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INTERNATIONAL DEVELOPMENT ASSOCIATION

PROGRAM DOCUMENT

FOR A PROPOSED DEVELOPMENT POLICY GRANT

IN THE AMOUNT OF SDR 1.7 MILLION (EQUIVALENT TO US$ 2.5 MILLION)

AND A PROPOSED DEVELOPMENT POLICY CREDIT

IN THE AMOUNT OF SDR 1.7 MILLION (EQUIVALENT TO US$ 2.5 MILLION)

TO THE

KINGDOM OF TONGA

FOR THE

SECOND ECONOMIC REFORM SUPPORT DEVELOPMENT POLICY OPERATION

September 30, 2014

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

Kingdom of Tonga

GOVERNMENT FISCAL YEAR
July 1 – June 30

CURRENCY EQUIVALENTS
(Exchange Rate Effective as
of September 25, 2014)

Currency Unit	Tongan Pa'anga
US$1.00	TOP$ 1.94

ABBREVIATIONS AND ACRONYMS

ADB	Asian Development Bank
AFS	Annual Financial Statement
BSMC	Budget Support Management Committee
CEO	Chief Executive Officer
CAS	Country Assistance Strategy
CPIA	Country Policy and Institutional Assessment
CPU	Central Procurement Unit
DFAT	Department of Foreign Affairs and Trade
DPO	Development Policy Operation
DPT	Diphtheria, Pertussis & Tetanus
DSA	Debt Sustainability Analysis
EU	European Union
FDI	Foreign Direct Investment
FEMM	Forum Economic Ministers Meeting
FY	Fiscal Year
GDP	Gross Domestic Product
GEC	Global Economic Crisis
GoT	Government of Tonga
HIES	Household Income and Expenditure Survey
IDA	International Development Association
IFC	International Finance Corporation
IMF	International Monetary Fund
JPRM	Joint Policy Reform Matrix
MFNP	Ministry of Finance and National Planning
NCDs	Non-Communicable Diseases
NGO	Non-Governmental Organization
NPL	Non-Performing Loan
NRBT	National Reserve Bank of Tonga
PED	Price Elasticity of Demand
PEFA	Public Expenditure and Financial Accountability
PFM	Public Financial Management
PFTAC	Pacific Financial Technical Assistance Centre
PIAC	Pacific Infrastructure Advisory Centre
PIC	Pacific Island Country
PPG	Public and Publically-Guaranteed
PPP	Purchasing Power Parity
RPC	Revenue Policy Committee
SMEs	Small and Medium Enterprises
TERM-IU	Tonga Energy Roadmap Implementation Unit
TPL	Tonga Power Limited
TSDF	Tonga Strategic Development Framework
WBG	World Bank Group
WHO	World Health Organization

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KINGDOM OF TONGA

SECOND ECONOMIC REFORM SUPPORT DEVELOPMENT POLICY OPERATION

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SUMMARY OF PROPOSED CREDIT/GRANT AND PROGRAM
Kingdom of Tonga
Second Economic Reform Support Development Policy Operation

Borrower	Kingdom of Tonga
Implementation Agency	Ministry of Finance and National Planning
Financing Data	SDR 1.7 million (US$2.5 million equivalent) IDA Grant and SDR 1.7 million (US$2.5 million equivalent) IDA Credit Standard IDA Grant and 40 years maturity including a grace period of 10 years for IDA Credit terms
Operation Type	The proposed operation is the second in a series of two programmatic development policy operations and will be provided in a single tranche. In addition to IDA financing, DFAT is expected to provide AU$5 million (US$ 4.4 million) in budget support for the same set of policy actions
Pillars of the Operation And Program Development Objective(s)	The Program Development Objective is to: i) Strengthen public financial management by improving the quality of public procurement processes and the credibility of the annual budget; ii) strengthen fiscal policy with new procedures for granting tax exemptions and by reflecting health externalities in excise duty rates; and iii) enhance the business enabling environment by establishing a new policy to support foreign investment, and introducing targeted reductions in the cost of electricity
Result Indicators	Under the development objective (i): 1) Reduction in proportion of public contracts awarded by methods other than open competition that are justified in accordance with legal requirements 2) Reduction in number of budgetary sub-programs overspent or underspent by more than 20 percent Under the development objective (ii): 3) Increase in domestic revenue as a proportion of GDP 4) Reduction in the amount of ad-hoc tax exemptions issued 5) Increase in the retail price of tobacco and soft drinks Under the development objective (iii): 6) Reduction in average cost of electricity for consumers at or below 50kWh consumption per month relative to those consuming greater than 100kWh a month 7) Improvement in distance to frontier score for resolving insolvency in the Doing Business Survey
Overall risk rating	Substantial
Operation ID	P149963

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

1. INTRODUCTION AND COUNTRY CONTEXT

1. **The proposed operation is the second and final in the Tonga Economic Reform Support Development Policy Program.** The proposed operation will support reforms in public financial management, fiscal policy, and the business environment. The operation will consist of a US$ 2.5 million equivalent credit and US$ 2.5 million equivalent grant. Australia, through its Department of Foreign Affairs and Trade (DFAT) is expected to provide associated sector budget support of AU$5.0 million (US$4.4 million) for the same policy actions supported by this operation.

2. **Tonga is a small, isolated economy that is highly vulnerable to external economic shocks and natural disasters.** Tonga's population of 106,000 is dispersed across 36 of the 176 islands that make up the archipelago. Located in the South Pacific, Tonga is one of the most remote countries in the world, when measured by indicators of proximity to major markets. 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. These same factors also push up the cost of providing public services. In addition, the lack of diversification of its sources of foreign exchange make Tonga highly vulnerable to external economic shocks, while its geographical characteristics make it highly vulnerable to natural disasters. Recent analytical work carried out by the World Bank estimates that the direct cost of natural disasters averages 4 percent of Gross Domestic Product (GDP) per annum in Tonga.

3. **Despite recent reform progress, Tonga has faced a slow and difficult recovery from the global economic crisis and has been struck this year by a devastating cyclone.** Since 2009, remittances have declined as many Tongan expatriates working in the United States, Australia, and New Zealand, often occupying marginal and temporary positions, were hard hit by the economic slowdown. Tourist air arrivals declined by 30 percent over the same period. While both have begun recovering, progress has been slow. Growth is also hampered by regular cyclones and flooding, with Cyclone Ian, a category 5 cyclone, devastating much of the Ha'apai island group in January 2014. Damages and losses from this event are estimated at US$ 49.5 million, around 11 percent of GDP. While public works and development partner-funded projects have provided a short-term stimulus, underlying economic growth remains weak and adversely affected by natural disasters.

4. **Food insecurity and inequality are low but material hardship remains a pressing problem.** While Purchasing Power Parity (PPP)-adjusted poverty lines are not yet available for Tonga, the food poverty line and the basic needs poverty line would likely be somewhat higher than $2 and $4 respectively. Data from the 2009 Household Income and Expenditure Survey (HIES) shows 22.5 percent of the Tongan population experience material deprivation, while food poverty is around 3 per cent (see Table 1), which indicates that World Bank's first goal of eradicating extreme poverty is likely to be already met in Tonga. The analysis shows poverty prevalence is similar across districts. While there is not yet sufficient data to assess Tonga's

recent performance in boosting shared prosperity, average consumption of the top 60 percent of households is estimated to be three times larger than the bottom 40 percent based on the 2009 HIES data. This is significantly better than the cross-country median of 4.7 based on the Global Income Dynamics Dataset. Inequality has been relatively stable, with the Gini index increasing only slightly from 0.23 in 2001 to 0.24 in 2009. Nevertheless, although reliable data for more recent years is not available for most income and non-income measures, there are indications that material hardship remains a pressing problem for some. The 2011 Census revealed that since 2006, 1,950 people had left the subsistence agriculture sector, yet only 260 formal jobs had been created nationwide. The World Bank is engaged in a coordinated dialogue with Government and other partners to support a new poverty assessment, possibly under the auspices of a proposed Pacific regional poverty programme.

Table 1: Population with Expenditure Below Food and Basic Needs Poverty Line

	Food poverty		Basic needs poverty	
Percentage	2001	2009	2001	2009
National average	2.8	3.1	16.2	22.5
Nuku'alofa	2.1	2.6	18	21.4
Rest of Tongatapu	5.1	4.1	18.8	23.5
Other Islands	0.9	1.7	11.8	22.9

Source: Tonga Department of Statistics

5. **Social and human development indicators are amongst the strongest in the Pacific, but challenges remain and there are important gender disparities that adversely affect development outcomes for women.** Primary and secondary school enrollments are high at 95.6 percent and 91 percent, respectively. Quality of education remains a challenge though, with children scoring poorly on early-grade reading assessments. Under-five mortality, at 13 per 1000, continues to decline, while 98 percent of births are attended by skilled health staff. However, the growing crisis of non-communicable diseases threatens to reverse improvements, with some evidence suggesting that life expectancy in Tonga is now falling as a result of NCDs. Levels of material deprivation are higher for female-headed households in all regions of Tonga. While women keep up and even outperform men in education participation, they are under-represented in senior civil service positions and only one Member of Parliament is female. There is no legislation prohibiting domestic violence or sexual discrimination, and women are unable to own land in Tonga. Women have a higher non-communicable disease burden, are 20 percent more likely to be obese than men and are almost 10 percent more likely to die prematurely.

6. **This DPO series supports a strong Government-led reform program that builds on previous engagement.** The Bank has worked with the Government of Tonga (GoT) and development partners in coordinating the formulation of a Joint Policy Reform Matrix (JPRM) that outlines shared reform priorities, and is fully aligned with the Government's national development plan – the Tonga Strategic Development Framework (TSDF). The proposed operation builds on three previous operations in two programmatic series which have supported reforms in public financial management, fiscal policy, and enhancing the business environment.

7. **The Development Objective is to: i) strengthen public financial management by improving the quality of public procurement processes and the credibility of the annual budget; ii) strengthen fiscal policy with new procedures for granting tax exemptions and reflecting health externalities in excise duty rates; and iii) enhance the business enabling environment by establishing a new policy to support foreign investment and introducing**

targeted reductions in the cost of electricity. Support to reforms in public finance and fiscal policy will improve the mobilization and targeting of public resources to support public service delivery goals. Business environment reforms will address constraints to private sector development and foreign investment, while supporting targeted reductions in the cost of basic services. Under public financial management, the operation will support reforms in Government procurement processes and budget credibility by reforming existing budget processes. Under fiscal policy, the operation will support revisions to Government tax exemption procedures that will increase the scrutiny and reduce the scope for ad-hoc tax exemptions, and put in place an excise duty regime that helps address growing Non-Communicable Disease (NCDs) burdens.

8. **Supported reforms will deliver direct improvements in living standards and better prospects of growth and job creation.** The measures supported are intended to improve living standards in the short and longer-term. Supported measures are not, on their own, expected to lead to any step-change in growth performance, but will better position the country to take advantage of business opportunities as they arise. Supported reforms will help reduce poverty and boost shared prosperity. Maintenance of public services is vital to the living standards of the poor. The introduction of a lifeline electricity tariff will deliver direct gains in disposable income to those households most in need. Excise duties to promote healthy products will help to improve diet and reduce the incidence of debilitating chronic disease over time. Business enabling reforms are targeted to support labor-intensive sectors which will help create jobs for all. Gains in revenue mobilization and effective allocation will benefit all via better delivery of core public services.

9. **The proposed operation carries substantial risk due to thin capacity in the public sector, vulnerability to external economic shocks and natural disasters, and the possibility of setbacks related to the political cycle.** The proposed operation faces three 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. Severe capacity constraints in particular areas may mean that program implementation can be directly affected by the performance or departure of a few officials. Secondly, macroeconomic stability is dependent on successful fiscal consolidation, and stable external financial flows including remittances and development assistance from donors. Macroeconomic disruption arising under several feasible shock scenarios, including natural disasters and any substantial scaling back of external assistance, would distract available capacity and resources from implementation of actions supported by the program, as well as undermine the impact of these actions on growth and poverty-reduction. Finally, elections will be held in November 2014. While Government has remained stable over the length of the current term, Tonga's political system has been recently reformed and political dynamics within the new system are still evolving. Broader political changes remain a possibility in the current challenging economic environment, and represent a source of substantial uncertainty, given limited experience under new political institutions. The WBG, coordinated with other development partners, intends to continue its close economic and fiscal dialogue in support of reform as a main means of mitigating some of these risks around limited capacity and political volatility. The WBG is also engaged at a policy and operational level to support Tonga to manage disaster risks.

2. MACROECONOMIC POLICY FRAMEWORK

2.1 RECENT ECONOMIC DEVELOPMENTS

10. **Tonga's average per capita GDP growth of 1.5 percent per year over the past 20 years is higher than that of comparable non-natural resource dependent Pacific island countries (PICs).** In common with most other Pacific Island Countries, Tonga's growth experience is manifestly affected by geographical disadvantages and a high degree of economic and climatic vulnerability. Despite these challenges, Tonga has performed well over the medium term, with average per capita GDP growth (constant US$ at market exchange rates) of 1.5 percent a year significantly higher than the PIC average of 1.0 percent per year (excluding Papua New Guinea and Timor-Leste). Recent analysis indicates that economic remoteness, internal dispersion and small size combine to sharply curtail the set of viable economic strategies and the potential to follow growth routes adopted by larger East Asian countries. Natural disasters and exposure to imported economic volatility further increase the cost and riskiness of doing business in Tonga. Major natural disasters such as the one that has recently struck Ha'apai are unfortunately all-too-common occurrences, while Tonga's high levels of openness to trade and income flows has meant it has been hard hit by the global economic crisis (GEC) and ongoing commodity price volatility.

11. **Recently economic growth has slowed as major public works have drawn down and external demand has weakened.** Over the last five years, Government has invested in large projects to support the reconstruction of buildings and new roads, following the destruction of the Nuku'alofa riots in FY2007. The economy grew by 3.2 percent in FY2009 and 3.3 percent in FY2010. The construction sector directly accounted for 73 percent and 57 percent of this growth in each year, respectively. Growth in FY2011 remained above average, with construction, manufacturing and services all registering solid gains. However, as major public works have drawn to completion, the stimulus has been drawn back, and coupled with a weakening of external demand arising from the GEC, has led to lower growth. Annual growth in FY2012 and FY2013 has dropped to less than 1 percent as growth in construction reversed.

12. **In the medium to long term, growth will likely depend on further developing tourism and fisheries and also overseas remittances.** Growth opportunities are concentrated in areas where economic rents can be generated – as from natural resource based activities such as tourism and fisheries – or in employment opportunities overseas. Tonga's tourism sector has considerable potential, but has lost out to other destinations as air arrivals have declined by around 30 percent since 2007, although this has been partially offset by a more than doubling of cruise tourists. Hit by lower demand in destination countries over the GEC, particularly the USA, expanding access to international labor markets will be key to maintaining remittances as a source of higher domestic incomes and standards of living. Development of fisheries resources represents an additional area of opportunity. Improving the efficiency of the public enterprises that provide infrastructure services could also benefit households and businesses, as could further efforts to reprioritize government expenditure towards higher priority areas such as agriculture and infrastructure.

13. **Inflation has moderated down.** From a peak of 7.1 percent over FY2011, inflation has fallen to a low of 0.2 percent over FY2013 as commodity prices have moderated down and demand remains weak. This has allowed the National Reserve Bank of Tonga to maintain its

current accommodative monetary stance without fear of resurgent inflationary pressures.

Table 2: Key Macroeconomic Indicators

	FY2010	FY2011	FY2012	FY2013	FY2014	FY2015	FY2016
Real Economy	Annual percentage change, unless otherwise indicated						
GDP (nominal Pa'anga m)	712.2	775.0	799.3	810.7	830.4	873.2	920.4
Real GDP	3.3	2.9	0.7	0.3	1.4	3.4	2.5
Per Capita GDP (in current US$)	3,547	4,044	4,495	4,433	4,557	4,776	5,018
Imports	11.7	37.1	36.2	3.0	4.0	9.0	9.0
Exports	-0.1	17.0	17.5	-22.0	10.1	12.1	7.0
GDP deflator	3.7	5.8	2.4	0.7	1.5	1.7	2.8
CPI (eop)	2.7	7.1	2.3	0.2	1.3	2.2	3.4
Fiscal Accounts	Percent of GDP, unless otherwise indicated						
Expenditures	32.3	33.7	30.2	25.1	30.0	29.7	26.9
Revenues	27.0	26.3	27.4	24.1	29.5	29.0	26.0
General Government Balance	-5.3	-7.4	-2.8	-1.0	-0.6	-0.7	-0.9
External PPG debt (percent of GDP, e.o.p.)	31.8	36.0	41.9	41.4	40.8	39.9	38.4
Selected Monetary Accounts	Annual percentage change, unless otherwise indicated						
Base Money	5.6	3.3	-1.8	8.2	8.0		
Credit to Private Sector	-15.6	-9.9	-2.7	-9.8	1.0		
Balance of Payments	Percent of GDP, unless otherwise indicated						
Current Account Balance	-4.9	-2.7	-6.6	-5.5	-3.3	-3.0	-6.0
Imports	35.3	36.1	38.0	30.0	31.9	34.1	32.9
Exports	2.1	2.6	3.1	3.3	3.3	3.4	3.3
Foreign Direct Investment	2.1	1.5	1.1	3.4	2.4	2.4	
Gross Reserves (in US$ m, e.o.p.)	87.5	120.8	140.6	152.8	168.3		
In months of next years imports	5.0	5.7	7.8	7.8	7.8		
As % of short-term external debt	74.5	79.4	71.1	79.0	85.7		
External Debt	31.8	36.0	41.9	41.4	40.8	39.9	38.4
Terms of Trade (annual percentage change)	5.2	-3.6	0.8	-1.6	0.3	0.9	
Exchange Rate (Average)	1.9	1.8	1.7	1.7	1.7		
Other memo items							
GDP (nominal US$ m)	369.2	423.0	471.6	466.8	482.2	505.8	561.5
Remittances (percent of GDP)	22.2	20.7	14.2	14.8			
Tourism receipts (percent of GDP)	7.0	7.9	7.7	8.7			

Source: IMF staff estimates

14. **The Government has strengthened fiscal management and implemented important business environment reforms, but economic performance remains weak.** Over recent years, Tonga has implemented major public finance reforms aimed at reining in the deficit and increasing the proportion of the budget allocated to basic social services, while strengthening the business regulatory environment and corporatizing several Public Enterprises (PEs). Reflecting these reforms, Tonga's Country Policy and Institutional Assessment (CPIA) rating has increased from 2.9 to 3.5 over the last five years. While recent years have seen some new private sector initiatives emerge that have supported modest increases in growth, mostly serving the import-

substitution and tourism markets, opportunities remain limited and incremental change resulting from progressive reform over time is more likely than a 'big bang' effect.

15. **Recovery has been further hampered by a prolonged and ongoing contraction in private sector credit.** Tonga's banking system, dominated by the local subsidiaries of two large foreign banks, has gone through a prolonged period of balance sheet adjustment since the third quarter of 2008. Over 2004 to 2008, a bubble developed in the housing market and the stock of private credit doubled to 54 percent of GDP. The boom came to an abrupt end in late 2008 due to sharply deteriorating debt servicing capacities and moderating asset prices in the wake of the global crisis. Non-performing loans (NPLs) peaked at 20 percent in 2009, and private sector credit declined precipitously, falling by 36 percent since 2008, including by 10 percent in FY2012. The National Reserve Bank of Tonga (NRBT) has attempted to stem the decline in credit through aggressive injections of liquidity. Despite looser monetary policy, banks have continued to shrink their loan books and accumulate excess reserves leading to a liquidity overhang. Banks' unwillingness to engage in new lending reflects efforts to deleverage and repair balance sheets, with NPLs remaining at uncomfortable levels, in the context of newly restrictive lending conditions set by overseas headquarters, limited competition in the banking sector, and a limited number of viable projects given difficult and uncertain external conditions.

16. **The current account balance narrowed slightly and remains adequately financed by FDI and capital inflows.** While current account deficits are persistent, the latest International Monetary Fund (IMF) assessment concludes that there are no imminent risks to external balance. The current account deficit narrowed to 5.5 percent of GDP in FY2013 from 6.6 percent in FY2012 as the temporary influx of imported inputs for public construction projects has wound down. The current account deficit is adequately financed by capital inflows, and inflows of development assistance have facilitated the continued build-up of foreign reserves – up to 7.8 months of import cover by end FY2013. According to the IMF, the currency remains broadly in line with fundamentals.

17. **The Government has brought down fiscal deficits and set the public finances on a sustainable footing although external shocks continue to present risks.** The overall deficit has fallen from over 7 percent of GDP in FY2011 to 1 percent of GDP in FY2013. Much of the variability has been driven by concessionally-financed capital expenditure in response to shocks. In light of Tonga's small size and limited domestic economy, domestic financing of a sufficiently high level of public services remains a serious challenge. Development grants, which financed 36 percent of total expenditure in FY2014 have been critical in financing improvements in public services and infrastructure. After a sharp fall over the 5 years to FY2012 from a peak of almost 25 percent of GDP to 18 percent, domestic revenue has begun to rebound, to 18.6 percent in FY2013. Over the same period, current expenditure was tightly constrained, falling from an average of 25.3 percent of GDP over the five years to FY2010 to an average of 23.2 percent of GDP over FY2011 to FY2013. The wage bill blew out to 15.3 percent of GDP in FY2005/06 after a large pay rise in the wake of public service pressure that also contributed to the Nuku'alofa riots. In the years since, supported by Development Policy Operations (DPO) actions, steady progress has been made to bring this under control, with payroll standing at 11.3 percent of GDP in FY2013.

2.2 MACROECONOMIC OUTLOOK AND DEBT SUSTAINABILITY

18. **Losses from Tropical Cyclone Ian and subsequent reconstruction activity will drive the economic outlook in the near term, while underlying growth is expected to improve moderately.** While economic losses due to the cyclone will bring down growth in FY2014, increased reconstruction activity will partially offset those losses. The fiscal cost of the recovery program is around TOP 70 million, which has been largely financed by donor contributions including US$12 million from the World Bank's Crisis Response Window, support from ADB, New Zealand, the EU and Australia. Overall, growth is projected to be 1.4 percent in FY2014, 0.7 percent lower than it would otherwise have been if the cyclone had not struck. Growth in FY2015 is expected to rebound to 3.4 percent and remain at a higher level of 2.5 percent in FY2016. Key external flows of remittances and tourism are both expected to recover gradually, subject to domestic conditions in partner countries.

Table 3: Key Fiscal Indicators

	FY2010	FY2011	FY2012	FY2013	FY2014	FY2015
	In percent of GDP, unless otherwise indicated					
Overall Balance	-5.3	-7.4	-2.8	-1.0	-0.6	-0.7
Primary Balance	-4.6	-6.6	-2.0	-0.1	0.3	0.2
Total Revenues and Grants	27.0	26.3	27.4	24.1	29.5	29.0
Domestic revenues	20.2	19.2	18.0	18.6	18.7	18.9
of which Sales and Conumption Taxes	10.2	10.6	11.0	10.7	11.0	10.9
of which Taxes on Income and Profits	3.9	4.9	3.2	3.6	3.2	3.6
of which Non-tax Revenue	3.8	2.1	2.2	2.4	2.7	2.5
Grants	6.8	6.8	9.4	5.4	10.7	10.0
Total Expenditures	32.3	33.7	30.2	25.1	30.0	29.7
Current Expenditure	25.8	22.6	23.5	23.5	27.2	24.7
Wages and Compensation	11.6	11.8	10.5	11.3	11.4	11.1
Goods and Services	9.7	6.6	8.3	8.5	8.7	9.0
Interest Payments	0.8	0.8	0.8	0.9	0.9	0.9
Current Transfers	2.7	2.2	3.0	2.0	2.6	2.6
Capital expenditures	2.6	9.6	5.6	1.6	2.8	5.0
General Government Financing	5.3	7.4	2.8	1.0	0.6	0.7
External (net)	3.5	8.4	5.2	0.2	0.6	0.9
Domestic (net)	1.9	-1.1	-2.4	0.8	0.0	-0.2

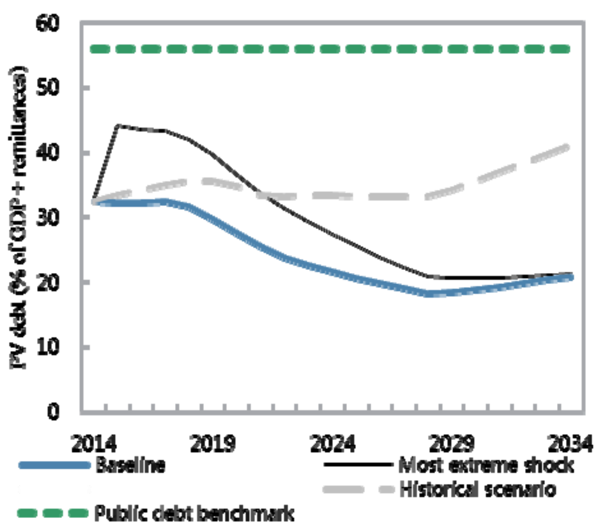
Source: IMF staff estimates

19. **Inflation is expected to moderate upwards while the current account deficit will worsen as the Cyclone Ian reconstruction and preparations for the South Pacific Games proceed.** Inflation is expected to rise to 2 - 3 percent in line with historical trends, as private sector credit returns to positive growth following the bottoming out of the credit cycle. The NRBT is expected to gradually tighten its policy stance to manage inflationary pressures. The current account deficit is forecast to lessen from 5.5 percent of GDP in FY2013 to 3.0 percent of GDP in FY2015 before large amounts of construction-related imports elevate it in FY2016 and FY2017. Foreign reserves are expected to remain ample, at more than 6 months of import cover

over the forecast window.

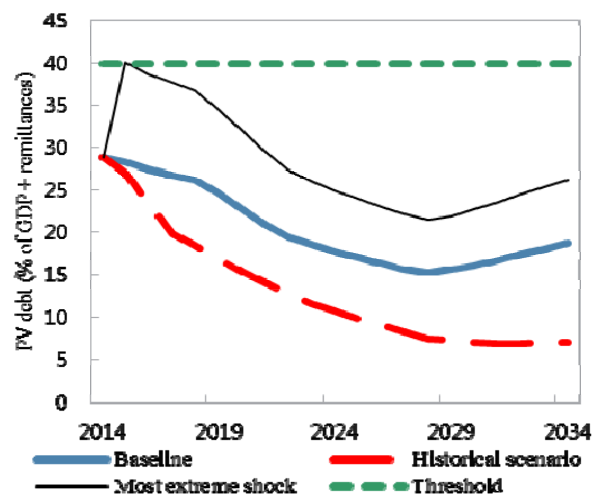
20. **Continued vigilance and prudent fiscal policy will be needed to maintain a healthy fiscal position into the medium-term.** Tonga faces important fiscal challenges over the coming years. The commencement of repayment of two large loans, now rescheduled for FY2019, will see a significant increase of 2 percent of GDP in debt repayment obligations. The South Pacific Games which Tonga will host in 2019 could substantially worsen fiscal outcomes if external grant funding is not forthcoming and/or costs escalate. Scope for further fiscal consolidation on the expenditure side is limited given pressing service delivery needs and successive real expenditure reductions in recent years. A gradual increase in domestic revenue collections from 18.6 percent of GDP in FY2013 to 18.9 percent of GDP in FY2015 is expected, building on recent gains, as tax policy and administration reforms bear fruit. External grants will be heightened while cyclone-recovery operations proceed, but are expected to fall back again by FY2016. While a small surplus was initially planned for FY2015, IDA credit financing for the cyclone recovery will see the budget remain in deficit. Government payroll policy is consistent with maintaining the target level of 45 percent of recurrent spending over the forecast period.

Figure 1:Public Debt Sustainability Analysis



Note: Most extreme shock is a one-time currency depreciation by 30 percent

Figure 2:External Debt Sustainability Analysis



Note: Most extreme shock is a one-time currency depreciation by 30 percent

Source: IMF-World Bank Debt Sustainability Analysis for Tonga, 2014

21. **Tonga is at moderate risk of debt distress.** A revision of Tonga's risk of debt distress from 'high' to 'moderate' was effected in the 2013 Debt Sustainability Analysis (DSA) and confirmed in the recently completed 2014 DSA. The assessment has improved rapidly over recent years driven by a number of factors, both methodological and due to fundamentals. In 2013, Tonga's strengthening CPIA rating moved it up to a 'medium' performer and the associated higher debt thresholds. In 2014, changes to the Debt Sustainability Framework meant that indicators now factor in remittances in the denominator, improving the assessment of ability to repay for Tonga, while changed market comparison rates increased the discount factor for concessional debt. Finally, the Government has successfully implemented and remains committed to a policy to avoid any new non-concessional borrowing, and debt levels have been trending downwards. Public and Publically-Guaranteed (PPG) external debt has fallen from 41.9 percent of GDP in FY2012 to 40.8 percent in FY2014 and is expected to fall further to 38.4

percent by FY2016.

22. **The current macroeconomic policy stance is adequate for the proposed operation, but outcomes remain subject to uncertainty and reliant on continued development assistance and supportive policy frameworks with larger countries.** Tonga is highly reliant on imports and a sharp rise in traded commodity prices would exacerbate inflation and threaten the incipient economic recovery in Tonga. Adverse shocks to employment and consumer demand in major partner countries would feed through to Tonga via reduced remittances and tourism receipts. The macroeconomic policy framework also depends on the continued availability of budget support from development partners over the medium term. Ongoing pressure for removal of the civil service hiring freeze and large public sector pay rises present a potential additional risk. Any large increases in the civil service wage bill are likely to undermine progress towards fiscal consolidation and cause a widening of the deficit or substantial disruptions to service delivery and the squeezing out of non-payroll expenditure. Continued progress with revenue policy and administration reforms will be vital to support projected increases in tax receipts. Finally, Tonga continues to be highly vulnerable to major natural disasters, which can devastate the local economy and create considerable fiscal pressure.

3. THE GOVERNMENT'S PROGRAM

23. **Tonga's national development strategy is set out in the Tonga Strategic Development Framework, 2011–2014, which was endorsed by the current government in May 2011.** It is underpinned by an extensive consultation process which involved line ministries working interactively with their stakeholders, including both civil society groups and private sector entities, over a period of at least one year. The Ministry of Finance and National Planning (MFNP) then led the coordination process within government, whereby line ministries worked together to integrate their sector-specific strategies into a single national development strategy.

24. **The vision guiding the TSDF is to develop and promote a just, equitable and progressive society in which the people of Tonga enjoy good health, peace, harmony and prosperity, in meeting their aspirations in life.** To achieve this vision, the Government aims to deliver on nine strategic objectives. The first objective is to build strong, inclusive communities by engaging local-level groups in meeting their service needs and ensuring the equitable distribution of development benefits across and within communities. The second and third objectives concern the role of a dynamic public and private sector partnership in driving economic growth, and the importance of adequate infrastructure for business activity and household wellbeing. The fourth, fifth and sixth objectives focus on key aspects of human development. The seventh, eighth and ninth objectives concern governance.

25. **The delivery of these objectives is to be facilitated by four 'enabling themes' on the public sector, macroeconomic framework, public enterprises and development assistance.** The efficiency and effectiveness of the public sector is to be improved, by focusing on core functions, optimizing the use of resources, improving service delivery and improving coordination. On the macroeconomic framework, the TSDF emphasizes the importance of good fiscal management, including effective revenue collection and sound public expenditure management. On public enterprises, further reforms are planned to improve their accountability and sustainability and to accelerate the privatization agenda. On development assistance, the TSDF stresses the value of a coordinated approach to Tonga's relationship with development partners. Each enabling theme in the TSDF is underpinned by a set of specific strategies, which

are themselves allocated to particular ministries to implement.

4. THE PROPOSED OPERATION

4.1 LINK TO GOVERNMENT PROGRAM AND OPERATION DESCRIPTION

26. **The proposed operation will support key national development objectives as set out in the TSDF.** The public financial management reforms in the proposed operation will support the objective of good governance, as well as the enabling theme on good fiscal management. Fiscal policy reforms will support good fiscal management and improved health outcomes. The business enabling environment reforms will further support private sector and infrastructure objectives, as well as more targeted electricity tariffs to support delivery of basic services whilst maintaining a sustainable operating environment for the sector.

27. **The operation has been developed through a process of detailed consultation with all relevant authorities and stakeholders, both within the central government and at the sector specific level.** The proposed operation was developed through dialogue mechanisms established to support the previous economic recovery operations. The Government has established a Budget Support Management Committee (BSMC) to facilitate discussion and monitoring of progress around actions under the Government reform program to be supported by the operation. The MFNP provides secretariat support to the committee and it includes representatives from various agencies involved in all key areas of the reform program, including the Ministry of Public Enterprises, the Ministry of Labor, Commerce and Industry, Ministry of Revenue, Tonga Power Limited and the Tonga Energy Roadmap Implementation Unit.

28. **The development objective of the operation reflects key constraints that the government is addressing as a matter of priority**. As a result of the consultative process, the program supported under this operation constitutes a set of key reforms that reflect substantial progress in some of the highest-priority areas of policy in Tonga. The reform program is expected to directly support poverty reduction and shared prosperity by: lowering costs of basic goods for low-income households, reinforcing incentives to support healthy living; and encouraging a more conducive business environment to support increased jobs and income-earning opportunities.

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

30. **The proposed operation has been supported by substantial technical assistance from the World Bank and its development partners in the budget support framework.** The World Bank Group has provided technical assistance and detailed engagement on three of the six

supported reforms this year with substantial engagement at the regional level on a fourth[1]. The remaining policy areas have benefitted from TA and detailed engagement from one of the World Bank's two close partners in the budget support dialogue in Tonga, DFAT and the ADB. The World Bank has continued to lead the overall dialogue on the joint policy reform matrix (JPRM), including coordinated oversight of TA and reform progress and negotiations with government on priority actions.

31. **It will be important for the government to sustain focus on implementation in reform areas supported under this operation to achieve the desired results.** The challenges inherent to governing in a small country like Tonga means that reforms require continuous TA and take longer to complete. This program has supported a number of key steps in reform, but follow-though will be important to achieve the desired results, particularly in business environment reforms like electricity tariff and foreign investment reform. WBG will remain engaged with the government in these areas, and would look to see progress in these areas before commencing a possible subsequent DPO.

4.2. PRIOR ACTIONS, RESULTS AND ANALYTICAL UNDERPINNINGS

POLICY AREAS

Strengthening Public Financial Management

32. **The Government of Tonga is committed to improving public financial management (PFM) as a key enabling reform in support of improved accountability, transparency and effectiveness of public services.** The emphasis of the PFM reforms underway is to improve the strategic effectiveness of the budget as a tool to link expenditure to policy priorities, while strengthening basic expenditure and commitment controls, both aimed at increasing the quality of expenditure.

Prior Action 1: Procurement Reform

33. **Addressing weaknesses in procurement is important for the government in the context of continued fiscal pressures and increasing budget support assistance from donors.** Recent reviews of procurement activity have highlighted 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. As a prior action for the first operation in this series, Cabinet approved a Procurement Reform Action Plan outlining a set of regulatory and procedural reforms that would progressively address weaknesses and build a more robust and efficient system. A key recommendation was to develop appropriate systems for procurement in the context of extremely limited procurement capacity across government and particularly in line ministries. This system would involve an increased role for a central procurement unit to exercise oversight over public procurement and to provide capacity support in a more efficient manner than seeking to increase procurement capacity in every ministry and agencies, given the binding constraints of small size.

[1] WBG provided TA for tax incentives reform and lifeline tariff policy options. WBG procurement and DPO teams have engaged with the authorities on procurement reform, and WBG has led the regional programme on fiscal policy responses to NCDs. The WBG DPO team has been closely involved in the oversight of other reform areas.

34. **As a prior action for this operation, The recipient, through its Ministry of Finance and National Planning has: i) Restructured and fully staffed the Central Procurement Unit (CPU); and issued a Treasury Circular to set a new threshold value at TOP 7,500 and above for all procurement to be handled by the CPU in order to improve compliance with procurement best practice standards.** The lowering of the contract value threshold will increase the oversight of the CPU for a large chunk of government procurement, and help address capacity constraints for the key processes of tendering and awarding contracts. Line ministries will continue to be responsible for preparing procurement plans and initiating procurements, while the small number of ministries that have sufficient procurement capacity will continue to carry out all steps in the process. In order to effect this significant procedural change, institutional procurement functions at the MFNP have been reformed and expanded. Procurement policy and operations functions have been separated with the CPU responsible for operational work and the Head of Procurement for policy. Overall, the staff has increased from 2 to 11. A new position of Head of Procurement has been established and recruited, four new Procurement Officers added to the existing two, two new Senior Procurement Officers have been recruited, with DFAT providing technical support in the form of two attached procurement advisors. The new procedures will be implemented during FY2015 with progressively more procurement tenders above TOP 7,500 coming under the oversight of the CPU. Related reforms are being pursued in establishing monitoring and evaluation systems. As noted by the latest PEFA assessment, there is no complete electronic record of procurement activity at present. To address this issue, a database will be introduced and put into use by the CPU with support from the World Bank. Accordingly, the data quality of the results indicator[2] is expected to improve, which means that there is a risk that if the baseline was over-estimated, the target value may prove to be over-ambitious.

Prior Action 2: Aligning Expenditure with Policy Priorities

35. **Better alignment between expenditure and policy priorities is an important focus of ongoing reforms.** Recent World Bank analytical work has highlighted opportunities for improvements in the alignment between budget allocations and policy priorities, and in budget execution (see Table 5). Government is undertaking efforts towards improved alignment through a number of mechanisms, and has made significant progress over recent years. Alignment between expenditure and policy priorities have been shown to have been compromised in two key ways: i) The 'contingency fund' has been used as a mechanism to allow for substantial reallocation of resources outside of the budget process; and ii) reliance on an outdated budget structure that has precluded allocation decisions based on policy priorities. The first of these problems was addressed under the first operation in this series.

36. **Weaknesses in the structure of the budget have led to a lack of transparency in regards to how public resources are used by ministries.** The existing budget system in Tonga is subject to important shortcomings. In some cases, large amounts of money can be reallocated from the original appropriation without a clear indication of how such movements support the delivery of government outputs. While appropriations are made on a line item (input) basis, agencies retain the right to reallocate recurrent non-wage resources between sub-programs at their discretion. However, the scope and definition of programs and subprograms varies substantially between ministries, with some programs grouping large sections of a ministry under

[2] Proportion of contracts awarded by methods other than open competition that are justified in accordance with legal requirement.

one sub-program while others are much more disaggregated. This has led to wide divergence between the Budget as passed and as implemented. Expenditure analysis carried out with World Bank support showed that actual expenditure varied from budgeted allocations by more than 20 percent for 65 percent of sub-programs across government. Nearly 20 percent of sub-programs are subject to variances of more than 50 percent of budget allocation. This analysis further shows a strong pattern of expenditure being reallocated from front-line service delivery expenditures to administrative and overhead costs. With variances of this magnitude, the capacity of the Government to allocate resources towards priority areas below the line ministry level is severely constrained.

37. **As a prior action, (a) the Recipient's Legislative Assembly has passed the 2014/15 Appropriation Act 2014, which includes standardization between budget sub-programs and organizational divisions in corporate plans; and (b) the Recipient's Ministry of Finance and National Planning has issued a Treasury Circular which introduces new controls on transfers between sub-programs.** This reform represents the culmination of several years' preparatory activity and is expected to support, over time, an improved balance between flexibility and control in the management of the budget, significant improvements in the alignment between Government policy priorities and expenditure, and improved accountability and incentives for efficiency at the line level. The new structure provides a more appropriate level of control and illustrates linkages between allocations shown in budget documents and the outputs that those resources are used to produce. Sub-programs are defined on a consistent basis, and aligned with outputs identified in the corporate plans, associated with "organizational units" within ministries, such that managers at the Director level will have discretion over the allocation of budget between line items. New controls will be introduced, requiring MFNP approval for transfers between sub-programs. These reforms facilitate allocation decisions based on policy objectives, rather than only on incremental input costs. With appropriate output indicators identified, over time, CEOs and directors of sub-programs will be increasingly accountable for delivery of key performance indicators and the variance between original budget and outturn expenditure should reduce at the sub-program level. The reform will be fully introduced for five key ministries during the FY2015 Budget Process (Ministry of Health, Ministry of Education, Ministry of Infrastructure, Ministry of Finance and National Planning, and Ministry of Labor, Commerce, and Industry). Ministries covered under this prior action comprise nearly 70 percent of recurrent expenditure. The result of this action would be to achieve a reduction in the number of sub-programs that under or over spend by more than 20 percent from 65 percent to 50 percent.

Table 4: 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
Operation Pillar 1: Strengthening Public Financial Management		
The Recipient's Cabinet has significantly reduced the contract value threshold for all procurement to be mandatorily handled by the Central Procurement Unit (CPU), in accordance with the Procurement Reform Action Plan.	The Recipient, through its Ministry of Finance and National Planning has: i) Restructured and fully staffed the Central Procurement Unit (CPU); and issued a Treasury Circular to set a new threshold value at TOP 7,500 and above for all procurement to be handled by the CPU in order to improve compliance with procurement best practice standards.	Increased specificity.
The Recipient has approved the Budget Law for Fiscal Year 2014/15, standardizing the definition and content of sub-programs in major ministries, with outputs, outcomes, and programs aligned with those specified in ministry corporate plans.	(a) The Recipient's Legislative Assembly has passed the 2014/15 Appropriation Act 2014, which includes standardization between budget sub-programs and organizational divisions in corporate plans; and (b) the Recipient's Ministry of Finance and National Planning has issued a Treasury Circular which introduces new controls on transfers between sub-programs.	Action strengthened to include new controls that will support the achievement of better budget credibility at sub-program level.
Operation Pillar 2: Strengthening Fiscal Policy		
The Recipient's Cabinet has (i) reviewed tax exemptions under the consumption and excise tax regimes; and (ii) approved revisions thereto in order to reduce their overall fiscal costs.	The Recipient's Cabinet has: (i) established a new Revenue Policy Committee tasked with reviewing and advising on all requests of discretionary tax exemptions; and (ii) approved a framework for standardized and transparent investment incentives in priority economic sectors.	Increased specificity. Part (i) of the original formulation has been met, and part (ii) of original formulation will be met by means of the actions in the new formulation.
	The Recipient's Ministry of Finance and National Planning has, through its 2014/2015 Budget Statement, has made adjustments to the excise duty regime in line with NCDs health policy.	New measure.
Operation Pillar 3: Enhancing the Business Enabling Environment		
The Recipient has brought a concession agreement with a private sector hotel operator for the management and exploitation of the International Dateline Hotel to the point of transaction.		Completed but not converted to a prior action. Government brought the deal to the point of transaction, carrying out a rigorous tendering and negotiation process but were unable to secure a final agreement.

The Recipient's Cabinet has submitted to the Legislative Assembly for its consideration, a draft amendment bill with proposed revision to the Foreign Investment Act in order to enable foreign investment in the fisheries, agriculture and tourism sectors.	The Recipient's Cabinet has approved a policy framework for foreign investment in order to open the fisheries and agriculture sectors to foreign investment and launched public consultations.	Following detailed scoping work, formulation of indicative trigger too ambitious given substantial technical assistance and consultation needed. Revised action to reflect milestone in reform process at an earlier stage.
The Recipient's Cabinet has adjusted the electricity tariff introducing: (i) a Lifeline tariff for poor and/or vulnerable consumers; and (ii) incentives for efficient generation, both in accordance with the recommendations of the recently completed Tariff Review.	The Recipient's Cabinet has approved the implementation of a sustainably-financed electricity lifeline tariff under provisions of the Public Enterprise Act, in order to support low-income households.	Government has prioritized and fully completed one of two aspects of the indicative trigger, having determined that there are other immediate measures to promote energy efficiency which are more effective than tariff reforms. The government still intends to carry out electricity tariff reforms that promotes greater generation efficiency.

Strengthening Fiscal Policy

38. **The Government is pursuing an ambitious tax reform agenda, guided by a review of tax policy and administration and recommendations to use fiscal instruments to address health challenges.** A review of tax systems conducted by the Pacific Financial Technical Assistance Centre (PFTAC) with World Bank participation in 2011 concluded that Tonga's current tax rates and structure are broadly in line with comparator countries and that overall tax performance is in the mid-range. The review recommended reforms to the exemption and concession processes to improve transparency and reduce revenue loss, the introduction of a presumptive tax for Small and Medium Enterprises (SMEs) and new tax regimes for natural resources and land rentals which were supported under the first operation in this series. Work is ongoing in various areas of tax administration, including major tax and customs IT upgrades. The NCD Roadmap launched at this year's Forum Economic Ministers Meeting (FEMM) and prepared by the World Bank, brings into sharp focus the scale of the health crisis facing Pacific Island countries. Specifically, Tonga is facing major health burdens and mounting fiscal sustainability challenges as a result of the rapid rise of NCDs. One of the top priorities in the Roadmap is to adopt whole of government approaches to address a growing epidemic and to use of fiscal policy to improve incentives to choose healthy behaviors. NCDs are also singled out by the Tonga Country Gender Action Plan because of their disproportionate impact on women.

Prior Action 3: Reducing the Cost of Tax Exemptions

39. **Tax exemptions issued at the discretion of Cabinet have been increasing and the criteria for granting them has lacked transparency.** The value of ad-hoc exemptions has risen from 4 percent of domestic receipts in FY2010 to an average of 10 percent of domestic revenue in the four years to FY2014. The list of exemptions includes some that serve a legitimate purpose, but the Government considers that there remains significant scope to reduce the breadth of exemptions offered, and reduce fiscal costs. Of particular focus are tax exemptions that are issued against consumption tax and import duty by discretionary power of Cabinet in accordance with provisions in the legislation. These exemptions are considered on a case-by-case basis by Cabinet, and there is a lack of a clear and transparent set of criteria for which exemption requests will be granted. In the absence of fixed criteria, there is a risk of perceived unequal treatment, and the incentive for tax-payers to apply for exemption for an increasingly wide range or reasons. With assistance of the International Finance Corporation (IFC) and World Bank, the Government recently prepared a review of exemptions and current investment incentive policy, which recommended the establishment of an advisory body to Cabinet and the development of a clear rules-based system that provides transparent and uniform incentives that are targeted at priority economic sectors.

40. **As a prior action for the second operation, The Recipient's Cabinet has: i) established a new Revenue Policy Committee tasked with reviewing and advising on all requests of discretionary tax exemptions; and ii) approved a framework for standardized and transparent investment incentives in priority economic sectors.** The Revenue Policy Committee's (RPC) Terms of Reference approved by Cabinet provide it a clear mandate to exercise systematic scrutiny over all tax exemption requests in relation to the exemption and incentive framework, and the guiding principles for any new ad-hoc exemptions to be considered.

As a result, Cabinet has moved to a more rules-based system for issuance of discretionary exemptions. Starting immediately and on an ongoing basis, applications for exemption will now be received by the RPC which will review and provide an assessment and recommendation to Cabinet for their final decision. To make the process more transparent, Cabinet has agreed and made public a framework of existing tax incentives designed to encourage investment in priority sectors. The results indicator for this action would be the value of new discretionary tax exemptions granted under the Consumption Tax and Import Duty regimes, which should decrease from 11 percent of total revenues in FY2013 to 8 percent in FY2015.

Prior Action 4: Tax Policy to Support Improved Health Outcomes

41. **Tonga is facing major health burdens and mounting fiscal sustainability challenges as a result of the rapid rise of Non-Communicable Diseases (NCDs).** Life expectancy in Tonga is falling as a result of NCDs.[3] Over one third (35.1 percent) of female and over one quarter (25.6 percent) of male premature death (before age 60 years) are caused by NCDs.[4] Since the 1950s deaths from infectious diseases have fallen dramatically but the proportion of deaths from diseases of the circulatory system have grown from 6 percent to 38 percent. In 2010 NCDs accounted for four of the five leading causes of mortality and were the leading causes of morbidity in Tonga. Unless addressed, the already high incidence of NCD-related morbidity will increase further as current generations age. For example, WHO data shows that 88 percent of adult Tongans are overweight or obese and one in four boys and one in five girls at school are obese. Tonga is also in the top ten countries in the world for male rates of smoking.

42. **Addressing the NCD crisis is a fiscal, as well as a human development, priority.** The World Bank NCD Roadmap and Tonga Health Financing reports bring into sharp focus the scale of the health crisis and the fiscal and economic burden of treating these diseases which, if left unaddressed, threaten to over-burden the government's budget. The NCD Roadmap notes that this crisis is eminently preventable, but coordinated efforts need to be mounted across government, with fiscal policy instruments the number one priority, particularly raising tobacco duty to 70 percent of retail price. Studies have shown that tobacco taxes do have a significant impact on behavior, with long-term price elasticity of demand (PED) estimated in the range of -0.4. Fewer studies exist on the impact of health-promoting tax on food and drink, but those that there are indicate a generally higher behavioral response, with PEDs centrally estimated (on meat) of -0.7[5]. Other important, complementary measures include strengthening tobacco control; policies on food and drink products directly linked to obesity, heart disease and diabetes; and improved efficiency and impact of healthcare spending by reallocating resources from treatment to prevention services. Tonga has taken some important steps towards implementing a number of these recommendations, including the establishment of a Health Promotion Foundation and rolling out of preventative programs.

43. **As a prior action for this operation, The Recipient's Ministry of Finance and National Planning has, through its 2014/2015 Budget Statement, made adjustments to the**

[3] WHO and Ministry of Health Tonga. Health service delivery profile: Kingdom of Tonga, 2012.

[4] WHO. Noncommunicable Diseases Country Profiles. Geneva: World Health Organization., 2011.

[5] Gallet, C. & J. List, 2003, "Cigarette Demand: a Meta-analysis of Elasticities", Health Economics, 12(821:835) and Andreyeva, T. et al, 2010, "The Impact of Food Prices on Consumption: A Systematic Review of Research on the Price Elasticity of Demand for Food", American Journal of Public Health, 100(2).

excise duty regime in line with NCDs health policy. Tonga is one of the foremost countries in the region in recognizing and taking action to address the NCD crisis. But to reinforce a positive move towards healthier behavior and away from NCD risk factors, the government has taken the step to use increases in excise duty as an instrument to disincentivize consumption of certain goods. The FY2015 Budget announced an increase in excise duty on cigarettes from TOP $210 per 1000 cigarettes or per kg to TOP $250 (imported) and from TOP $200 to TOP $238 for locally manufactured tobacco/cigarettes. This raises taxation as a proportion of retail price to over 70 percent – the first country in the Pacific to reach the taxation level recommended by the WHO. This measure has also been complemented by a halving of the permissible duty-free allowance of tobacco on entering the country, implemented at the same time. Further to this, new excise duties of TOP $0.50 per liter on drinks with added sugar and TOP $1.00 per kg on lard and other animal fats have been introduced. While these taxes may have a temporary positive revenue impact, over time revenues are expected to reduce as demand for these products falls. However, the benefits in the way of reduced treatment of late-stage NCD cases will far outweigh the small reduction in revenue. The overall excise duty revision has been designed so as not to increase overall household costs of basic needs, and includes offsetting reductions in rates on more healthy foods such as tinned fish and vegetable oil. The results indicator will be the retail price of a typical pack of cigarettes and soft drink as monitored by the Bureau of Statistics, which should increase over the period 2013 to 2015[6], and would be expected to lead to a reduction in the consumption of these products.

Enhancing the Business-Enabling Environment

44. **Business environment reforms have the potential to support private sector development.** Since the global crisis and in the context of ongoing declines in remittances, the Government has stepped up its commitment to business environment reforms as a means of encouraging investment and private sector development. Since 2007, Tonga has made significant progress in strengthening the business regulatory environment and corporatizing and privatizing several SOEs. Reflecting these reforms, Tonga is now the highest ranked Pacific Islands Country in the Doing Business survey, having moved up three places and above Fiji in the last year. Reforms supported under the previous operation have continued to progress. The Business Names Act has been passed by Parliament and will be enacted shortly. Government has begun implementation of the Tonga Communications Corporation restructuring plan and subject to an initial assessment of interest is intending to decide on an appropriate transaction structuring. The Receivership Bill, supported by the first DPO, has been through its first reading with Parliament and is being readied for a second reading. Despite the significant steps taken, more remains to be done, including addressing constraints to Public Enterprise performance, and the foreign investment environment.

45. **Substantial reform efforts have been made to issue a concession for the International Dateline Hotel.** An indicative trigger for this operation was for the Recipient to bring a concession agreement with a private sector hotel operator for the management and operation of the International Dateline Hotel to the point of transaction. Over the last year the Government, with transaction support from IFC, carried out rigorous market sounding, expression of interest and selection processes. A bidder was selected, and the point of final negotiations reached. However, despite the Government's best efforts, they were unable to reach a final agreement with

[6] Retail price data is not monitored for lard or drippings.

the bidder. Immediately on hearing this, the government initiated a second round of bidding, but indications are that has not generated any additional interest. As a result, although the indicative trigger was met, it has been removed from this operation. However, the government is committed to finding a private sector partner and is working with the IFC to identify the next steps for this reform.

Prior Action 5: Business regulatory reform

46. **A lack of foreign investment in key sectors is constraining opportunities for growth and job creation.** Building on analysis such as the ADB's 2008 private sector assessment for Tonga, the Government has identified a lack of foreign direct investment (FDI) as a constraint to growth in the country. The number of regulatory requirements foreign investors must comply with in addition to other business requirements leads to a significant amount of red tape that is likely to deter many potential investors, while restrictions exclude foreign investors from some priority economic sectors like agriculture and fisheries. The Government is committed to regulatory reform to encourage increased foreign investment in Tonga and recognize that existing legislation imposes undue restrictions that impede potential for inclusive growth.

47. **As a prior action, the Cabinet has approved a policy framework for foreign investment in order to enable foreign investment in the fisheries and agriculture sector and launched public consultations.** Existing legislative restrictions are unevenly and incompletely enforced, and represent a substantial source of uncertainty for potential foreign investors. Over the last year, extensive work has been done, with support of ADB TA and World Bank participation, to review the legislative framework for foreign investment and processes and procedures to apply the rules, and to prepare a clearly defined set of reforms that will address key constraints. The Cabinet has approved the framework for a new foreign investment policy and legislative environment and a time-bound implementation plan which will see consultations completed by October 2014 and draft legislation readied for submission to Parliament by March 2015. The policy framework identifies key constraints and clear policy proposals to address them. The policy framework is a key step towards putting in place revised legislation that will support Government priorities for increased foreign investment, while also ensuring that adequate regulatory controls remain in place to address any potential negative social impacts of such investment. When the indicative trigger for this action in the first operation in this series was set, it was envisaged that the reform would consist of updated the restricted and reserved lists associated with the Foreign Investment Act. In carrying out the review, it has become apparent that more extensive revisions to legislation are required to adequately address key constraints, including complementary amendments to the Immigration Act to enable foreign investor to get the appropriate visas. It will also be critical to carry out public consultations on the proposed changes to build public understanding and consensus. The original formulation of the trigger has been amended which reflects a more phased approach to the reforms, given the need for more extensive technical reviews and public consultations. The Government expects to complete consultations by end October 2014 and complete revised draft bills by end of Q1 2015, and submit to Parliament for their consideration.

Prior Action 6: Electricity tariff reform

48. **The current structure of the electricity tariff presents obstacles to achieving Tonga's energy policy objectives.** High and volatile energy costs are a constraint to business activity in

Tonga, and contribute to hardship among poor households. Energy affordability, and particularly electricity, is a high priority for government and the utility, Tonga Power Limited (TPL), has come under pressure to lower costs, especially in the face of sharply rising energy costs. In recent years, there have been a number of attempts to reduce prices which could not be sustained as the company's operating balance rapidly declined. With the current cost structure, TPL is unable to support the government's energy affordability objectives without undermining its financial sustainability, and could become a fiscal liability to the government. The existing tariff structure is a simple linear tariff which offers no scope to provide more targeted, affordable electricity pricing. In the absence of a lifeline tariff, it has proved politically very difficult for the government to allow the appropriate pass-through of oil price increases into the electricity tariff, jeopardizing the sustainability of TPL's operations. Based on a survey of six Pacific island countries, Tonga is only one of two that does not already have a lifeline tariff and has the highest electricity tariff for low-volume consumers of all those countries. The Tonga Energy Roadmap Implementation Unit (TERM-IU), has worked closely with the World Bank and Pacific Infrastructure Advisory Center (PIAC) over the past two years to review the existing electricity tariff, and has carried out extensive stakeholder consultation as part of the process. Cabinet agreement to this review, including guiding principles, was supported by the previous series of development policy operations.

49. **A lifeline tariff would sustainably address electricity affordability priorities, and is one of the most cost-effective poverty reduction policies the Government could implement in the short-term.** In Tonga, electricity coverage is good, but costs are high. Household survey data indicates that near 98 percent of households have access to electricity and the average household in the bottom three income deciles spends more than 8 percent of its budget on electricity alone. Data from TPL indicates that about 30 percent of users consume 50 kWh or less per month, so a lifeline tariff set at this level would reach a significant proportion of low-volume, low-income households.

50. **The government continues to place high priority on energy efficiency policy and renewable energy.** An indicative trigger in the previous operation was electricity tariff reforms that would support energy efficiency and a lifeline tariff. This trigger was modified to focus only on lifeline tariffs given that it was determined that other immediate actions, described in this paragraph, were deemed more effective than tariff reforms for promoting energy efficiency. The government has approved a lifeline tariff to be effective as of January 2015; such a tariff has energy efficiency incentives embedded by design through price signals that encourage energy consumers to remain within their segment of consumption or below. TPL improvements on network losses have achieved reductions in electricity losses from 18 percent in 2007 to 12 percent in 2013. The World Bank is also supporting the Government to assess and potentially negotiate new petroleum contracts that would achieve a lower cost of supply. Complementing the measures above, the Government has established a target for 50 percent renewables by 2020 and is seeking to scale up its renewable capacity to support overall efficiency of the power sector. Significant investments are underway which are expected to raise renewable generation from 6 percent of the total now to 15 percent by 2015. The next tariff reset is scheduled for mid-2015, and the Bank will remain engaged to support adjustments that will support incentives for efficient generation during the course of this assessment.

Table 5: DPO Prior Actions and Analytical Underpinnings

Prior actions	**Analytical Underpinnings** (be specific about the finding informing the prior action)
Operation Pillar 1: Strengthening Public Financial Management	
1. The Recipient, through its Ministry of Finance and National Planning has: i) Restructured and fully staffed the Central Procurement Unit (CPU); and issued a Treasury Circular to set a new threshold value at TOP 7,500 and above for all procurement to be handled by the CPU in order to improve compliance with procurement best practice standards.	The 2010 Public Expenditure and Financial Accountability (PEFA) Assessment noted significant weaknesses in procurement processes and rated them overall as 'C'. The GoT/Ausaid Public Procurement System Review found significant deviations from established processes, and weaknesses including i) low procurement capacity in line ministries; ii) inadequate staffing in Central Procurement Unit and highlighted the need to address capacity constraints.
2. (a) The Recipient's Legislative Assembly has passed the 2014/15 Appropriation Act 2014, which includes standardization between budget sub-programs and organizational divisions in corporate plans; and (b) the Recipient's Ministry of Finance and National Planning has issued a Treasury Circular which introduces new controls on transfers between sub-programs.	Tonga achieved low scores in both the 2007 PEFA and 2010 PFTAC PFM Assessment on indicators of budget credibility at the disaggregated level and strategic budgeting at the sectoral level. The 2012 MFNP/WB Medium-Term Expenditure Mapping showed high levels of variation in outturn against budget allocations for most sub-programs across government and pattern of reallocation from front-line service delivery expenditures to administrative and overhead costs.
Operation Pillar 2: Strengthening Fiscal Policy	
3. The Recipient's Cabinet has: i) Established a new Revenue Policy Committee tasked with reviewing and advising on all requests of discretionary tax exemptions; and ii) approved a framework for standardized and transparent investment incentives in priority economic sectors.	The 2011 PFTAC Review of Revenue Policy and Administration found that the current system of tax exemptions is costly, lacks transparency and in some cases lacks a clear rationale. The 2013 IFC/WB Investment Incentive Report supports these findings and puts forward specific recommendations to reform the tax exemption system to reduce cost, improve transparency and better target investment incentives.
4. The Recipient's Ministry of Finance and National Planning has, through its 2014/2015 Budget Statement, has made adjustments to the excise duty regime in line with NCDs health policy.	The 2012 WB Financing Options for the Health Sector in Tonga report and the 2014 WB NCD Roadmap Report outlined the scale of the NCD epidemic facing the Pacific, with Tonga particularly seriously affected. Key recommendations include reinforcing 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.
Operation Pillar 3: Enhancing the Business Enabling Environment	
5. The Recipient's Cabinet has approved a revised policy framework for foreign investment in order to enable foreign investment in the fisheries and agriculture sector and launched public consultations.	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.
6. The Recipient's Cabinet has approved the implementation of a sustainably-financed electricity lifeline tariff under provisions of the Public Enterprise Act, in order to support low-income households.	The 2012 Tonga Review of Regulated Electricity Prices recommended Government articulate the energy affordability policy behind a lifeline tariff, instruct TPL to implement it and provide for a costed subsidy. The 2014 WB Pacific Hardship and Vulnerability Report provided further evidence on the role energy costs play in contributing to hardship in Tonga.

51. **As a prior action for this operation, the Recipient's Cabinet has approved the implementation of a sustainably-financed electricity lifeline tariff under provisions of the Public Enterprise Act, in order to support low-income households.** In line with recommendations of the recently completed Tariff Review, the authorities have held consultations on different options for supporting the Government's energy affordability agenda. Based on these consultations and analysis, supported by the World Bank, Cabinet has issued a decision to implement an electricity lifeline tariff, financed by a Government subsidy. As a community service obligation defined under the Public Enterprises Act, this subsidy would be subject to annual review and appropriation in the annual budget. TPL is in the process of carrying out customer sensitization to the change and expects to fully implement early in 2015. The new tariff addresses concerns about affordability of the lifeline tariff by adopting a subsidy-and-drawback approach. The full subsidy is granted to low-volume households (less than 50kWh a month) but is then gradually drawn back between units 51 and 100 per month so that households consuming 100kWh are not subsidized, nor do they pay any more than they did before. In this way, the fiscal costs are more than halved and the benefits more tightly targeted compared to a simple lifeline tariff[7]. Given the focus of tariff policy reform on lifeline tariff issues, the results indicator on renewables has been augmented with an indicator of average price per kWh paid by consumers using less than 50kWh per month, which should decline by at least 10 percent over the price in June 2014.

4.3 LINK TO CAS AND OTHER BANK OPERATIONS

52. **The World Bank Group's Country Assistance Strategy (CAS) for the Kingdom of Tonga is built around three themes of: reform, integration and resilience.** The first theme is supporting policy reform to strengthen economic growth prospects and to improve service delivery. The second theme is generating opportunities through greater global and regional integration. The third theme is building resilience against shocks. The proposed operation contributes mainly to the first theme of engaging with the Government on policy reforms to strengthen growth performance and improve service delivery. The policy framework strengthens core aspects of public expenditure control and execution, improves the mobilization and targeting of taxation and supports economic policy reforms that support private sector development and reduced costs of basic needs in Tonga.

53. **The proposed operation builds on a number of technical assistance projects of both the Bank and development partners.** Energy sector reform complements and benefits from extended engagement of the World Bank Tonga Energy Road Map project. 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. Business-enabling reforms have been discussed jointly with the IFC, and complement IFC projects in tourism and private sector development. Tax exemptions and investment incentive technical assistance has been provided jointly by IDA and IFC. The operation supports a broader engagement which includes World Bank TA on debt management, climate change adaptation and sustainable energy and ongoing, active programs of private sector support from the IFC and the ADB's Private Sector

[7] Based on a subsidy or TOP 0.30, the cost is estimated at TOP 1.0m per year.

Development Initiative.

4.4 CONSULTATIONS AND COLLABORATION WITH DEVELOPMENT PARTNERS

54. **The operation has been developed through a process of detailed consultation with relevant government authorities and stakeholders, both within the central government and at the sector specific level.** The proposed operation was developed through dialogue mechanisms established to support the previous economic recovery operations. The Government has established a Budget Support Management Committee to facilitate discussion and monitoring of progress around actions under the Government reform program to be supported by the operation. The MFNP provides secretariat support to the Committee and it includes representatives from various agencies involved in all key areas of the reform program, including the Ministry of Public Enterprises, the Ministry of Labor, Commerce and Industry, Ministry of Revenue, Tonga Power Limited and the Tonga Energy Roadmap Implementation Unit. The relevance of the actions supported by this program was reaffirmed during an economic dialogue in 2012 that was attended by a broad range of Government, Non-Governmental Organisation (NGO), private sector, and donor representatives including the Bank. The operation is informed by consultation with civil society and the legislature. The operation design reflects dialogue with the Civil Society Forum of Tonga, an umbrella NGO, regarding the social and poverty impacts of recent economic shocks. Members of the Civil Society Forum emphasized the need for job creation, especially in rural areas, and emphasized existing under-representation of women in the formal business sector as a barrier to poverty reduction. The program also reflects discussion with representative of the Tonga Chamber of Commerce and Industry, commercial banks and other business representatives regarding constraints to economic development in Tonga, and priority reforms to enable private sector growth. The Public Accounts Committee was supportive of the program, emphasizing the importance of budget support and a streamlined set of key policy reforms.

55. **The World Bank collaborates very closely with key development partners on economic and fiscal policy.** The World Bank and IMF collaborate closely and Bank staff have participated in each of the last five Article IV missions and jointly prepare the Debt Sustainability Analysis for Tonga. Based on this cooperation, the Bank and Fund share a common view about Tonga's macroeconomic and structural reform priorities. The World Bank coordinates the Budget Support Management Committee, which is the primary mechanism for formal dialogue regarding selection of and monitoring progress against policy actions. DFAT budget support of AU$5 million is expected to be mobilized for the same policy actions. The ADB and the European Union (EU) also provide budget support against actions included in the joint policy matrix. The ADB is expected to provide US$4.5 million in FY2015, while the EU is expected to provide Euro 2.5 million. 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, PFTAC, and New Zealand International Development Group are all providing assistance to the achievement of the proposed program of policy reforms through varying combinations of budget support and technical assistance.

5. OTHER DESIGN AND APPRAISAL ISSUES

5.1 POVERTY AND SOCIAL IMPACT

56. **Extreme poverty is rare in Tonga but there are significant levels of material deprivation throughout the country.** 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.

57. **Reforms supported by the operation will help reduce poverty and boost shared prosperity.** Energy sector reform included in this operation will have a positive poverty impact. Reduced costs of energy will directly benefit low-income households, increase disposable income and increase availability of electricity for basic needs like cooking and lighting. Households benefitting from the lifeline tariff will save over TOP 200 a year on electricity bills. Improved access to electric lighting is also expected to support educational attainment of school children, allowing them to do homework after nightfall. Analysis from the most recent HIES indicates that lower income households spend a large proportion of their total outgoings on electricity, so a reduction in costs would have a noticeable impact. NCDs are a major cause of mortality, morbidity and economic inactivity in Tonga, all of which are drivers of poverty. Although some households may pay more in the short-term for the three goods being taxed, offsetting reductions in duty for more healthy foods should minimize any short-term increase in costs, while substitution towards readily-available alternatives will provide much greater health and financial benefits over their lifeline. Tax reforms will improve the Government's ability to mobilize resources to finance improved public service delivery that addresses causes of poverty, an example of which is the Government's new social protection programme to provide social services to disadvantaged children and the elderly that will be launched in FY2015. Improved management of public resources will also, over time, contribute to improved economic performance and an expansion in economic opportunities, with international studies showing that increases in disposable household income are associated with higher investment in education, especially for girls. Evidence from the Pacific[8] demonstrates the important role played by access to telecommunications in opening new opportunities for business, including providing business benefits in remote, rural areas and creating employment. At the same time, reforms to TCC are not anticipated to have a significant impact on employment levels, and the organization will ensure appropriate redundancy and re-training packages should any become necessary. The regulatory regime is frequently cited as a constraint to private sector development in Tonga, and reforms to the foreign investment regime are expected to create economic benefits that will help to reduce poverty and boost shared prosperity. While, in certain cases, foreign investment can have the potential to adversely affect local livelihoods, safeguards to avoid adverse impacts on local employment opportunities are already reflected in the legislation framework and will be strengthened by the reforms supported under this operation, which include the requirement to demonstrate that skills cannot be locally sourced before being granted skilled work visas.

58. **The operation includes actions that are specifically targeted at addressing issues of primary concern to women, and supporting more balanced gender outcomes.** NCDs were highlighted as gender action priorities in the World Bank's recent Country Gender Action Plan for Tonga. In Tonga, women have a higher incidence of NCDs risk factors than men (except for

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[8] Pacific Institute of Public Policy Study on impacts of telecommunications access in Vanuatu.

smoking). In 2011, the number of deaths in Tonga due to NCDs was 50 percent higher for women than men. Women in Tonga are 20 percent more likely to be obese than men. Therefore, NCD taxation measures, especially on food and drink, will disproportionately benefit women. Women are also expected to disproportionately benefit from electricity tariff reforms. They are traditionally responsible for cooking and other household duties, and stand to benefit from improved access to electricity to carry out these tasks more easily. Public financial management reforms will provide the tools for the Government to adequately resource efficient delivery of social services to improve women's health and education outcomes.

5.2 ENVIRONMENTAL ASPECTS

59. **The policy actions supported under the operation are not expected to have a significant impact on Tonga's environment, natural resources or forests.** The introduction of the lifeline tariff provides a modest incentive that encourages consumers at 100kWh a month to make efficiency savings although this is not expected to have a significant impact on overall energy demand. 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.

60. **Tonga has a well-established environmental impact assessment process administered by the Ministry of Environment and Climate Change.** It is noted that the Transport Sector Consolidation Project (TSCP) has been implemented using the Tongan legislation and to date, the project is being implemented effectively and no environmental issues have been identified. Legislation includes firstly the Environmental Impact Assessment Act 2003 to provide for the application of environmental impact assessment to the planning of development in Tonga. The Act is structured in five parts, starting with definitions of key terms in Part I and clarifying functions and powers in Part II. The third part outlines the EIA process. Part IV deals with cases of non-compliance with the previous provisions and Part V contains further miscellaneous provisions. Secondly, the Environmental Impact Assessment Regulations 2010 to regulate major development projects and the applications of notification consistent with the EIA Act 2003. Finally, the Environment Management Act 2010 to establish the Ministry of Environment & Climate Change which is now the principal Ministry responsible for the protection and proper management of the environment and the promotion of sustainable development.

61. **All land in Tonga is owned by the Crown and is divided into Royal Estates, Royal Family Estates, Hereditary Estates and Crown Land.** In all cases, the legal and administrative framework for processing, registering and protecting land titles and interests are controlled by the Land Act. A process exists for the acquisition of land for public purpose, in which circumstances full compensation needs to be paid for the land and any assets that sit on the land. A Land Court has jurisdiction to hear and determine disputes, claims and questions of title. It is noted that the Bank's Tonga Post-Tsunami Reconstruction Project which was recently completed applied provisions under the Land Act for the acquisition of land required for the relocated villages. This process was found to be transparent and representative.

5.3 PFM, DISBURSEMENT AND AUDITING ASPECTS

62. **Reflecting reform efforts over the recent years, Tonga's CPIA rating has increased from 2.9 to 3.5 over the last five years, with Tonga's policy and institutional performance now above average for IDA countries.** The 2010 PEFA showed that the legal and regulatory framework for PFM in Tonga provides a solid basis for budgeting, spending and accountability, but indicated areas of weaknesses in accounting, recording and reporting and in external scrutiny and audit. Satisfactory ratings were received on all indicators and sub-indicators pertaining to the credibility of the budget and on comprehensiveness and transparency. The annual budget, as approved by Parliament, is publicly disclosed and available on the Ministry of Finance website. Within the area of accounting, recording and reporting, unsatisfactory ratings were issued on the availability of information on resources received by service delivery units and the quality and timeliness of Annual Financial Statements (AFS). Other weaknesses were identified in each of the aspects of 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. On this basis, the overall fiduciary risk is rated as “High”.

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

64. **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 the foreign exchange risk is rated as “High”.

65. **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 (US$ 5 million equivalent) will be disbursed against satisfactory completion of the specified policy actions as listed in Table 5 and the Government agreement as summarized in the Letter of the Development Policy, and is not tied to any specific purchases. Once the grant and credit are approved by the Board and become effective, the proceeds of the grant and credit will be deposited by IDA in one tranche, at the request of the Recipient, into a dedicated Foreign Currency Deposit Account at the NRBT, which will form part of Tonga's foreign exchange reserves.

66. **Flow of funds (including foreign exchange) is subject to normal Financial Management processes.** It is not possible to track the ultimate use of the foreign exchange provided by the development policy operation proceeds, but grant and credit proceeds will, within 30 days of the IDA disbursement, flow into a dedicated Foreign Currency Deposit Account at the NRBT and from it to the budget of the Government, and are thus subject to normal PFM processes and NRBT procedures. By way of a letter, the Government will provide

confirmation to the Bank when the grant and credit amount has been credited to a Local Currency Deposit Account used to finance budgeted expenditures.

67. **The Bank will retain the right to request the auditors of the Government to conduct 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 AND EVALUATION

68. **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.

69. **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.

6. SUMMARY OF RISKS AND MITIGATION

The overall risk level for the DPO is substantial.

70. **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 program can directly affect the speed and quality of implementation of the reform program. The availability of data is much more limited than in larger countries where the fixed costs of preparing statistics are lower. This risk is being mitigated by strong dialogue through which the Government and the Bank have carefully selected a limited number

of policy actions that are key priorities for the Government. The Government and the Bank have also discussed the implementation requirements for each action at length, to ensure that expectations regarding the timeframes for implementation are realistic. Limited capacity is also being mitigated through the provision of dedicated technical assistance from various development partners to the achievement of nearly all specified actions, while the development of the results framework takes into account the limitations of what data is available.

71. **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 through: i) conservative fiscal management; ii) accumulation of cash reserves and foreign exchange reserves to manage shocks; and iii) the Bank's dialogue with Government on appropriate ways to approach and manage expenditure or revenue shocks and pressures.

72. **Political and governance risks result from political uncertainty and frequent Cabinet reshuffles.** Tonga's political system has been recently reformed and is subject to some uncertainty. While the Government has remained stable over the length of the current term, political dynamics within the new system remain a source of potential uncertainty. There have been frequent Cabinet reshuffles and ministerial moves and further changes in the composition of key ministerial posts could present challenges to the momentum of progress with specified actions. Changes in political leadership and potential diversion of political focus from established reform process represent a risk to the results of this operation, since they are dependent on sustained support and implementation. Risks are being mitigated as far as possible through the Bank's dialogue with a range of Ministers and officials on macroeconomic policy issues, which has helped strengthen support around planned reforms across a broad cross-section of the Government.

73. **The risks described above also significantly impact the sustainability of the reforms beyond the current DPO series.** Limited capacity, political volatility and short-term crisis management are also risks to the continued follow-through on supported reform areas beyond the current program. The team intends to mitigate this risk by remaining engaged in close dialogue, coordinated with other partners. Annual budget support operations in Tonga supporting similar pillars have been an effective means of maintained the sustained effort over time that is needed to deliver transformational reform in Tonga.

ANNEX 1: POLICY AND RESULTS MATRIX

Actions taken for First Operation	Prior Actions for Second Operation	Results
Strengthening Public Financial Management		
1. The Recipient has approved a procurement reform action plan outlining a roadmap of regulatory changes in public procurement procedures, addressing major weaknesses observed in the recent procurement review.	1. The Recipient, through its Ministry of Finance and National Planning has: i) Restructured and fully staffed the Central Procurement Unit (CPU); and issued a Treasury Circular to set a new threshold value at TOP 7,500 and above for all procurement to be handled by the CPU in order to improve compliance with procurement best practice standards.	**Outcome: Increased compliance with requirements for public procurement** Indicator: Proportion of contracts awarded by methods other than open competition that are justified in accordance with legal requirement[9]. Baseline (2011): At least 60 percent of the value of contracts awarded Target (2015): At least 80 percent of the value of contracts awarded **Outcome: Improved alignment between budget outturns and the appropriated budget at the sub-program level** Indicators: Percentage of sub-programs overspent or underspend by more than 20 percent Baseline (FY12): 65 percent Target (FY15): 50 percent
2. The Recipient has implemented a new policy to prevent misuse of Contingency Fund including through restricting replenishment to the fourth quarter of the fiscal year.	2. (a) The Recipient's Legislative Assembly has passed the 2014/15 Appropriation Act 2014, which includes standardization between budget sub-programs and organizational divisions in corporate plans; and (b) the Recipient's Ministry of Finance and National Planning has issued a Treasury Circular which introduces new controls on transfers between sub-programs.	
Strengthening Fiscal Management		
3. The Recipient has approved a bill to amend the Recipient's Income Tax Act to provide for a simplified taxation systems for small business.	3. The Recipient's Cabinet has: i) established a new Revenue Policy Committee tasked with reviewing and advising on all requests of discretionary tax exemptions; and ii) approved a framework for standardized and transparent investment incentives in priority economic sectors.	**Outcome: Domestic revenues as a proportion of GDP stabilizes at or above 2013 outturn** Indicator: Domestic revenue as a proportion of GDP Baseline (2013): 18.6 percent Target (2015): 18.6 percent or higher **Outcome: Reduction in ad-hoc tax exemptions** Indicator: Value of ad-hoc exemptions issues by Order of Cabinet that are not in line with approved Incentives Policy as a percentage of total revenues Baseline (FY13): 11 percent Target (FY15): Less than 8 percent **Outcome: Increase in retail price of tobacco, and soft drinks[10]** Indicator: Retail price of tobacco and soft drinks Baseline (2013): Tobacco (TOP 11.25 pack of 25), soft drinks (TOP 2.25 can) Target (2015): Increase in price greater than overall CPI for tobacco and soft drinks
4. The Recipient has approved a bill to amend the Recipient's Income Tax Act to provide for the taxation of extractive industries.	4. The Recipient's Ministry of Finance and National Planning has, through its 2014/2015 Budget Statement, has made adjustments to the excise duty regime in line with NCDs health policy.	

[9] Aligned with the definition of PEFA Dimension PI-19(ii)
[10] As monitored by the Tonga Statistics Office. Retail price data is not monitored for lard or drippings by the Tonga Statistics Office.

Enhancing the Business Enabling Environment		
5. The Recipient has approved two bills on receivership and on business registration to improve the business environment	5. The Recipient's Cabinet has approved a policy framework for foreign investment in order to enable foreign investment in the fisheries and agriculture sector and launched public consultations.	**Outcome: Reduced electricity costs for low-volume consumers** Indicator: Average cost of kWh of electricity for consumers at or below 50kWh a month relative to high-volume consumers (200kWh a month) Baseline: (Jun 2014): TOP 0.92 / TOP 0.92 = 100% Target (2015): < 90% **Outcome: An improved business enabling environment** Indicator: Distance to frontier score for resolving insolvency in the Doing Business Survey[11] Baseline (2013): Resolving insolvency = 28% (DTF) Target (2015): Resolving insolvency > 28% (DTF)
6. The Recipient has approved a policy to restructure Tonga Communication Corporation through the introduction of private participation in order to improve its services and profitability	6. The Recipient's Cabinet has approved the implementation of a sustainably-financed electricity lifeline tariff under provisions of the Public Enterprise Act, in order to support low-income households.	

[11] This is a composite measure of the distance of economies to the 'frontier' which represents the highest performance observed against each of the topics: i) time to resolve insolvency; ii) cost of resolving insolvency as a proportion of the value of the estate; and iii) recovery rate in cents per dollar following insolvency.

ANNEX 2: LETTER OF DEVELOPMENT POLICY

OFFICE OF THEMINISTER FOR FINANCE& NATIONAL PLANNING

MINISTRY OF FINANCE & NATIONAL PLANNING NUKU'ALOFA TONGA

Reference:69/39/1/115

25th September, 2014

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

Dear President Kim,

Re.: Letter of Development Policy

As reflected in our ongoing policy reform partnership with the World Bank over the last four years this Government has overseen significant reforms that have helped to modernise government processes, set in place the foundations for a more sustainable fiscal base, corporatise and improve the efficiency of Public Enterprises and deliver a series of business-friendly reforms to cut red tape and improve the environment for businesses.

Over the same period, the Tongan people have faced numerous setbacks, including the decline in remittances and dip in tourism demand arising from the Global Economic Crisis, severe spikes in the price of fundamental import products like diesel and foodstuffs, and most recently the terrible Cyclone Ian that devastated parts of the Tongan isles in January 2014. We have got back up after each of these shocks and recovered. However, the impacts and losses linger well after the event, and manifest themselves in a lower rate of economic growth than we could otherwise have expected thereby increasing hardship amongst some of the population and a strain on the fiscal and human resources of government.

Despite the external challenges we face, we firmly believe that the course we have set is the right one. With the sustained effort and continued advancement in key areas of reform, we will be in a better position to make good progress to deliver on the promise of the Tonga Strategic Development Framework (TSDF) for "a just, equitable and progressive society in which the people of Tonga enjoy good health, peace, harmony and prosperity, in meeting their aspirations in life". It is with this in mind that myself and my fellow ministers applaud the progress that this Development Policy Operation represents, not just in providing essential fiscal resources to support enhanced service delivery, but the effective knowledge and strong policy partnership that assists us in implementing key reforms.

There are four enabling themes in the TSDF, which will underpin the achievement of its objectives. These concerns progress towards a more efficient and effective government – including efficient government services to facilitate private sector growth through regulatory and

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licensing reforms, improving the macroeconomic environment and fiscal management, ensuring the sustainability and accountability of public enterprises, and ensuring a more coordinated whole-of-government partnership with development partners.

Each of these enabling themes is reflected in the Bank's DPO, which is the fourth successive DPO focused on these themes, and is coordinated with other budget support partners. All the policies represented this year reflect achievements that are key to achieving the government's priority development objectives.

The first component of the Government's reform plan is strengthening public financial management. Under previous operations, Government instituted a new process for in-year fiscal reporting, submitted to the Audit Office all the outstanding financial statements, tabled in Parliament all audited annual financial statements of Government that have been completed up to the financial year 2011/2012, implemented new Contingency Fund controls and launched a new procurement reform action plan. Over the last year, the structure of the Ministry of Finance and National Planning has been amended to establish a new Central Procurement Unit which provides a central oversight function to ensure compliance and improve value for money in procurement across all of government. A newly issued Treasury circular establishes a new threshold over which the CPU will exercise oversight of procurement methods. Another key part of our drive to improve effectiveness of public funds is the implementation of a newly aligned corporate planning and budgeting framework. In the Annual Budget for Fiscal Year 2014/15, the majority of appropriations are now better linked to organizational units, which in turn have specific deliverables, providing greater transparency and oversight over the use of public monies. Again, this reform has been complemented by a Treasury circular that establishes a MFNP pre-approval for transfers to ensure the reforms are built into every ministry's budgeting.

The second component of the Government's reform plan is strengthening fiscal policy. Under previous operations, the Government took decisive action to better manage the public service wage bill and embarked on two important programs on tax and expenditure reform. The Government reviewed tax policy and administration and took steps towards implementation of significant tax policy and administrative reforms, including the small business with natural resource tax regimes being considered. Work is being done for publication in the annual budget statement of the full costs of tax expenditure. This year the government has implemented two tax reforms that acknowledge and seek to address the competing priorities of tax policy –to provide a solid revenue base whilst also supporting other national development priorities. In that light, Cabinet has moved to standardize and make more transparent the hitherto ad-hoc tax exemptions available to potential investors, by establishing a Revenue Policy Committee to advise on all requests and make public a set of eligibility criteria for prospective investors in priority sectors under the TSDF. Secondly, Tonga has recognized the urgency of the non-communicable disease crisis gripping our region, and as part of a broader set of measures, in the Annual Budget for Fiscal Year 2014/15 introduced amended excise duty rates to increase the duty on harmful products like tobacco and high fat and sugar foods, whilst easing rates on healthy choices.

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The third component of the Government's reform plan is enhancing the business-enabling environment. Under previous operations, the Government has improved the business regulatory environment, with important changes to the business licensing regime and associated Business Names Act made that will substantially reduce compliance costs associated with registering and operating a business, and a revised framework for receivership prepared. Efforts have also been made to improve the efficiency of public enterprises, especially those that operate in key sectors, with the audited accounts of key public enterprises now available to the public. There will be a review of those public enterprises that could be considered with good potential for partial and/or full privatization under the prevailing economic conditions.

The government has a long-standing priority to provide more affordable energy, cognizant of the challenges and cost structures faced by Tonga Power Limited. Following a detailed study and public consultation, the Government has moved to implement an electricity lifeline tariff for the first time in Tonga, which will deliver large savings to the poorest households, but crucially not impact on TPL's ability to operate competitively. Over time we will continue to focus on further electricity tariff reform that supports greater generation efficiency. The World Bank has been a long-standing partner in supporting the work on this policy and we wish to recognize the significance of a reform that addresses complex multi-sector policy challenges. While we are continuing to improve the competitiveness of our other PEs, the difficult economic environment and costs of doing business in Tonga continue to make themselves known. Unfortunately, we were not able to finalise the comprehensive process of concessioning the International Dateline Hotel after the selected bidder backed out at the last minute. Nevertheless, we are exploring all avenues to find a solution for this tourism sector flagship hotel. We have initiated a second round of bidding, and should that not be successful, would like to actively engage with the World Bank Group to consider other options for private sector involvement in the Dateline.

Finally, we want to strike the right balance between providing opportunities and jobs for Tongans whilst at the same time welcoming investors and entrepreneurs from abroad that bring capital, skills and the know-how to help us prosper. In light of that, the Government has recognized that the foreign investment regime is overly burdensome and restrictive, and has set in place a plan to bring it in line with our economic growth priorities, especially encouraging investment in commercial agriculture, fisheries and tourism. In reviewing the framework over the last year, it is clear that a significant number of rules and regulations that stretch across two Acts need to be revised, and the changes will need to be consulted on. That is why this year we have launched a new policy framework for foreign investment, an implementation plan and public consultations, which will lead up to revised legislation next year. This is an important reform that this government, a broad group of civil society stakeholders and business leaders, and the Tongan people at large, recognize as crucial in getting the business environment right, and we are confident reforms will be carried forward in a spirit of bipartisanship under any future government.

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The development aspirations of Tonga are strongly reflected in this year's budget, which was passed by Parliament in June. The budget included a continued emphasis on reprioritizing expenditure within sustainable fiscal limits in order to achieve better service delivery. It also provided for the continuation of the Social Protection program started in the previous financial year. The Government also remains determined to take the measures necessary to regain the fiscal space needed for Tonga to be able to respond to future economic shocks and natural disasters.

Despite the ongoing challenges that will no doubt come our way in the coming years, the Government is firmly committed to implementing this medium-term reform program. The Government looks forward to the continued active engagement of the World Bank in Tonga, in order to support this reform process.

Yours sincerely,

MINISTER FOR FINANCE & NATIONAL PLANNING * TONGA *

'Aisake Valu Eke
Minister of Finance and National Planning

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ANNEX 3: FUND RELATIONS ANNEX

INTERNATIONAL MONETARY FUND

COM COMMUNICATIONS DEPARTMENT

Press Release No. 14/386
FOR IMMEDIATE RELEASE
August 6, 2014

International Monetary Fund
700 19th Street, NW
Washington, D. C. 20431 USA

IMF Executive Board Concludes 2014 Article IV Consultation with Tonga

On July 23, 2014, the Executive Board of the International Monetary Fund (IMF) concluded the Article IV consultation[1] with Tonga.

A major cyclone hit Tonga in January 2014, causing damage estimated at 10 percent of GDP and depressing GDP growth in fiscal year (FY) 2013–14(to June 30) by about 1 percent. As a result, after sluggish growth of 0-1 percent in FY2012–13, the pace of recovery will rise to just 1.4 percent in FY2013–14 before strengthening to 3.4 percent in FY2014–15, led mainly by the post-cyclone reconstruction. This recovery is also supported by rising agricultural production and an improving outlook for tourism. Over the longer term, growth is expected to gradually converge to the historical trend of 1.7 percent, driven by remittances, tourism receipts, as well as credit growth. Risks to the near-term outlook are tilted to the downside.

Risk to the inflation outlook is low. Headline consumer price index (CPI) inflation has largely fluctuated between 1 to 2 percent since mid 2012, reflecting low global food prices, stable oil prices, and weak domestic demand. Inflation is expected to incrementally increase to 4-5 percent toward FY2018–19. The deleveraging cycle of the Tongan banks appears to be ending, with both lending and asset quality indicators substantially improving.

The projected fiscal cost relating to the cyclone will be broadly met by confirmed funding mainly from donor agencies. As a result, the budget is expected to record only small overall deficits in FY2013–14 and FY2014–15, estimated at around 0.6-0.7 percent of GDP. The external current account is projected to show a deficit of close to 3 percent of GDP in FY2013–14 and FY2014–15, largely financed by foreign direct investment (FDI) inflows. International reserves increased about threefold since 2008—to about 8 months of prospective imports. In the medium term, stronger imports and lower foreign grants will slightly decrease international reserves to 7 months of imports.

Executive Board Assessment[2]

[1] Under Article IV of the IMF's Articles of Agreement, the IMF holds bilateral discussions with members, usually every year. A staff team visits the country, collects economic and financial information, and discusses with officials the country's economic developments and policies. On return to headquarters, the staff prepares a report, which forms the basis for discussion by the Executive Board.

Executive Directors welcomed that Tonga's economy is rebounding, supported by a recovery in agricultural exports and post-cyclone reconstruction activity. Directors noted that while the near-term focus should be on reconstruction, in the medium term, priority should be given to building buffers to enhance resilience to shocks. Business-enabling structural reforms will be key to achieving sustainable and robust growth.

Directors encouraged the authorities to maintain overall fiscal prudence while accommodating cyclone-related financing needs. They welcomed that the projected fiscal cost related to the cyclone will be broadly met by funding from development partners. Over the medium term, the fiscal strategy should aim to gradually increase the primary surplus, and to reduce the debt-to-GDP ratio. In this context, Directors underscored the need to continue with revenue reform and wage restraint, strengthen debt management, and avoid cost overruns associated with the South Pacific Games.

Directors considered the current accommodative monetary policy stance appropriate. They agreed that the National Reserve Bank of Tonga (NRBT) should consider tightening monetary conditions when signs of credit growth firm up. Directors welcomed the plan to expand the NRBT's regulatory mandate to include nonbank financial institutions, and supported continued efforts to address bottlenecks in credit information and creditor rights. They noted that the authorities' plan to lower the cost of credit through supportive measures, including by commercializing Tonga Development Bank, should be accompanied by robust safeguards to ensure the soundness of the bank.

In view of challenges posed by Tonga's geographic remoteness and smallness, and its exposure to natural disasters, Directors encouraged the authorities to identify and strengthen new engines of growth. They underscored the need to continue to improve the business environment and to bolster confidence. Directors agreed that the promotion of foreign direct investment should focus on business-enabling structural reforms, while the use of tax incentives should be minimized and well targeted.

[2] At the conclusion of the discussion, the Managing Director, as Chairman of the Board, summarizes the views of Executive Directors, and this summary is transmitted to the country's authorities. An explanation of any qualifiers used in summings up can be found here: http://www.imf.org/external/np/sec/misc/qualifiers.htm.