nonetheless leave us with a growth path well below what we could have achieved otherwise. In addition, they divert attention, capacity and financial resources away from our reform path, thereby requiring even greater efforts to maintain a stable and consistent policy framework to achieve the desired 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.

This government cherishes, and is building even further on, our close relationship with our development partners. Since 2011 the Government and major development partners have been working together through the Budget Support Management Committee and its Joint Policy Reform Matrix (JPRM) process to develop, implement and monitor reforms for us to advance on our development path. This year marks the continuation of a reinvigorated reform program that was embarked on last year. The current fiscal year's budget support operations continue our close partnership between the Government of Tonga and 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 to achieve our goals.

Aligned to the priority agenda of Government, the JPRM aims at building macroeconomic resilience to support inclusive growth and improved living standards. We plan to achieve this through building a strong fundamental fiscal position; further developing good governance and civil service performance; and engendering a dynamic, inclusive and sustainable economy.

In the first year of this program we introduced tax reforms to raise collections and provide incentives to consume healthy foods by raising the price of some unhealthy foods while cutting duty rates on healthy alternatives. The major new public service remuneration framework was approved, and a new medium-term debt management strategy put in place. New procurement regulations were introduced as were new institutions and processes to manage and ensure appropriate government follow-up of audit recommendations. To support a more dynamic and inclusive economy, a new ICT regulator was established in law, and governance of public enterprises was overhauled by introducing new and more professional "shared boards" of public enterprises.

This year we have improved the strength of the government books further, providing an ideal launching pad for more responsive and better performing public services. Revenue collections have been strengthened further by putting back in place duties on fuel that were

P.O. Box 87, Vuna Rd, Nuku'alofa Telephone: (676) 23066 Fax: (676) 26011 Email: minister@finance.gov.to

removed during peak oil prices in previous years, while also adding duties on foods that have harmful health impacts in Tonga, to encourage healthy life choices. The FY2018 budget now includes a clear and evidence-based vision for the public finances, which will help guide the economy along a sustainable path, despite the very large shocks that we are regularly beholden to. This strategy encapsulates much work already done by this government, including maintaining the revenue collections that we have built up, firmly keeping external debt to a manageable level and ensuring a sustainable wagebill, so that enough resources go to critical spending for public services and infrastructure. The final element of our fiscal reform program this year is the implementation of a new public sector remuneration framework, which ensures a fair and attractive return for skills and expertise and provides strong incentives for our civil service to perform at their full potential and continue to grow and develop professionally.

A quiet transformation of our public financial management and private sector regulatory frameworks is already well underway; and this program sees through major reforms that will ensure efficient public service resourcing and competitive markets. Following three years of building capacity and structures, this year the government launched a new procurement database which enables the fast processing of large procurement contracts, and monitoring to ensure that all due process is followed and that key performance indicators track the service standards of the public procurement system. As a culmination of a series of procurement reforms, we expect this to provide the basis of continued improvement in the speed of processing, competitiveness and compliance of procurements. Secondly, the Cabinet has approved a draft new Energy Bill which will create a regulatory framework for the whole sector. This Bill will now be carefully consulted to ensure it meets the people's needs, before progressing to the National Parliament in due course. Tonga has seen great advances in the electricity sector over the past decade, including through the establishment of an independent electricity regulator. We are now extending this model in a cost-effective way to mandate an independent regulator for all energy sub-sectors to provide a similar level of effective regulation in the sectors of critical importance to both business and households in Tonga.

Finally, the private sector can be a driver of growth, even though we face an uphill struggle to deliver an effective economic strategy in a region where costs are high and markets small. Government efforts supported under the JPRM framework previously have helped reinvigorate the tourism sector by rebuilding and bringing under international management the largest hotel in Tonga, the Tanoa International Dateline Hotel. If you have not yet had the opportunity to visit, I warmly extend an invitation for you to come and stay here. We want to bring in more international investors like this, and to do so we have approved a new Foreign Investment (Amendment) Bill to go to Parliament which will make it far easier for investors to come here, and open up more areas of the economy to competition. Finally, our ongoing public enterprise reform program, which as a result has led to Tonga having the best-performing public enterprise portfolio in the Pacific region, is continuing. This year, we have carried out two substantial transactions – the first is a long-term concession over commercial forestry assets, which will bring in investment in new plantings, improve environmental management while ensuring adequate safeguards, and create sustainable jobs and livelihoods over the long-term. Secondly, the Government has agreed for a transaction to sell a minority share of Tonga Cable Limited to a private telecommunications operator, Digicel, which means the company is now jointly owned by Government, and the two main telecommunications operators – Digicel and Tonga Communications Corporation – putting them on a level playing field and bringing new capital to TCL for future investments in high-speed and affordable internet connectivity throughout the country.

P.O. Box 87, Vuna Rd, Nuku'alofa **Telephone: (676) 23066** **Fax: (676) 26011** **Email: minister@finance.gov.to**

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 the scale of the master plan which resulted in a 25 percent cost reduction of the games. We have now secured the majority of Pacific Games funding from grants from partners and are confident the full cost will be met in a prudent manner.

On the fiscal side, expected outcomes of these reforms over the three-year period are an increase in domestic revenue mobilization as a proportion of gross domestic product, a reduction in the 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.

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

Yours sincerely,

MINISTER FOR FINANCE & NATIONAL PLANNING * TONGA *

Dr. the Hon. 'Aisake Valu Eke
Minister for Finance and National Planning

P.O. Box 87, Vuna Rd, Nuku'alofa Telephone: (676) 23066 Fax: (676) 26011 Email: minister@finance.gov.to

ANNEX 3: FUND RELATIONS ANNEX

DOCUMENT OF INTERNATIONAL MONETARY FUND AND FOR OFFICIAL USE ONLY

FOR INFORMATION

FO/DIS/17/33

March 10, 2017

To:	Members of the Executive Board
From:	The Secretary
Subject:	**Tonga—Assessment Letter for the World Bank**

Board Action:	Executive Directors' **information**
Publication:	Not yet decided*
Questions:	Ms. Loukoianova, APD (ext. 39694)

***If the authorities consent to the publication of this assessment, it may be published by the World Bank.**

Tonga—Assessment Letter for the World Bank
March 10, 2017

1. **Economic activity has evolved largely as expected in the last Article IV consultation.** Growth is projected at 2.3 percent in fiscal year 2016/17 and is expected to moderately accelerate in the coming years to 2.5 percent owing to intensified construction works in preparation for the 2019 South Pacific Games (SPG). Inflation increased significantly in 2016/17, reaching 6.6 percent in November 2016, due to the combined effect of a newly introduced import tax and higher oil prices. However, the increase in inflation is expected to be temporary, with headline inflation returning to approximately 2 percent in FY2017/18.

2. **The overall balance of risks remains tilted to the downside.** The risk of weaker global growth as well as retreat from cross-border integration may weigh on Tonga's ability to finance fiscal expenditure and external position, via reduced grants, remittances, and tourism. Domestic risks include unforeseen increases in fiscal expenditure, especially on public sector wages and the SPG. Tonga is vulnerable to natural disasters (cyclones in particular).

3. **The fiscal position weakened in FY2015/16 (based on preliminary data), and risks to debt sustainability increased.** The overall balance declined to a deficit of 2.1 percent of GDP in 2015/16, from a deficit of 0.6 percent in the previous year. The debt sustainability analysis (DSA) conducted in 2016, where risk of external debt distress was rated "moderate", is still current. A specific risk to debt sustainability stems from a potential shortfall in donor grants financing of the SPG. The policy priorities ahead should focus on building buffers, implementing structural reforms, and addressing fiscal risks.

4. **The current monetary stance is appropriate.** The National Reserve Bank of Tonga's (NRBT) supportive monetary policy stance underpinned credit growth from a low base. However, with credit growth accelerating from 13 percent y-o-y in November 2015 to 21 percent in November 2016, the authorities should remain vigilant. Consistent with staff advice during the 2016 Article IV consultation, the authorities have lowered the reference rate of inflation, from a range of 6–8 percent to 5 percent.

5. **The balance sheet of the banking sector continued to improve during FY2016/17.** The banking sector in Tonga remains profitable and stable. The non-performing loan (NPLs) ratio has declined substantially over the last year, from 8 percent in September 2015 to 4.7 percent in September 2016, mainly due to the write-off of one major non-performing business loan, a decline in NPLs in several sectors, as well as strong credit growth in 2016.

6. **The external position remains stable.** International reserves remain adequate and stood at US$157 million in November 2016 (equivalent to 6 months of imports). The real effective exchange rate appreciated by 1.7 percent in the year up to November 2016. The current account deficit is projected to moderately increase in the current fiscal year and further until FY2018/19, reflecting SPG related spending and imports.

7. **IMF's relations.** Tonga is a surveillance country. The last Article IV consultation mission took place during February 29-March 11, 2016, and the consultation was concluded by the Board on June 13, 2016.

ANNEX 4: ENVIRONMENT AND POVERTY/SOCIAL ANALYSIS TABLE

Prior actions	Significant positive or negative environment effects (yes/no/to be determined)	Significant poverty, social or distributional effects positive or negative (yes/no/to be determined)
Operation Pillar 1: Supporting fiscal resilience		
The Recipient has increased the rate of fuel excise tax by TOP 0.09 per liter (an increase in the rate of 16%) 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	No	Yes
The Recipient's Cabinet has approved a transparent, target-based fiscal anchor system and monitoring framework that supports medium-term fiscal sustainability and a more efficient mix of public spending	No	No
The Recipient's Cabinet has approved and begun to implement a new public service remuneration structure and performance management system to ensure effective public service delivery, adequate pay, and consistency with fiscal sustainability	No	No
Operation Pillar 2: Democratic and government accountability		
The Recipient has implemented a new procurement tracking database and adopted compliance and performance indicators and associated targets	No	No
The Recipient's Cabinet has approved for public consultation a National Energy Bill, which includes provisions for multi-sector regulation for all energy sub-sectors (electricity, gas, petroleum)	No	Yes
Operation Pillar 2: Supporting a more dynamic and inclusive economy		
The Recipient's Cabinet has approved the Foreign Investment Bill for submission to the Recipient's parliament, which includes provisions to facilitate foreign investment in the Recipient's territory	No	Yes
The Recipient's Cabinet has directed the Ministry of Public Enterprises to proceed with a sale of shares in Tonga Cable Ltd	No	No