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INTERNATIONAL DEVELOPMENT ASSOCIATION

PROGRAM DOCUMENT

FOR A PROPOSED DEVELOPMENT POLICY GRANT

IN THE AMOUNT OF SDR 4.0 MILLION (EQUIVALENT TO US$ 5.5 MILLION)

TO THE

KINGDOM OF TONGA

FOR THE

THIRD INCLUSIVE GROWTH DEVELOPMENT POLICY OPERATION

April 19, 2019

Macroeconomics, Trade and Investment Global Practice
East Asia and Pacific Region

Kingdom of Tonga

GOVERNMENT FISCAL YEAR
July 1 – June 30

CURRENCY EQUIVALENTS
(Exchange Rate Effective as of
March 31, 2019)

Currency Unit	Tongan Pa'anga
US$ 1.00	TOP$ 2.33
SDR 1.00	US$ 1.38825

ABBREVIATIONS AND ACRONYMS

ADB	Asian Development Bank
AFS	Annual Financial Statement
BSMC	Budget Support Management Committee
CEO	Chief Executive Officer
CoA	Chart of Accounts
DFAT	Department of Foreign Affairs and Trade
DPO	Development Policy Operation
DSA	Debt Sustainability Analysis
EAP	East Asia Pacific
EIA	Environmental Impact Assessment
ERB	Employment Relations Bill
EU	European Union
FDI	Foreign Direct Investment
FY	Fiscal Year
GDP	Gross Domestic Product
GoT	Government of Tonga
GRS	Grievance Redress Service
HIES	Household Income and Expenditure Survey
ICT	Information and Communication Technology
IDA	International Development Association
IFMIS	Integrated Financial Management Information System
ILO	International Labor Organization
IMF	International Monetary Fund
JPRM	Joint-Policy Reform Matrix
MOF	Ministry of Finance
MFAT	Ministry of Foreign Affairs and Trade
MPE	Ministry of Public Enterprises
NCD	Non-Communicable Disease
NPL	Non-Performing Loan
NRBT	National Reserve Bank of Tonga
OCO	Oceania Customs Organisation
PAT	Ports Authority Tonga
PE	Public Enterprise
PEFA	Public Expenditure and Financial Accountability
PFM	Public Financial Management
PFTAC	Pacific Financial Technical Assistance Centre
PIC	Pacific Island Country
PIC8 SCD	Systematic Country Diagnostic for 8 small PICs
PPG	Public and Publicly-Guaranteed
PPP	Public-Private Partnership
PSC	Public Service Commission
PV	Present Value
RPF	Regional Partnership Framework
SDR	Standard Drawing Right
SME	Small and Medium Enterprises
SORT	Standardized Operational Risk-Rating Tool
TA	Technical Assistance
TCC	Tonga Communications Corporation
TCL	Tonga Cable Limited
TIN	Tax Identification Number
TOP	Tongan Pa'anga
TSCP	Transport Sector Consolidation Project
TSDF II	Tonga Strategic Development Framework 2015-2025
WBG	World Bank Group

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KINGDOM OF TONGA

THIRD INCLUSIVE GROWTH DEVELOPMENT POLICY OPERATION

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SUMMARY OF PROPOSED GRANT AND PROGRAM
Kingdom of Tonga
Third Inclusive Growth Development Policy Operation

Recipient	Kingdom of Tonga
Implementation Agency	Ministry of Finance
Financing Data	SDR 4.0 million (US$ 5.5 million equivalent) IDA Grant. Standard IDA grant terms.
Operation Type	The proposed operation is the third development policy operation in a programmatic series of three operations. It will be provided in a single tranche.
Pillars of the Operation and Program Development Objective(s)	The Program Development Objective is to: i) <u>Support fiscal resilience</u> by means of strengthened revenue mobilization and strategic fiscal and debt policies; ii) <u>support improved government accountability</u> by improving compliance with public procurement regulations, improving budgetary classifications, and improving the adequacy of responses to external audit; and iii) <u>support a more dynamic and inclusive economy</u> by adopting investor-friendly foreign investment legislation, improving oversight and private participation in public enterprises, introducing regulation to private sector labor markets, and strengthening regulatory frameworks in selected sectors.
Result Indicators	<u>Development objective (i): Support fiscal resilience</u> 1) Increase in domestic revenue as a proportion of GDP 2) Ensure that annual budget estimates are consistent with medium term fiscal anchors, and that any divergences are adequately explained 3) All new external debt taken on is highly concessional 4) Reduction in public wage bill as a proportion of domestic revenue over time 5) Increases in public sector wages are based on performance as measured by an annual moderated performance assessment process <u>Development objective (ii): Support improved government accountability</u> 6) Increase in the proportion of contracts that are subject to open competition 7) Improvement in the proportion of audit recommendations acted on 8) Chart of Accounts revision reflected in budget systems 9) Regulators for the communication and energy sectors are established and operational <u>Development objective (iii): Support a more dynamic and inclusive economy</u> 10) Basic labor market protections introduced 11) Increase in applications for investment permits from prospective foreign investors 12) Public enterprises reformed to increase private participation
Overall risk rating	Substantial
Climate and disaster risks *(required for IDA countries)*	There are short- and long-term climate and disaster risks relevant to the operation (as identified as part of the SORT environmental and social risk rating)
Operation ID	P159263
Closing date	September 30, 2020

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

1. INTRODUCTION AND COUNTRY CONTEXT

1. **This operation is the last in a programmatic series of three operations designed to build fiscal resilience, support accountability and promote inclusive growth in Tonga.** The operation will consist of a US$5.5 million equivalent grant. Australia, through its Department of Foreign Affairs and Trade (DFAT), the Asian Development Bank (ADB) and the European Union (EU) are all expected to provide budget support this year against actions and indicators in the joint policy reform matrix (JPRM) supported by this operation, while New Zealand, through its Ministry of Foreign Affairs and Trade (MFAT), provided budget support in FY2018 based on the expected completion of this set of actions.

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

3. **This programmatic engagement reflects a strong Government reform program, and a continuation of the reform partnership with development partners.** The current three-operation program builds on two previous two-year programs implemented over the period FY2012 to FY2015. The previous development policy engagements supported domestic revenue mobilization and public financial management reforms while addressing private sector constraints. For this programmatic engagement, the Bank has worked with the Government of Tonga (GoT) and development partners to elaborate key reform actions via the formulation of a JPRM that outlines shared reform priorities, and is fully aligned with the GoT's national development plan—the Tonga Strategic Development Framework 2015-2025 (TSDF II)—and the Budget priorities of the government.[1] This operation reflects an extension and deepening of previous reforms in the areas of revenue mobilization, wage bill management, public financial management (PFM), foreign investment facilitation and public enterprise performance. It also includes landmark employment relations legislation that codifies basic labor rights for the first time in Tonga. The operation thus reflects a very substantive reform program overall, while also supporting implementation and follow-up in key policy areas that strengthen the foundations for inclusive growth in Tonga.

4. **Tonga is a small Pacific island nation that has just undergone major democratic changes.** Tonga's population of 108,000 is dispersed across 36 of its 177 islands with around one quarter of the population based in the capital of Nuku'alofa. Tonga is a constitutional monarchy. Until 2010, the legislative assembly of 16 representatives consisted of 9 unelected noble representatives and 7 elected "people's" representatives. Major constitutional reforms in April 2010 saw the legislative assembly change to become majority democratically elected, with 17 elected representatives and 9 nobles. There have been three elections since the reforms. In November 2010, a party led by the nobles formed government. The next election in November 2014 saw a hand-over of power to a party led by elected representatives for the first time in Tonga's history. The elected Prime Minister, the Honorable 'Akilisi Pohiva, co-founded the first democratic party in Tonga and has been a leading figure in the call for democratic change. However, in August 2017 King Tupou VI unexpectedly dissolved the Parliament, more than a year before the end of its

[1] The TSDF II was finalized in early 2015 and reflects the priorities of the Government that took office in late 2014. While there was an election in 2017, the same party and Prime Minister were returned to office, and the new Government has retained the TSDF II as the overall national development plan.

term. In the subsequent national elections in November 2017, the Honorable ʻAkilisi Pohiva was returned as Prime Minister, with his party winning an expanded majority in the Parliament.

5. **Like many other small Pacific island nations, Tonga's economic growth potential is constrained by structurally high costs of production and public service delivery and exposure to economic and environmental shocks.** Its location makes Tonga the most geographically remote nation from major centers of economic activity in the world[2]. Over the last twenty years, per capita GDP has grown by 1.3 percent on average, compared to 2.3 percent globally. While this growth is modest by developing country standards, it is faster than the small Pacific islands average (0.9 percent). In any given year, it is likely that Tonga is either hit by or recovering from a major natural disaster. Small size and remoteness combine to push up the cost of economic activity in Tonga, limiting the competitiveness of its exports of goods and services in world markets and reducing the potential to realize economies of scale. Small size and remoteness also push up the cost of providing public services. High dependence on imports combined with a lack of sufficient size for meaningful diversification makes Tonga highly vulnerable to external economic shocks. These factors combine to make growth particularly elusive in Tonga.

6. **Tonga's vulnerability to natural disasters was again highlighted in February 2018, when Tropical Cyclone (TC) Gita is estimated to have caused physical damages and economic losses of TOP$356 million (US$164 million), equivalent to 38 percent of Tonga's FY2017 GDP.** On 12 February 2018 the islands of Tongatapu and ʻEua were hit by TC Gita, a level 4 cyclone that was the strongest tropical cyclone to impact these islands since TC Isaac in March 1982. The cyclone caused widespread damage to commercial and private property, crops and fruit trees, and public infrastructure, including power lines, schools, the domestic airport and Parliament building. Over 800 houses were destroyed and a further 4,000 damaged. The disaster is estimated to have affected 75 percent of Tonga's population (80,000 people). The Government of Tonga's (GoT) Disaster Recovery Framework estimated the total recovery and reconstruction needs to be TOP$347 million (US$160 million) over the four years FY2018 – FY2021. While some of the burden of the reconstruction and recovery costs will fall on the private sector and households, the GoT expects to assume up to two-thirds of the costs (TOP$246 million, US$113 million). This includes repairs and reconstruction in the infrastructure, energy, health and education sectors, and support to households for repairs to damaged housing. The World Bank provided US$10 million in supplemental financing for the Second Inclusive Growth Development Policy Operation to help the GoT cover the unanticipated financing gap that arose due to the impact of TC Gita. Despite some delays in reconstruction spending (see paragraph 19)—for example, the rebuilding of school infrastructure and housing—services have generally been restored, although at somewhat sub-optimal levels in some areas.

7. **Extreme poverty is rare in Tonga but there are significant levels of material deprivation, especially in rural areas, posing a serious challenge to securing prosperity for all**. Preliminary estimates based on the 2015/16 Household Income and Expenditure Survey (HIES) show that less than 1 percent of Tongans live below the international poverty line of $1.90 a day, but a higher share of the population are struggling to meet the cost of local basic needs. Tonga's national poverty statistics, based on the Consensual Method of estimation (a sociological approach which reflects the extent to which people can achieve a basic standard of living as defined by a majority of the population), indicate that around a quarter of the population were living in poverty in 2015/16. Poverty rates were particularly high in rural and remote areas relative to urban areas: 17 percent in rural Tongatapu and 47 percent on the other islands on average, relative to 14 percent in urban Tongatapu. The estimated Gini coefficient of 41.7 is in line with other countries in the East Asia Pacific (EAP) region, controlling for income.

8. **Social and human development indicators are amongst the strongest in the Pacific, but challenges**

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

remain and there are important gender disparities that adversely affect development outcomes for women. Primary and secondary school net enrollment rates are relatively high at 87 percent and 76 percent, respectively. The quality of education remains a challenge though, with children scoring poorly on early-grade reading assessments. Under-five mortality, at 16 per 1000, continues to decline, while 96 percent of births are attended by skilled health staff. However, the growing crisis of non-communicable diseases (NCDs) threatens to reverse improvements, with some evidence suggesting that life expectancy in Tonga is now falling as a result of NCDs. While women generally are not more likely to be poor in Tonga, they outperform men in education participation at all levels. Women are relatively well represented in senior management levels[3]. At the same time, they face a number of serious challenges. Women are underrepresented in politics: there is only one female in Cabinet and only two female Members of Parliament. Forty percent of ever-partnered women aged 15-49 have experienced gender-based violence. Women have a higher non-communicable disease burden, are 20 percent more likely to be obese than men, and are almost 10 percent more likely to die prematurely.

9. **The program supports objectives that are critical to strengthening the foundations for inclusive growth in Tonga.** The Program Development Objective is to: i) support fiscal resilience by means of strengthened revenue mobilization and strategic fiscal and debt policies; ii) support improved government accountability by improving compliance with public procurement regulations, improving budgetary classifications, and improving the adequacy of responses to external audit; and iii) support a more dynamic and inclusive economy by adopting investor-friendly foreign investment legislation, improving oversight and private participation in public enterprises, introducing regulation to private sector labor markets, and strengthening regulatory frameworks in selected sectors.

10. **Reforms supported by this operation will contribute to all three pillars of the Program Development Objective.** To support fiscal resilience, policy actions comprise the adoption of revised revenue and customs legislation that will support improved revenue administration and efficiency, including by setting updated and graduated penalties for non-compliance and aligning customs practices with international standards; and improvements to the administration of the new public sector remuneration framework and performance management system. To support improved government accountability, this operation supports reform that improves the GoT's accounting and financial reporting system. To support a more dynamic and inclusive economy, the operation supports legislation that—for the first time in Tonga—codifies basic labor rights and protections and reduces gender disparities; the adoption of revised foreign investment regulations; and reforms the management model of an important public enterprise.

11. **This operation will support the achievement of the twin goals by strengthening the inclusivity of growth to support shared prosperity and improving economic prospects for women and vulnerable groups.** This engagement is a product of the GoT's inclusive growth program and the World Bank's Systematic Country Diagnostic for the eight small Pacific islands (PIC8 SCD). It seeks to target the main constraints to achieving the twin goals under the selected pillars and is based on a solid analytical basis and strong government ownership. Reform actions supported by this operation under the first and third pillars of the development objective—to build fiscal resilience and promote inclusive growth—are expected to help reduce poverty and boost shared prosperity in Tonga. The public sector is a key provider of infrastructure and services that low-income households need to improve their opportunities. By supporting fiscal resilience, the policy actions under the first pillar will help ensure that the government has more fiscal space to respond to future economic shocks and natural disasters, which tend to have a particularly adverse impact on the poor, while maintaining critical health, education, and community services on which the bottom 40 per cent are particularly dependent. Efforts to build up fiscal space in recent years put the government in a stronger fiscal position than it otherwise would have been to deal with the pressing cyclone recovery needs

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

following the impacts of TC Gita in early 2018. By improving the environment for private sector activity, reforms under the third pillar should help bring jobs and opportunities to Tonga, including for the poorest and most vulnerable, while ensuring basic labor rights are protected for women and workers currently at risk of exploitation.

12. **The proposed operation carries substantial risk due to thin capacity in the public sector and vulnerability to external economic shocks and natural disasters.** The proposed operation faces two main risks. Firstly, Tonga experiences the thin capacity typical of public sectors in very small states, with a small number of qualified public servants called upon to implement the many tasks of a central government. This implies that program implementation can be directly affected by the performance or departure of a few officials. This risk has been demonstrated in the aftermath of TC Gita, with the burden of coordinating the immediate disaster relief effort, followed by the longer-term recovery and reconstruction phase, falling to a small cadre of key public servants, on top of their already high-level of responsibility for the day-to-day functioning of government. Secondly, macroeconomic stability is dependent on a continued sustainable fiscal position, and stable external financial flows including remittances and development assistance from donors. Despite the focus of this policy program on building fiscal resilience, relatively large sources of possible risk remain, including a high public wage bill, and the future repayment of sizeable existing loans. Policy slippages or macroeconomic disruption arising under several feasible shock scenarios, including another natural disaster or a substantial scaling back of external assistance, could divert available capacity and resources from the implementation of actions supported by the program and/or reduce the sustainability of government finances. To mitigate these risks, the World Bank intends to continue its close economic and fiscal dialogue in support of reform as a primary means of managing risks related to limited capacity and is also engaged at a policy and operational level to support Tonga in its management of disaster risks. In the event of unexpectedly large future pressures on the budget, the government is expected to rely on additional support from development partners and reallocations of domestic spending.

2. MACROECONOMIC POLICY FRAMEWORK

2.1 RECENT ECONOMIC DEVELOPMENTS

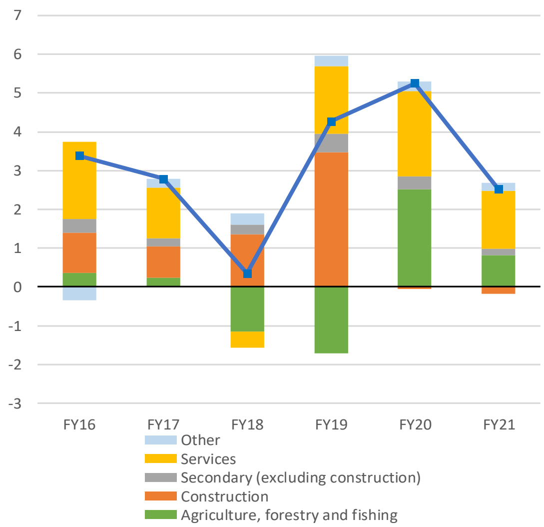
13. **Tonga's economic growth has been low by global standards, and adversely affected by the frequent occurrence of natural disasters and external price shocks.** Tonga experienced low average growth over the decade prior to TC Gita, averaging 2.2 percent annually.[4] Growth has also been volatile, with deep recessions in FY2007 and FY2013 being offset by growth spurts over the periods FY2008—FY2012 and FY2014—FY2017, driven by public construction following political disturbances in 2006, and reconstruction and strong remittance inflows following the impacts of TC Ian in January 2014.

14. **Damages and losses caused by TC Gita had a substantial effect on economic activity in FY2018, with the economy estimated to have expanded by less than 1 percent.** Published in January 2018—just prior to the cyclone—the IMF's latest Article IV report noted a favorable economic outlook, with growth forecasted to register around 3 percent in each year over the period FY2018—FY2020, driven by a pickup in construction, agricultural production, and tourist spending. Immediately after TC Gita struck, FY2018 growth was revised down sharply, reflecting the estimated impact on agricultural crops and fruit trees, lost production in the wholesale and retail trade sector, and reduced tourism receipts (although these losses were expected to be offset somewhat by initial repair and reconstruction activity). Estimates of FY2018 economic activity from the GoT's FY2019 Budget Statement indicate that losses sustained in the agriculture

[4] This marks a marginal improvement compared to the previous decade, however, in which growth averaged just 1.5 percent.

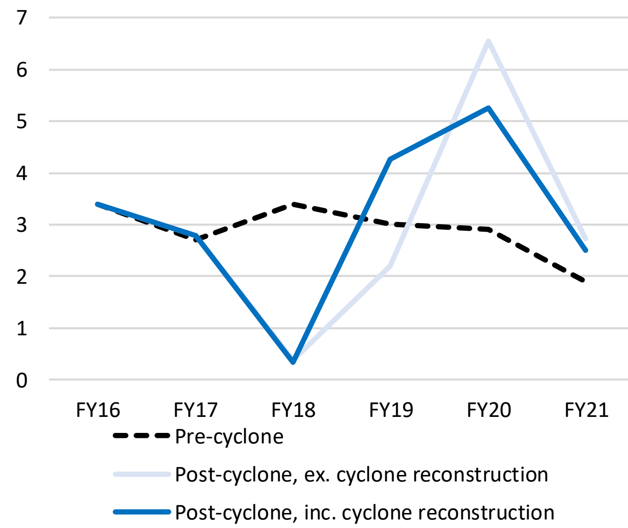
and commercial sectors were not as great as initially projected—although the roll-out of public reconstruction spending was also slower than expected. Overall, growth is now expected to have slowed to less than 1 percent in FY2018, with TC Gita shaving off over 2.5 percentage points from growth in FY2018 (Figure 1, Figure 2, Table 1).

Figure 1: Contributions to Growth
(Percentage point)



Source: World Bank Staff Estimates

Figure 2: Pre- vs Post-cyclone GDP projections
(Percent)



Source: World Bank Staff Estimates

15. **Inflation spiked in FY2017 due to one-off factors and remained high in FY2018 due to the impact of the cyclone on food stocks but is expected to moderate over the medium term.** Inflation spiked to 7.2 percent in FY2017 due to dry weather which pushed up domestic food prices, as well as policy-driven tax increases on fuel, alcohol, tobacco, and less healthy foods and drinks. Prior to TC Gita, the outlook was for inflation to ease in FY2018, following the pass through of the one-off effects that pushed up prices in 2017. However, lost production due to the cyclone put some upward pressure on food prices, with year-average inflation remaining high at 7 percent in FY2018. Meanwhile, the Pa'anga has remained relatively stable against the currencies of Tonga's major trading partners over the last couple of years. This has allowed the National Reserve Bank of Tonga (NRBT) to maintain its accommodative monetary policy stance, which is designed to support growth and the recovery from TC Gita. The latest IMF Article IV report (published in January 2018) assessed the level of the exchange rate as broadly in line with medium-term fundamentals and expected inflation to return to around 3 percent over the medium term. The NRBT is considering moving towards a new indicative inflation reference rate that is more in line with the medium-term inflation outlook.

16. **Private sector credit growth remains solid, supported by government initiatives and accommodative monetary policy.** Following a prolonged period of balance sheet adjustment, over the past five years Tonga's banking sector has returned to a sound footing, reflected by a strong capital position, comfortable profitability, and low non-performing loans (NPLs). In the wake of an abrupt end to a housing market bubble which saw NPLs peak at 20 percent in 2009 and private sector credit fall cumulatively by 34 percent over the period FY2009 to FY2014, the NRBT implemented a number of macro-prudential and regulatory reforms, including a new set of legislation governing the central bank, the banking sector, and the non-bank financial sector. Following improvements in banks' capital and credit quality, NPL ratios have trended down, and stood at 3.9 percent in February 2018. Supported by government initiatives—including a subsidized lending scheme through the Tonga Development Bank and lower lending rates due to accommodative monetary policy—domestic private sector credit expanded by almost 7 percent in FY2018, which was a moderation in growth compared with previous years, though still faster than nominal GDP growth.

Table 1: Key Macroeconomic Indicators

	FY2014	FY2015	FY2016	FY2017	Est. FY2018	Proj. FY2019	FY2020	FY2021
Real Economy	Annual percentage change, unless otherwise indicated							
GDP (nominal Pa'anga m)	804.5	846.1	889.5	950.9	988.0	1,061.3	1,139.3	1,191.8
Real GDP growth	2.1	3.7	3.4	3.0	0.3	4.3	5.3	2.5
Per Capita GDP (in current $US)	4,278	4,168	3,842	4,113	4,099	4,390	4,704	4,907
GDP deflator	1.0	1.4	2.4	3.9	3.6	3.2	2.1	2.1
Inflation (CPI, average)	2.3	0.1	-0.6	7.2	7.0	5.5	4.5	3.8
Fiscal Accounts	Percent of GDP, unless otherwise indicated							
Total Revenues and Grants	37.7	34.9	40.9	44.0	45.0	55.3	49.9	46.6
Total Expenditures	31.3	37.6	41.3	44.5	43.7	56.6	52.2	47.3
General Government Balance	6.4	-2.7	-0.4	-0.4	1.3	-1.3	-2.3	-0.7
Selected Monetary Accounts	Annual percentage change, unless otherwise indicated							
Money Supply (M2)	8.0	2.4	15.0	13.0	9.4	..	..	..
Credit to Private Sector	-0.6	8.9	17.5	18.0	6.7	..	..	..
Balance of Payments	Percent of GDP, unless otherwise indicated							
Overall Balance	2.5	-3.7	6.0	6.0	4.0	-3.3	-3.1	-1.4
Current Account Balance	-6.7	-15.0	-13.9	-11.7	-6.7	-12.8	-12.2	-10.2
Trade Balance	-40.6	-47.9	-46.9	-51.7	-53.8	-69.4	-61.6	-57.6
Goods Exports	4.0	4.5	6.0	5.9	4.4	4.4	5.5	5.3
Goods Imports	-42.2	-47.9	-50.6	-54.4	-61.5	-67.8	-63.1	-58.9
Services (net)	-2.4	-4.5	-2.3	-3.2	3.3	-6.0	-4.1	-3.9
Investment Income (net)	0.7	1.0	0.6	1.6	-0.9	2.6	2.6	2.6
Current Transfers (net)	33.1	31.8	32.4	38.4	48.0	54.0	46.8	44.8
Capital and Financial Accounts	9.3	11.3	19.8	17.7	10.6	9.5	9.1	8.8
Foreign Direct Investment	1.7	2.4	2.6	2.7	2.8	2.8	2.8	2.8
Gross Reserves (in $US m, e.o.p)	158.7	142.5	166.4	192.2	209.3	194.0	178.6	171.4
In months of next year's imports	6.8	6.3	6.3	6.9	5.9	5.5	5.1	5.1
Terms of Trade (annual percent change)	1.5	-3.6	2.1	2.9	-1.8	-0.5	0.0	0.5
Other Memo Items								
GDP (nominal $US m)	444.5	433.9	400.7	430.3	429.6	461.4	495.3	518.2
Nominal public sector debt (% GDP)	47.1	51.4	49.2	51.0	53.1	54.3	56.2	56.3
Exchange rate (TOP per $US, average)	1.8	2.0	2.2	2.2	2.3	..	..	..
Remittances (% of GDP)	23.1	23.6	28.0	27.2	30.3	29.0	28.7	28.8

Source: IMF and World Bank staff estimates.

17. **The current account deficit is driven by construction cycles, with remittances a key source of support, and is largely financed by development grants and foreign direct investment (FDI).**[5] The current account deficit has remained sizeable over recent years, driven by construction-related imports, which have been largely financed by capital grants. Prior to the cyclone, the deficit was projected to remain at around 12-13 percent of GDP in FY2018 and FY2019. As a result of TC Gita, the trade deficit widened in FY2018 due to an increase in imports and a decline in exports of agricultural products and tourism services. However, this was more than offset by increased development assistance and remittances to support disaster recovery, which resulted in a narrowing of the current account deficit and a small overall surplus on the balance of payments in FY2018. The pick-up in imports was due to two factors: (i) increased food imports to offset the lost domestic production of fruit and vegetables; and (ii) increased imports of building materials and fuels related to the most urgent repair and reconstruction needs. Nevertheless, the slower-than-

[5] Recent years have seen improved remittance growth following the expansion of overseas worker programs such as the Australian Seasonal Worker Program and the New Zealand Recognized Seasonal Employers Program.

expected roll-out of public reconstruction spending meant that FY2018 imports did not increase by as much as the GoT's initial estimates of short-term recovery needs had indicated. Exports of agricultural produce declined in FY2018, in line with the projected effects on economic activity in the agricultural sector. In line with the small balance of payment surplus, foreign reserves rose to over USD 209 million by the end of FY2018, equivalent to 6 months of imports cover.

18. **Authorities have maintained a generally prudent fiscal stance in recent years.** Careful prioritizing of public investment and a strong domestic revenue performance saw the overall deficit (after grants) shrink from 7.4 percent of GDP in FY2011 to small deficits of 0.4 percent of GDP in FY2016 and FY2017.[6] Consequently, Tonga's fiscal balance averaged a modest deficit of less than 1 percent of GDP over the six years FY2012 to FY2017. Domestic revenues increased by almost 8 percentage points of GDP over the same period, and government cash buffers were built to 2.6 months of expenses, reflecting the government's commitment to improving fiscal resilience—including through DPO-supported reforms to: review tax exemptions and investment incentives; increase excise rates on fuel and unhealthy foods; and introduce a Medium-Term Debt Management Strategy and a set of transparent fiscal anchors with targets for debt, revenue, and the wage bill. At the same time, total public expenditure also increased, mostly in response to reconstruction needs following TC Ian (which struck the country in FY2014), investments in key maritime, transport and energy infrastructure, and increases in wages for civil servants. Ongoing public enterprise (PE) reform has also supported improved fiscal resilience—as improved profitability since 2009 has led to Tonga's PE portfolio switching from being a drag on the fiscal accounts to making a net contribution to government in recent years.

19. **Despite the substantial recovery and reconstruction needs, delays in the scaling up of public spending resulted in a small fiscal surplus in FY2018.** Prior to TC Gita, both the GoT and the IMF had projected a widening of the fiscal deficit for FY2018. After TC Gita struck, the GoT demonstrated its willingness to control own-financed capital spending by freezing various sports and leisure-related investments, which together with freezes to staff hiring saved around TOP$35 million from the FY2018 budget. Reprogramed spending and a drawdown from the National Emergency Fund freed up TOP$3.3 million in own-source finances for disaster-relief spending. International donors were also quick to respond, providing TOP$43 million in emergency assistance (much of which was in-kind). However, there were delays in the roll-out of recovery-related public spending in the months following TC Gita, given capacity constraints. Consequently, the GoT registered a small fiscal surplus in FY2018, although a return to deficits is expected over the projection period as recovery and reconstruction spending steps up (Table 2).

20. **The public-sector wage bill continues to place pressure on overall spending, but growth should be contained over the medium-term because of recent reforms**. The wage bill blew out to 15.3 percent of GDP in FY2006 after a large pay rise in the wake of public service pressure that also contributed to the Nuku'alofa riots. In the years following, supported by DPO actions, steady progress was made to bring the wage bill under control, with the cost falling to 10.4 percent of GDP in FY2012. However, further pressures led to two pay increase settlements of 6 percent and 5 percent in FY2014 and FY2016 respectively, highlighting the need for a more systematic approach to managing public service remuneration, as supported by this program. Despite the staff hiring freeze following TC Gita, one-off transition costs associated with the implementation of the new remuneration framework led to a slight increase in the wage bill as a percentage of GDP in FY2018.

21. **Generally prudent fiscal management has kept public debt in check, though Tonga's external debt distress rating moved from moderate to high risk in December 2017.** The change in classification was due to efforts to better account for the average annual impact of natural disasters in the IMF/World Bank Debt

[6] Fluctuations in development assistance and low capital spending saw the fiscal accounts register a one-off strong surplus in FY2014.

Sustainability Analysis (DSA). The 2017 DSA incorporated natural disaster effects in the baseline, by reducing long-term annual growth by 0.7 percentage points (from 1.8 percent to 1.1 percent) and introducing an additional average debt-creating flow of 1 percent of GDP per year to finance recovery efforts. While the change in risk rating does provide a more accurate picture of Tonga's debt situation, it does not indicate that Tonga's debt position has worsened recently. Tonga's external public debt has remained well below the government's threshold of 50 percent in recent years (which is consistent with a PV of external public debt of around 35 percent, below the 'high risk' threshold of 40 percent), and the GoT has successfully maintained a stance of avoiding any new non-concessional external borrowing, consistent with its Medium-Term Debt Strategy.

Table 2: Key Fiscal Indicators

					Est.	**Proj.**		
	FY2014	**FY2015**	**FY2016**	**FY2017**	**FY2018**	**FY2019**	**FY2020**	**FY2021**
	Percent of GDP, unless otherwise indicated							
Overall Balance (including grants)	6.4	-2.7	-0.4	-0.4	1.3	-1.3	-2.3	-0.7
Overall Balance (excluding grants)	-11.3	-16.2	-17.2	-18.9	-17.5	-31.0	-27.0	-21.3
Primary Balance	7.3	-1.9	0.5	0.4	2.1	-0.6	-1.6	0.0
Total Revenues and Grants 1/	**37.7**	**34.9**	**40.9**	**44.0**	**45.0**	**55.3**	**49.9**	**46.6**
Domestic revenues	20.0	21.4	24.1	25.6	26.2	25.6	25.1	26.0
of which: Consumption Tax	11.8	12.2	14.5	15.0	15.4	14.9	14.6	15.3
Taxes on Income and Profits	3.6	4.1	4.0	4.8	4.1	4.0	4.0	4.0
Other Tax Revenue	1.9	2.0	2.3	2.6	2.7	2.7	2.7	2.7
Non-tax Revenues	2.7	3.1	3.4	3.2	4.1	4.0	3.9	4.0
Grants	17.7	13.5	16.8	18.4	18.8	29.7	24.7	20.6
Total Expenditure 1/	**31.3**	**37.6**	**41.3**	**44.5**	**43.7**	**56.6**	**52.2**	**47.3**
Current Expenditure	27.8	31.6	32.0	33.7	33.9	39.0	36.7	34.0
Wages and Compensation 2/	12.6	13.7	14.3	13.6	13.9	13.8	13.6	12.9
Goods and Services	10.6	12.1	12.1	12.3	14.8	18.4	17.1	15.6
Interest Payments	0.9	0.8	0.9	0.9	0.8	0.8	0.7	0.7
Current Transfers	1.7	2.6	2.8	2.7	2.5	2.8	2.7	2.4
Other Expenses	2.0	2.4	1.9	4.2	1.9	3.2	2.7	2.4
Development Expenditure	3.4	6.0	9.4	10.7	9.8	17.6	15.5	13.3
General Government Financing	**-6.4**	**2.7**	**0.4**	**0.4**	**-1.3**	**1.3**	**2.3**	**0.7**
Domestic (net)	-6.1	3.1	0.2	0.2	-2.4	0.3	0.2	-0.7
External (net)	-0.3	-0.4	0.2	0.2	1.1	1.0	2.1	1.4
Memorandum Items								
Cash Reserves (Pa'anga m)	..	..	..	69.8	77.4	66.6	59.7	60.5
In months of current expenditure	..	..	..	2.6	2.8	1.9	1.7	1.8
Wages and Compensation								
as % domestic revenues	63.2	63.9	59.3	53.2	53.3	54.0	53.9	49.7
as % current expenditure	45.4	43.3	44.8	40.4	41.1	35.4	37.0	38.0

1/ Excludes in-kind development grants and expenditure

2/ Includes employer contributions to defined-contribution pension scheme

Source: IMF and World Bank staff estimates.

2.2 MACROECONOMIC OUTLOOK AND DEBT SUSTAINABILITY

22. **Reconstruction activities and a recovery in the agriculture sector will be the key drivers of the economic outlook over the next three years.** The scaling up of reconstruction and repair activities is expected to drive a rebound in economic growth in FY2019, and ongoing recovery efforts—particularly

related to housing, public infrastructure and schooling—will maintain construction activity at elevated levels over the projection period. TC Gita caused major crop losses which are expected to see the agriculture sector detracting from growth in FY2018 and FY2019. However, agriculture output is expected to recover strongly in FY2020 and FY2021 and make a sizeable contribution to growth over this period. Wholesale & retail trade and tourism are also expected to rebound strongly over the period FY2019 – FY2021, consistent with stronger domestic demand and a return to full capacity of key tourism operators. Overall, the economy is expected to expand by around 4 percent and 5 percent in FY2019 and FY2020, respectively, before easing to around 2.5 percent in FY2021, slightly above its historical average growth rate of 1.8 percent. To the extent that some of the planned public sector recovery spending scheduled for FY2019 has been delayed, FY2019 growth may come in slightly lower than expected, and FY2020 growth may be slightly faster. Nevertheless, it is expected that the key drivers of growth in FY2020 and FY2021 will be the recovery in the agriculture and services sectors, and these drivers are likely to remain relatively unaffected by the timing of public spending on recovery activities.

23. **Inflation is expected to ease as agriculture production recovers, while the current account deficit will remain sizeable due to sustained high imports for reconstruction activities.** Following strong prices growth over the past two years, inflation is expected to ease as domestic agriculture production recovers over the coming years. Lower global commodity prices, particularly for oil, are also expected to contribute to easing domestic price pressures. Imports will likely remain elevated through to FY2021, reflecting the need for imported machinery and materials in the reconstruction phase, though the resulting pressure on the current account deficit will be offset by a recovery in agriculture exports. To the extent that foreign currency needs are not met by increased aid and remittance flows, there may be some additional pressure on the balance of payments (Table 3). Nevertheless, grants (both capital and current) are expected to be substantially higher over the projection period than in recent years, due to increased donor support for cyclone recovery (see paragraph 25 for details).

Table 3: Balance of Payments sources and uses

USD		Est.	Proj.		
	FY2017	FY2018	FY2019	FY2020	FY2021
Total financing needs	**54.8**	**33.0**	**71.4**	**64.5**	**57.0**
Current account deficit	50.2	28.6	59.1	60.3	52.7
Scheduled debt amortization	4.6	4.4	12.2	4.3	4.3
Total financing sources	**54.8**	**32.9**	**71.4**	**64.5**	**57.0**
FDI inflows	11.6	12.0	12.9	13.9	14.5
External debt disbursements	5.7	9.0	14.7	14.0	15.0
Other net inflows on capital & financial account	63.4	29.0	28.5	21.2	20.2
Use of FX reserves	-25.8	-17.1	15.2	15.4	7.3

Note: Change in reserves: "-" denotes an accumulation; "+" denotes a reduction.
Source: NRBT; Ministry of Finance; World Bank staff projections

24. **While reserves are projected to decline, this is contingent on the assumption that households self-finance a substantial amount of housing repairs and reconstruction**. Three consecutive balance of payments surpluses in FY2016 – FY2018 allowed the NRBT to build foreign reserves to a comfortable level of around 6 months of imports cover by the end of FY2018.[7] Reserves are projected to decline to around 5 months of imports cover over the projection period, though this decline is based on the assumption that the private sector fully meets its estimated recovery needs to FY2021 (TOP$123 million)—three-quarters of which are for housing repairs and reconstruction (which have a high import component). To the extent that households spend somewhat less on housing reconstruction and repairs than was estimated in the GoT's Recovery Framework, the decline in international reserves is likely to be somewhat more modest than that illustrated in Table 1.[8] In March 2018 the Foreign Exchange Control Act was enacted. The Act is designed to

[7] Foreign reserves have been equivalent to over 3 months of imports since 2003.
[8] The estimates for housing needs in the GoT's Recovery Framework were based on the cost for GoT to repair or replace damaged and destroyed housing. Subsequent to the finalization of the Recovery Framework, authorities decided that

provide additional mechanisms to ensure an adequate level of reserves by requiring exporters to repatriate export earnings and providing the NRBT with the power to request residents to repatriate locally-sourced capital invested overseas.

25. **Modest fiscal deficits are expected over the period FY2019 to FY2021, with large reconstruction and recovery spending financed primarily by additional donor grants.** In the FY2019 Budget Statement the GoT projected modest budget surpluses over the projection period, based on continued strong domestic revenues growth and expectations for significant additional development partner grant pledges. Recent revenue estimates suggest that these projections were overly optimistic, with authorities now projecting small fiscal deficits in FY2019 and FY2020.[9] The bulk of the public recovery and reconstruction spending is expected to occur over the three years from FY2019 to FY2021, with overall public spending projected to step up significantly from 44 percent of GDP in FY2018 to around 57 percent of GDP in FY2019. Consistent with the GoT's prudent fiscal strategy, the increase in spending will be largely financed by an 11-percentage-point-of-GDP increase in development assistance—which reflects around TOP$115 million of additional grant financing pledged by development partners as part of the GoT's Disaster Recovery Framework—combined with some reprogramming of government spending (Table 4). The additional grant financing has been pledged to support the reconstruction, repair and upgrading (including retrofitting) to boost disaster resilience of school infrastructure, health centers, water and sanitation infrastructure, public buildings, and the power distribution and generation network, among others. Public spending is projected to remain well above pre-cyclone levels in FY2020 and FY2021, with authorities projecting that these ongoing recovery needs will be financed largely by donor grants. Higher current expenditure is predominantly due to increased spending on goods and services associated with the recovery effort, including additional outlays for road and building maintenance and professional services fees.

Table 4: Financing the budget deficit

	FY2019
Tongan Pa'anga millions	
Overall Balance (excluding grants)	**-329.0**
Budget support grants	56.6
of which: World Bank (a)	33.5
Asian Development Bank	11.5
Australia	6.4
European Union	5.2
Other grants (b)	258.3
Other external financing (net)	10.6
External grants and financing	**325.5**
Domestic financing (net)	**3.5**
Total grants and financing	**329.0**

(a) This includes budget support related to this operation plus the TOP$22 million in Crisis Response Window financing provided as supplemental financing to the second operation in this series to support the TC Gita response.
(b) 'Other grants' includes around TOP$60 million in recovery-related grants.
Note: Donor financing estimates are projections only. Source: World Bank Staff Estimates.

26. **Improving the management of the wage bill, including through reforms supported by this**

the public sector would not provide full compensation for damaged and destroyed private housing. Thus, in practice, households are likely to spend somewhat less on housing repairs and reconstruction than the GoT initially estimated.

[9] Domestic revenues are projected to increase by an average of 6 percent annually over the period FY2019 – FY2021. However, this rate of expansion is lower than projected nominal GDP growth, resulting in a decline in domestic revenues as a percent of GDP over the projection period. This is predominantly due to the GoT's decision to provide consumption tax exemption for imported construction materials and capital goods (i.e. machinery, equipment, vehicles and tools) for two years following TC Gita to support the recovery effort, which is expected to result in consumption tax receipts growing more slowly in FY2019 and FY2020 (by 4 – 5 percent annually) than has been the case in recent years (where growth has averaged over 12 percent annually during the period FY2014 to FY2018). Consumption tax receipts growth is expected to rebound to almost 10 percent in FY2021, due to a combination of the ending of the exemption and improved revenue compliance consistent with the implementation of the revised Revenue Services Administration Bill and Customs Bill supported by this operation.

program, will be important to ensure space for other essential recurrent spending, including that associated with the recovery effort. Authorities expect payroll costs to remain contained as a percent of GDP in FY2019 and beyond, as the new remuneration framework and public-sector performance management system act to contain wages growth, combined with ongoing efforts to control the public-sector headcount. Regarding the latter, authorities plan to prioritize the filling of existing vacancies before creating new positions, and to review existing vacancies, with a view to potentially eliminating open positions that have not been filled for more than two years. Indeed, the government's wage bill affordability ratios—wages as a share of: (i) current expenditure; and (ii) domestic revenues—are expected to fall below their targets by FY2021. Furthermore, while the wage bill expanded at an average annual rate of over 11 percent between FY2013 and FY2017, following the implementation of the new remuneration structure and PMS, the wage bill expanded by only 4 percent, on average, during FY2017 and FY2018—a rate of annual expansion that is expected to be maintained over the projection period. While scope for significant fiscal consolidation on the expenditure side is limited given pressing service delivery needs, a gradual decline in wages and salaries as a proportion of spending will create space for other essential expenditure. Nevertheless, the large number of existing vacancies does pose a risk to the wage bill, although only to the extent that the existing vacancies are filled (and filled more quickly than expected).[10] Continued close supervision of the wage bill (and its components) will be important to ensure that payroll pressures do not crowd out essential service delivery spending or compromise fiscal sustainability.

27. **The projections indicate that the government will take on a small amount of additional debt over the period FY2019 to FY2021 in order to meet recovery needs, although these projections may well overstate the implications for public debt, particularly given the GoT's demonstrated commitment to ensuring total public spending remains within the overall revenue envelope**.[11] The projections presented in Table 1 and Table 2 assume that: i) the GoT meets the majority (two-thirds) of its estimated recovery needs over the period FY2018 to FY2021 (TOP$165 million), of which only TOP$115 million has been covered by pledged development partner grants to date; and ii) there are no additional donor grants forthcoming to help finance these needs, beyond those already pledged.[12] As a result, it is assumed that the GoT is forced to take on around TOP$50 million in additional external debt to meet these needs. However, given the GoT's policy of avoiding new non-concessional debt, in practice authorities will likely seek as much additional grant financing as possible in coming years, and then carefully weigh whether to take on available domestic or (concessional) external debt financing to meet any further needs, with the likelihood that some recovery needs will remain unmet. In practice, the GoT has shown a strong commitment to managing total public spending within the GoT's overarching revenue envelope, suggesting that fiscal deficits and external debt may not expand to the extent set out in Table 2 and Figure 3.

28. **The debt trajectory is projected to worsen slightly due to the fiscal effects of TC Gita, but not to the extent indicated by the natural disaster scenario in the 2017 DSA.** Based on the assumptions presented above, total public debt would increase by around 3 percentage points of GDP by FY2021, to around 56 percent of GDP. The present value of Tonga's external debt to GDP ratio is projected to breach the DSA

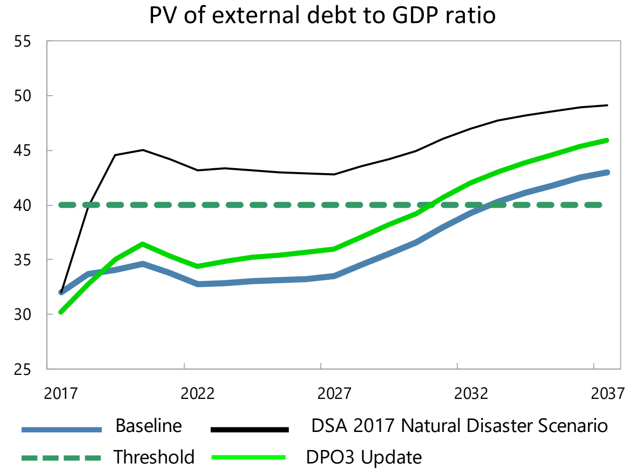
Figure 3: External Debt Sustainability Analysis

[10] According to the MoF there are currently 746 vacancies across the public service (equivalent to 14 percent of the overall headcount).

[11] Available cash reserves have already been run down to around their targeted minimum coverage of two months of recurrent expenditure (around TOP$60 million), with these reserves viewed as an emergency fiscal buffer.

[12] Total public-sector recovery needs (TOP$246 million, see paragraph 6) include TOP$86 million to boost the overall electricity network's resilience to natural disasters and TOP$20 million to rebuild public buildings. To date, pledged development partner grant financing covers all non-electricity and public buildings recovery needs, but only around TOP$25 million of the electricity and public building needs. Consequently, only around TOP$165 million of the total public sector recovery needs are assumed to be met over the period FY2018 – FY2021.

threshold of 40 percent more quickly than under the 2017 DSA baseline scenario (Figure 3).[13] However, the impact is not expected to be as negative as the 'Severe Natural Disaster' scenario in the 2017 DSA, as the projected growth impacts are not as severe, and the projected increase in new debt is not as large. A key reason for the latter is because of the substantial donor financing that has been provided and pledged on grant terms. To the extent that donors provide additional financial support over and above the amounts currently committed, this would allow GoT to minimize reprogramming of planned spending and/or reduce the issuance of new external debt, which would help flatten the debt trajectory from that presented in Figure 3.



Source: Bank staff calculations based on Tonga 2017 DSA.

29. **The recent extension of the maturity and grace period on an external loan has reduced short-term fiscal pressures but could exacerbate long-term debt servicing risks, although GoT are analyzing mechanisms to safeguard fiscal sustainability.** In December 2018 the Chinese Export-Import Bank granted a five-year extension of the maturity period and the grace period for a loan that the GoT were due to begin repaying in FY2019.[14] This has helped to alleviate pressure on the fiscal deficit in the short term, although it will still necessitate large annual principal repayments over the period FY2024 – FY2034. Consequently, GoT are considering the establishment of a specific mechanism, such as a sinking fund, to ensure that sufficient resources are set aside over the coming years to meet the scheduled principal repayments. Establishing—and remaining committed to—a clear savings plan will be important to protect Tonga's hard-won fiscal sustainability, and to minimize the likelihood that a severe fiscal adjustment will be required to meet the future principal repayments.

30. **The current macroeconomic policy stance is adequate for the proposed program, but outcomes remain subject to uncertainty and are contingent on continued prudent fiscal management and ongoing contributions from development partners.** Prior to TC Gita, Tonga had enjoyed robust growth and maintained a relatively prudent fiscal stance, while demonstrating a commitment to building domestic revenues and increasing fiscal resilience, as elaborated in paragraph 18. Despite a projected weakening of the fiscal position over FY2019 to FY2021, the latest IMF Article IV assessment (January 2018) noted that the economic outlook was favorable (albeit with risks tilted to the downside), that the monetary policy stance was appropriate, and that the level of foreign exchange reserves was broadly adequate. A recent IMF assessment of Tonga's macroeconomic conditions (as contained in the Assessment Letter at Appendix 3) also notes that the short-term outlook remains favorable despite the damage done by TC Gita. Recently the government has demonstrated fiscal discipline in its decision to freeze various sports and leisure related investments and reprogram spending, in its commitment to carefully prioritize capital spending and seek donor grant financing wherever possible, and through its continued commitment to the revenue, spending, and debt management reforms supported by the current DPO series. Nevertheless, the cyclone had a sharp negative impact on growth in FY2018 and has widened the current account deficit and increased inflation

[13] The projections assume additional future debt over this period is external and contracted on semi-concessional terms.
[14] Signed in FY2008, the loan of around USD70 million was to finance the reconstruction of the Nuku'alofa central business district following the 2007 riots. A five-year extension of the grace period for the loan was also granted in 2013. Following the latest extension of the maturity period and the grace period, the principal repayment period for the loan will now be FY2024 – FY2034.

relative to pre-cyclone expectations. Key risks to the outlook include risks that the productive sectors (particularly agriculture and tourism) recover more slowly than expected, risks to fiscal sustainability posed by substantial disaster recovery needs, and the risk of another natural disaster, which would put severe pressure on Tonga's government finances given the reduction in fiscal buffers resulting from TC Gita. These risks are mitigated by the government's demonstrated willingness to build fiscal space by mobilizing domestic revenues and containing expenditures, the successful completion of DPO-supported policy reforms, and the readiness of development partners to provide financial and technical assistance in support of these aims over the medium-term, combined with additional financial support to meet the unexpected recovery needs arising due to TC Gita.

3. THE GOVERNMENT'S PROGRAM

31. **The government has set out Tonga's national development strategy in the Tonga Strategic Development Framework 2015-2025 (TSDF II).** This document, which was endorsed by the government in April 2015, sets out a medium-term vision and directly builds on the preceding TSDF 2011-2014. It is underpinned by an extensive consultation process which involved all parts of government as well as intensive consultations with stakeholders and the public, including both civil society groups and private sector entities across Tonga. In February 2019 the new Government outlined the reform priorities for their remaining three years in office (FY2020 – FY2022), which are aligned with the five pillars articulated in the TSDF II: economic institutions; social institutions; political institutions; infrastructure and technology inputs; and natural resource and environmental inputs.

32. **The vision of the TSDF II is for "a more progressive Tonga supporting a higher quality of life for all".** This vision is translated into seven high-level National Outcomes to achieve over the next 10 years. Inclusivity and sustainability are emphasized in each of the seven outcomes: i) a more dynamic, knowledge-based economy; ii) more balanced urban-rural development; iii) more empowering human development and gender equality; iv) responsive and good governance, including law and order; v) successful provision and maintenance of infrastructure and technology; vi) effective land administration, environmental management and resilience to climate and risk; and vii) consistent advancement of Tonga's external interests, security and sovereignty. The national outcomes are to be achieved via a set of 29 organizational outcomes, which are grouped under five pillars to strengthen coordination across government institutions and stakeholders.

33. **The strategic framework includes a heightened emphasis on sustainability, good governance and shared prosperity.** The strategic priorities clearly emphasize the cross-cutting importance of sustainability and inclusivity. The importance of governance to facilitate effective public service provision and international relations is also a key area of focus for the TSDF II.

4. THE PROPOSED OPERATION

4.1 LINK TO GOVERNMENT PROGRAM AND OPERATION DESCRIPTION

34. **This programmatic development policy operation (DPO) series is designed to strengthen the foundations for the achievement of key national outcomes under the Government's TSDF II.** The series supports National Outcomes one to five as outlined above. Fiscal and economic management reforms under pillar one support the government's inclusive development priority and improve the resourcing of key public service delivery. Pillar two supports more responsive and effective government systems. Pillar three supports the preconditions for more dynamic, inclusive and sustainable growth. The supported outcomes are consistent with the comparative advantage of development policy programming, while other outcomes are

being supported by investment operations and with technical assistance from the World Bank and other development partner programs.

35. **The development objective of the operation reflects key constraints that the government is addressing as a matter of priority**. The reform program is expected to directly support poverty reduction and shared prosperity by ensuring basic labor protections and reducing gender disparities, encouraging a more conducive business environment through public enterprise reform and by making it easier to invest in Tonga (which should help create jobs and income-earning opportunities), and boosting government resources for inclusive service delivery. In this operation the program development objective has been slightly amended by removing the reference to private sector regulation in the second pillar, given that improved regulation in itself is not strictly a development outcome, but rather is an intermediate step towards a more dynamic and inclusive economy. Accordingly, the reform actions in previous operations related to strengthening sector regulations have been moved to the third pillar. The reference to extending coverage of the credit bureau has also been removed from the program development objective, following a change in Fijian laws that had caused the provider to cease operation of the Tongan credit bureau which was previously hosted in Fiji (see paragraph 68 for a detailed discussion). In line with this change, the results indicator on credit bureau checks made for credit applications has also been removed.

36. **The proposed operation reflects key lessons learned from previous DPOs that the Bank has undertaken in Tonga, while the current multiyear series has also highlighted important lessons for future programmatic engagements.** Past operations have demonstrated that DPOs in Tonga can achieve good results in the context of solid government ownership, and can be an important means of advancing economic and fiscal policy reforms. Nevertheless, a key lesson from the current series is that a three-year program can involve significantly greater implementation challenges than a two-year program (the standard duration in the Pacific, and the duration of two previous programmatic series in Tonga), given high rates of turnover (both within the civil service and at the Ministerial level) and Tonga's exposure to disruptive external shocks. These challenges have been evident in the current series which has spanned several years (the reform priorities were first discussed with authorities in 2015), different governments, and a major natural disaster—all of which have affected the capacity of government to achieve as much progress in some specific reform areas as was envisaged when this programmatic series was formulated. The current series has therefore highlighted the importance of flexibility to adjust the reform program (including the flexibility to adjust indicative triggers) in order to ensure multi-year reform programs remain relevant and informed by the latest evidence and conditions. Past and current operations have also highlighted that adequate investment in policy dialogue is vital but resource intensive, and that close coordination and engagement with other development partners in the identification of policy priorities is critical in sectors where the Bank has more limited knowledge and engagement. Finally, coordinated management of fiscal needs and budget support can provide vital support to mitigate the impact of external shocks.

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

38. **Following on from the substantial reforms supported by the past two DPOs, a continuation of the**

series is appropriate given the progress achieved to date, the need to maintain focus on implementation and next steps, and the continued need for budget support. Soon after the approval of the previous DPO (April 2017) policy reform momentum was interrupted by the dissolution of Parliament in August 2017 and subsequent national elections in November 2017, and then the impact of TC Gita in February 2018 (the strongest tropical cyclone to hit Tonga since 1982) just as the new government had been established. To help finance the immediate reconstruction needs following TC Gita, the GoT requested US$20 million of grant financing from the World Bank's Crisis Response Window, of which US$10 million was channeled through a Supplemental Financing operation to the previous operation in this series. Government attention turned back to the reform program supported by the current operation in the second half of 2018. When considered in light of the substantial stress placed on GoT systems and capacity over the last year by the disaster recovery effort, and the fact that the policy reforms supported by this operation were originally agreed with a previous Government, the GoT has shown commendable commitment to making progress on what is a very substantive reform program overall. Notably, the program includes landmark employment relations legislation that codifies basic labor rights for the first time in Tonga (reflecting work and consultations that have taken place over a number of decades); important revisions to the Revenue Services Administration Act and Customs Act to improve revenue administration and efficiency, and to align customs practices with international standards; and the approval of regulations related to the revised Foreign Investment Act that represents the culmination of a reform agenda that commenced in 2011. Other supported reforms demonstrate substantial progress on strengthening wage bill management, PFM systems, and public enterprise performance. While two triggers have not been converted to prior actions, and others have been adjusted, overall the GoT has made good progress on its reform agenda since the second operation went to Board in April 2017 (and further progress than expected in some areas such as customs reform), consistent with the development objectives of the program (see Table 5).

Table 5: Indicative triggers and prior actions for the second operation

Indicative trigger for this third operation (as presented in the program document for the second operation in this series)	Third operation prior action	Explanation / Status
Pillar I – Supporting fiscal resilience		
Revise the Revenue Administration Services Act to set more realistic penalties and introduce more avenues for revenue recovery.	The Recipient's Cabinet has approved for submission to Parliament a revised Revenue Services Administration Bill that introduces additional avenues for revenue recovery and sets updated and graduated penalties.	Trigger has been met.
	The Recipient's Cabinet has approved for submission to Parliament a new Customs Bill that aligns with international standards (including the Revised Kyoto Convention and World Customs Organization recommended practices) and simplifies customs administration.	Action added to the program following more rapid progress than had been expected when the triggers were set.
Cabinet has approved draft legislation to institutionalize a transparent reward and pay-setting mechanism to support improved control of the wage bill and effective performance and motivation of public servants.	The Recipient has: (i) realigned the performance management system year; (ii) provided target performance-rating distributions to public institutions; and (iii) clarified the eligibility of public sector employees to receive performance rewards and the application of procedures to manage poor performance, based on a review of its new public service remuneration structure and performance management system.	Trigger has been amended and met. The trigger was amended to reflect: (i) clarification that legislative changes were not required, as the responsibility and authority to enact amendments to the remuneration framework and PMS are clearly delegated to the Public Service Commission under the existing Public Services Act; (ii) the need to review the first year of implementation of the new system in order to resolve areas of concern; and (iii) progress on implementing recommendations from the review.
Pillar II – Government accountability		
Approval of a Chart of Account revision in order to accurately reflect standard economic classifications in the Government budget system.	The Recipient has removed the non-economic items from the economic segment of the Chart of Accounts, which will improve the accuracy and integrity of budget reporting.	Trigger has been met. Wording has been made more specific, based on a recommendation from IMF-PFTAC technical assistance that reforms in this area prioritize the strengthening of the economic segment of the CoA, and that reforms to the overall structure of the CoA occur in parallel with the implementation of an ongoing upgrade to the GoT's financial management information system.
Pillar III – Supporting a more dynamic and inclusive economy		
The Recipient's Cabinet has approved the National Energy Bill for submission to Parliament.	Dropped.	Trigger dropped as sufficient progress has not yet been made, although GoT now has a clear roadmap to finalize the bill for submission to Parliament by October 2019. Progress on this trigger has been slow after a series of shocks outside

		of the control of the GoT (dissolution of Parliament in August 2017, national elections in November 2017, impact of TC Gita in February 2018) resulted in the new Cabinet requesting that all in-principle approvals for legislative reform be resubmitted for approval by the new Cabinet. In July 2018 Cabinet approved the re-submitted proposal for a new bill to be drafted, but a combination of TC Gita recovery priorities, rotation of key staff out of MEIDECC, and the desire of new decision-makers to review the scope and terms of the reform plan has delayed preparation of the bill.
Employment Relations Bill that, among others, reduces gender disparities approved by Cabinet for submission to Parliament.	The Recipient's Cabinet has approved for submission to Parliament the Employment Relations Bill, which will ensure fundamental labor rights are enshrined in domestic law.	Trigger has been met.
Cabinet approval of revised foreign investment regulations, including reserved and restricted lists, and work permit rules.	The Recipient's Cabinet has approved revised foreign investment regulations, which provide clearer and more transparent requirements for foreign investment applications.	Trigger has been amended and met. Revised regulations that clarify the procedures for foreign investment applications and the reserved and restricted lists have been approved. However, new work permit rules have not yet been addressed, due to the considerable technical demands and consultative requirements placed on the implementing ministry to support Parliament's consideration of the Foreign Investment Bill and Cabinet's approval of the revised regulations.
The Recipient's Central Bank has issued a directive to mandate credit bureau reporting in order to reduce costs of due diligence and support access to finance for Small and Medium Enterprises (SMEs) and individuals.	Dropped.	Trigger dropped as the proposed reform is now only feasible over the medium term, for reasons beyond GoT's control. The Tonga Credit Bureau, operated by a company housed in Fiji, was affected by the law passed in Fiji in 2016 relating to credit information. As a result, the operator decided to close the Tongan Bureau. Following intensive discussions with development partners (including the World Bank) to identify alternative options, the NRBT have decided to move forward with the licensing of a new, domestically-domiciled credit bureau company, Tonga Data Bureau. However, the new credit bureau has yet to complete the NRBT accreditation process.
Cabinet has approved the reform of an additional Public Enterprise (PE) reformed in accordance with the PE Reform Plan, where 'reformed' may consist of	The Recipient's Cabinet has approved a recommendation that the Ports Authority Tonga adopts a landlord model for Nuku'alofa port.	Trigger has been met. Wording amended to precisely describe the specific reform supported, as was envisaged when the trigger was set.

privatization, liquidation, substantial restructuring, outsourcing or another form of public-private partnership.		

4.2 PRIOR ACTIONS, RESULTS AND ANALYTICAL UNDERPINNINGS

39. **The proposed program supports policy reforms under three pillars: i) supporting fiscal resilience; ii) supporting improved government accountability; and iii) supporting a more dynamic and inclusive economy.** To support fiscal resilience, policy actions include the introduction of new revenue and customs legislation to strengthen revenue collection, streamline administration and lower transaction costs; and the review and strengthening of the new public-sector remuneration framework and performance management system. To support government accountability, this operation supports a reform to the public Chart of Accounts (CoA) that will improve GoT's accounting and financial reporting policies and system. To support a more dynamic and inclusive economy, the operation supports the submission to Parliament of the nation's first Employment Relations Bill (ERB) that will safeguard employee rights and narrow gender disparities**;** the adoption of updated foreign investment regulations (including reserved and restricted lists); and the issuance of a concession contract to a private sector company for the delivery of key port services (see Table 6 for the analytical underpinnings of these reforms).

Table 6: DPO Prior Actions and Analytical Underpinnings

Prior actions	Analytical Underpinnings
Pillar I: Supporting fiscal resilience	
The Recipient's Cabinet has approved for submission to Parliament a revised Revenue Services Administration Bill that introduces additional avenues for revenue recovery and sets updated and graduated penalties.	The latest IMF Article IV Staff Report highlights that increased revenue mobilization is required to support growth-enhancing spending. TA provided by IMF-PFTAC highlighted the need to encourage greater compliance through the introduction of variable penalties and to maximize revenue collection through the expansion of tax recovery methods.
The Recipient's Cabinet has approved for submission to Parliament a new Customs Bill that aligns with international standards (including the Revised Kyoto Convention and World Customs Organization recommended practices) and simplifies customs administration.	The Oceania Customs Organisation (OCO) conducted a legal review of Tonga's customs legislation in 2018. Reform to Tonga's customs practices is necessary to ensure consistency with Chapter 4 (Customs Procedures) of the Pacific Agreement on Closer Economic Relations Plus (PACER Plus), which requires Parties to observe internationally-recognized (WTO and World Customs Organization) customs trade facilitation principles, and to apply a fair, uniform and neutral system for the valuation of goods for customs purposes.
The Recipient has: (i) realigned the performance management system year; (ii) provided target performance-rating distributions to public institutions; and (iii) clarified the eligibility of public sector employees to receive performance rewards and the application of procedures to manage poor performance, based on a review of its new public service remuneration structure and performance management system.	World Bank has provided TA to the GoT to support the development and implementation of the remuneration framework and performance management system that was introduced in 2017. Following the implementation of the new framework, PSC noted opportunities to improve its administration. The ADB provided funding for an independent review of the system in 2018, which outlined recommendations to improve implementation.
Pillar II: Government accountability	

Prior actions	Analytical Underpinnings
The Recipient has removed the non-economic items from the economic segment of the Chart of Accounts, which will improve the accuracy and integrity of budget reporting.	At the request of GoT, in 2017 IMF-PFTAC conducted a review of Tonga's Chart of Accounts (CoA) with a view to support its redesign. The review found that the current design of the CoA inhibits proper reporting and limits the analytical information available from the system. The report recommends upgrading the CoA in three phases: (i) remove non-economic items form the economic segment; (ii) upgrade the economic segment; and (iii) redesign the entire CoA. It was recommended that stages 2 and 3 be completed in parallel with the ongoing ADB project to upgrade the GoT's financial management information system.
Pillar III: Supporting a dynamic and inclusive economy	
The Recipient's Cabinet has approved for submission to Parliament the Employment Relations Bill, which will ensure fundamental labor rights are enshrined in domestic law.	The ILO has provided numerous rounds of TA to support the GoT to establish a legal framework that protects labor rights and ensures a fair labor market. During the last round in 2012-2015, the ILO conducted a technical review, financed a capacity assessment and provided TA to support the refinement of the Bill. The review highlighted the need for extensive consultation through a tripartite process (government, employers and workers).
The Recipient's Cabinet has approved revised foreign investment regulations, which provide clearer and more transparent requirements for foreign investment applications.	Following up from the 2012 ADB Private Sector Assessment, the 2014 Foreign Investment Policy Review conducted with ADB support identified a number of issues with the existing regime that created uncertainty for potential foreign investors. The review recommended legislative and regulatory changes.
The Recipient's Cabinet has approved a recommendation that the Ports Authority Tonga adopts a landlord model for Nuku'alofa port.	ADB Tonga Economic Update Outlook 2012, ADB Finding Balance 2016, and GoT PE Reform Strategy suggest imposing stronger commercial disciplines on PEs and taking steps to enhance accountability and transparency. The Ports Authority Tonga (PAT) Strategic Review 2018, prepared by PAT and the ADB, considered various reform options to improve PAT's operating efficiency, service delivery, and financial sustainability, with the review recommending that PAT restructure under a landlord model.

Pillar I: Supporting Fiscal Resilience

40. **Building fiscal buffers through domestic revenue mobilization and careful management of spending is the best way to support fiscal resilience to future shocks.** The Government is committed to leveraging development policy financing to strengthen fiscal resilience, while increasing domestic revenue mobilization through strengthened taxation settings and improving the oversight of key sources of fiscal risk. The reforms being progressed in this area continue an ongoing engagement from two previous DPO series and the two previous operations in the current DPO series, and are focused on improving revenue performance and administration through setting better calibrated penalties, introducing more avenues for revenue recovery, and aligning customs with international standards; and addressing major expenditure items, including the public service wage bill, in order to ensure the sustainability of public finances.

41. **The actions supported in this operation build on actions completed in the previous operations in this DPO series, which included tax increases on petroleum products and unhealthy foods (offset by**

reductions in taxes on healthy alternatives), Tonga's first medium-term Debt Management Strategy and a system of fiscal anchors, and the implementation of a new public-sector remuneration framework and Performance Management System (PMS). The GoT raised excise duty on tobacco and all kinds of alcohol, implemented a new excise duty on instant noodles and ice cream, increased the import duty rates on turkey tails and lamb flaps to 15 percent, and reduced import duty on various fruit, vegetables and fish products. To support revenue mobilization, the excise duty on petroleum was raised by 30 percent.[15] Cabinet approved and made public a new Medium-Term Debt Strategy to ensure that Tonga's borrowing strategy is clearly defined and new loans are subject to rigorous assessment to ensure they maximize the benefits to the country and maintain low portfolio risk. Authorities also adopted a system of fiscal anchors and a monitoring framework designed to provide greater fiscal resilience over the medium term, in the context of an inherently volatile fiscal context in which the nation is regularly exposed to large, discrete shocks, which often dominate the annual budget planning process.[16] To address the ongoing fiscal risk of the public payroll, GoT also introduced a new remuneration framework and PMS which sets a solid foundation for equitable and performance-related pay by ensuring that similar jobs receive commensurate remuneration across the public service, and that institutionalizes a new system which rewards performance in place of a system in which automatic increment in pay are expected.

Prior Action 1: The Recipient's Cabinet has approved for submission to Parliament a revised Revenue Services Administration Bill that introduces additional avenues for revenue recovery and sets updated and graduated penalties.

42. **Historically in Tonga, up to eighty percent of tax revenue has been collected from consumption and trade taxes.** In a highly trade-dependent country with limited domestic value added and limited capacity to ensure direct tax compliance, import duties, consumption tax and excise duties form the mainstay of the revenue system. Maximizing the efficiency of tax and customs administration and the collection of indirect taxes is thus crucial to increase revenue mobilization and ensure that the public sector has the resources to deliver critical public goods and services.

43. **The revised Revenue Services Administration Bill provides a comprehensive and clear framework for tax administration, which is consistent with modern tax administration principles and will improve revenue recovery and compliance.** The legislation introduces the obligation to apply for a Tax Identification Number (TIN) which—along with the expansion of measures to recover unpaid taxes—is expected to improve compliance management. Penalties related to tax administration (i.e. registration, late lodgment and payment, false or misleading statements, dishonored checks) and tax offences (i.e. failure to maintain proper records, fraud, obstruction) are also clearly defined, and graduated penalties (i.e. where the penalty increases depending on the severity and/or length of time of the infraction) have been introduced for several offences to encourage compliance. In addition, the legislation provides the legal framework for future regulation to require all vendors to use cash registers or Point of Sale devices. This will facilitate the recording of sales and generation of receipts, which is designed to improve consumption tax collection by reducing undeclared sales. Implementation responsibility rests with the Inland Revenue Division (IRD) of the Ministry of Revenue and Customs. While the bill is expected to encourage compliance, tax evasion and avoidance remain key challenges to maximizing revenue collection. To support improved enforcement, the IRD plan to focus initially on the application of the revised legislation to businesses subject to consumption tax

[15] The rate of fuel excise tax was increased in two phases, by TOP$0.09 per liter in FY2016 and by a further TOP$0.06 per liter in FY2017, resulting in an aggregate price increase from TOP$0.50 per liter to TOP$0.65 per liter.

[16] The key components comprise: i) a debt target—to maintain external debt below 50 percent, only contracting highly concessional debt; ii) a revenue target—to maintain domestic revenues at or above 22 percent of GDP; and a wage bill affordability target—to maintain public remuneration below 53 percent of domestic revenues, moving towards 50 percent over time (Including employer social security contributions).

collection. The projected 0.7 percentage point increase in consumption tax revenues as a proportion of GDP in FY2021 is partially attributable to the implementation and enforcement of this legislation (noting the difficulty of precisely estimating the revenue impacts of measures aimed at improving compliance), as well as the cessation of the TC Gita-related consumption tax exemption for imported construction materials and capital goods.

Prior Action 2: The Recipient's Cabinet has approved for submission to Parliament a new Customs Bill that aligns with international standards (including the Revised Kyoto Convention and World Customs Organization recommended practices) and simplifies customs administration.

44. **Consistent with an ongoing agenda to modernize Tonga's customs regime, authorities have finalized a new Customs Bill that ensures national rules are consistent with key international standards and improves customs administration.** Over the past decade the GoT have made continuous improvements to the customs procedures and practices in Tonga,[17] reflecting a strong modernization agenda to enhance the efficiency and effectiveness of customs collection. This most recent round of reforms includes revisions to both the Customs Bill and the Tariff Bill, and in line with good practice, these bills have been drafted alongside associated regulations that will help facilitate the implementation of both bills. The preparation of these four legal instruments simultaneously has ensured that the legal framework is clear, consistent and comprehensive, while provisions are also included to enhance transparency. Importantly for a country that is among the most open economies in the world, the new legislation ensures alignment with key international standards (including the Revised Kyoto Convention and World Customs Organization recommended practices)—a key prerequisite for Tonga to comply with the provisions of PACER Plus, in preparation for the new trade agreement to enter into force. The reforms also streamline customs legislation by integrating current legislation on tariffs, enforcement, and administration into two bills. Finally, this round of reforms is designed to reduce documentary compliance costs (both in terms of time and money) by facilitating the online access and lodgment of documents, payments, and customs clearance, inspection and release processes—key cross-border trade indicators on which Tonga substantially underperformed relative to the East Asia & Pacific regional average of the 2019 Doing Business survey.[18] Greater efficiency and lower transactions costs will contribute to improvements in trade facilitation, and should ultimately help to put downward pressure on domestic consumer prices.

Prior Action 3: The Recipient has: (i) realigned the performance management system year; (ii) provided target performance-rating distributions to public institutions; and (iii) clarified the eligibility of public sector employees to receive performance rewards and the application of procedures to manage poor performance, based on a review of its new public service remuneration structure and performance management system.

45. **Public sector remuneration has for years been a major fiscal challenge in Tonga, and reform is highly contentious, given the importance of public service salaries for much of the population.** The public-sector wage bill, which has historically represented around 60 percent of domestic revenue, is high even when compared with similar economies in the Pacific. Following an aborted reform of the public service remuneration program which was met with public service strikes and public outcry, a large pay settlement in 2005 left horizontal inequities in the remuneration system and poor performance management systems

[17] The current legislation was introduced in 2007, and was subsequently amended in 2010, 2012 and 2013.

[18] Across the eight key 'Trading Across Border' indicators in the Doing Business survey—which comprise the time and financial cost to export and import, in terms of border compliance and documentary compliance—Tonga outperforms the East Asia & Pacific average for all exporting indicators, and for border compliance costs for importing. However, the costs (both financial and time) of document compliance for Tongan importers are around 30 percent above the regional average.

unaddressed.

46. **Building on a Remuneration Review which began in 2014, the Government has implemented a systematic program of reform to the public-sector remuneration system.** The critical components of the reform program are: i) a revision of the remuneration structure, to reflect competitive returns for skills and experience using a robust and fair methodology; ii) a new individual performance management framework that includes competitive and fair performance assessments as a basis for in-grade pay progression; iii) a policy framework to ensure that the individual remuneration framework (parts i and ii) are consistent with broader fiscal sustainability and allocative efficiency which will, among other things, determine the available funding for performance rewards. The new system helps to address sustainability issues by removing the de-facto automatic increments of the previous system, which contributed to an expectation of continual, substantial pay rises year-on-year irrespective of performance.

47. **While implementation of the new system has generally been a success, authorities identified that administration of the evaluation process could be strengthened and streamlined.** In particular, many public institutions submitted staff performance assessments that were heavily skewed towards the highest ratings, which then required a lengthy moderation process where the central Oversight Moderation Committee (OMC) reviewed individual staff performance assessments. The performance management process was also administratively cumbersome, with staff spending considerable time recording and gathering evidence for up to 60 Key Performance Indicators (KPIs) and over 20 competencies.

48. **Based on a comprehensive independent review, PSC have implemented a series of reforms to strengthen and streamline administration of the PMS.** An independent review of the new system and its implementation was performed in early 2018 and was considered by Cabinet in August 2018. The report commended the PSC and Performance Development team for their high level of competence in implementing the reforms. Nevertheless, several areas were identified where implementation could be improved and streamlined. Overall, the report outlined 17 recommendations to improve the implementation of the reforms. PSC have already taken action to respond to ten of these recommendations, work on another six is in progress, and one was deemed redundant.[19] Reflecting some of these adjustments, PSC have reported that the review and moderation process has substantially improved, with the burden of processing time and paperwork significantly reduced. Key among the reforms already implemented in response to the independent review are: (i) a realignment of the PMS year to delink it from the peak periods of activity in the budget cycle, and thus ensure that management and staff have sufficient time to adequately complete the performance assessment process; (ii) the provision of target performance-rating distributions to ministries to reduce the need for substantial moderation of the ratings by the OMC; and (iii) amendments to the Performance Development Framework and the Public Service Policy Instructions to clarify the eligibility criteria for performance rewards, and elucidate the procedures for managing poor performance, including the formulation and regular monitoring of employee performance improvement plans.

49. **The indicative trigger for this policy area was legislation to institutionalize the new reward and pay-setting mechanism.** When the indicative trigger was prepared, it was envisaged that legislation would help to institutionalize the reform. On further discussions with the authorities, it became clear that the first priority was to review the first year of implementation of the PMS and remuneration framework, in order to resolve areas of concern and establish lessons learned. In addition, it subsequently became clear that legislative change is not required to strengthen the system, as the responsibility and authority to enact amendments to the remuneration framework and PMS are clearly delegated to the Public Service Commission under the existing Public Services Act. Consequently, the proposed trigger has been amended

[19] This recommendation reflected a minor point regarding the process for assessing CEO performance, and PMC note that to a large extent the recommendation for reform may reflect a misunderstanding of the details of the system by the evaluator, rather than a fundamental difference in views regarding the implementation of the PMS.

to support the recommended improvements to the system.

50. **Results indicators under this pillar target improvements in indicators of fiscal resilience.** Results indicators for this pillar target increased domestic revenues, adherence to the GoT's objective of contracting only highly concessional debt, improved public sector wage bill affordability—measured as a reduction in public remuneration as a proportion of domestic revenues, and the continued application of an annual, moderated performance management process to determine public sector wages. The GoT has already made good progress as measured by its performance against each of these indicators, with domestic revenues increasing by around 2 percentage points of GDP since FY2016, no new non-concessional debt being contracted, and the wage bill as a proportion of domestic revenues declining.

Pillar II: Government accountability

51. **The Pohiva Administration was elected on a platform of good governance, and a key priority is to ensure the democratic mandate is extended across government and to entrench a culture of transparency, audit and accountability.** The proposed program supports key steps that will strengthen accountability and oversight frameworks within the public sector and in private markets. Policy areas supported under this pillar of the program include improvements to the GoT's accounting and financial reporting policies and system, and strengthening the regulatory environment for the energy sector.

52. **Actions completed in the previous two operations under this pillar include revised procurement regulations, adoption of a new procurement tracking database and monitoring framework, and new procedures to ensure follow up of audit recommendations.** A revised set of Procurement Regulations was introduced which rationalized a previously complex set of procurement rules. Supporting manuals and standard bidding documents were also approved by Cabinet and the Government Procurement Committee and implemented alongside the regulations. The procurement database establishes an institutional mechanism to enable the MoF to maintain a detailed record of all procurements above the small item threshold (TOP$7,500), and to monitor key performance indicators on procurement, which has helped MoF to identify bottlenecks in the procurement process. A new biannual report of audit recommendations and actions for all ministries and agencies of government has been prepared, and Parliament approved a new Communications Commission Act that is designed to establish a new multi-sector ICT regulator.

Prior Action 4: The Recipient has removed the non-economic items from the economic segment of the Chart of Accounts, which will improve the accuracy and integrity of budget reporting.

53. **The economic segment is the most critical segment of the Chart of Accounts (CoA) linking all of the government's public financial management reporting requirements.** The economic segment classifies items as either revenues, expenditures, assets or liabilities, and then assigns these into standard categories such as (on the expenditure side) salaries, goods & services, capital investment, etc. A well-designed CoA with a comprehensive, mutually exclusive, internally consistent economic segment is a fundamental building block to meet all of the government's reporting requirements, including statistical, budget, and macro-fiscal reporting. Timely, accurate and flexible reporting is critical for tracking and reporting on budget execution; to support budget management, financial planning and internal controls; and ultimately to facilitate accountability through the monitoring and evaluation of public spending towards stated, specific government objectives.

54. **The updated economic segment will improve the accuracy and integrity of budget reporting—a fundamental precondition to improved PFM and greater accountability of public spending.** In Tonga, the integrity and robustness of the economic segment had been compromised by allowing non-economic concepts to be defined in the structure—for example, items that relate to projects, programs, funds, or activities (such as spending for national celebrations). This reduces the ability of the CoA to properly meet all government reporting requirements, undermines the effectiveness of budget controls, and presents the

risk that inaccurate or misclassified information could lead to incorrect decision-making and poor public policy. The updating of the economic segment to remove non-economic items will assist the GoT to produce more flexible and accurate budget reporting, to more systematically monitor spending across the budget, and to strengthen the budget's internal control mechanisms. Extensive consultations, led by MoF, were undertaken across government to determine the requirements of a revised economic segment. The results indicator targets the utilization of the new economic segment in budget reporting, and indications from GoT are that this updated segment will be used in the FY2020 budget currently being prepared.

55. **The indicative trigger for this policy area was a revision to the CoA, in order to accurately reflect standard economic classifications in the Government budget system.** Recent technical assistance (from IMF-PFTAC) has confirmed that—in light of the ongoing ADB project to upgrade the GoT's integrated financial management information system (IFMIS)—reform efforts in this area should prioritize the standardization of the economic segment of the CoA. The IFMIS upgrade involves the addition of new modules for aid information and project management, budget preparation, and forecasting—elements that will be directly impacted by changes to the CoA. Consequently, it was recommended that further revisions to the CoA be implemented concurrently with the finalization of the IFMIS upgrade,[20] to ensure that these two major changes are compatible and do not have adverse impacts on the system or its functionality.

Pillar III: Supporting a more dynamic and inclusive economy

56. **Building on past and ongoing reforms, the government has committed to providing a more supportive environment for private sector development, which has the potential to enhance inclusive growth.** Over the past eight years, the authorities have implemented a series of business-supporting reforms under previous DPO programs, including a new, simpler business registration system, a new legislative framework for receiverships and a clear governance framework for natural resources. In the area of public enterprise reform, they have also supported the establishment of public-private partnerships (PPPs) and improved governance. In the 2018 Doing Business Survey, Tonga ranked 91st in the world and (together with Samoa, ranked 90th) was one of the two top-ranked Pacific developing nations. However, a series of assessments combined with ongoing dialogue has identified a number of critical gaps. This program builds on actions supported in previous programmatic series to address the most critical issues, including those related to the legislative framework governing foreign investment and the relationship between employers and workers.

Prior action 5: The Recipient's Cabinet has approved for submission to Parliament the Employment Relations Bill, which will ensure fundamental labor rights are enshrined in domestic law.

57. **Tonga is one of the few countries in the region that lacks any form of labor regulation for the private sector, which is recognized as a serious risk in ensuring salaries and conditions for workers are fairly set.** Tonga lacks legislation to ensure most of the key basic protections that are considered standard in the region and globally, including rights to leave from work, non-discrimination, rights for fair dismissal and redundancy, etc[21]. This is of particular concern in an environment where workers tend to lack bargaining power due to the small number of (in some cases monopsonistic) employers and often low levels of skills and education. The lack of assurance around basic working conditions in the private sector may also contribute to reduced participation in the labor market, especially for women requiring flexible working conditions and maternity leave. Tonga is the only country in EAP that does not entitle parents to any kind of leave (paid or unpaid) when a child is born. A recent World Bank Study on Women, Business, and the Law (2016) also shows that Tonga has lagged behind in promoting gender equity in business. There is also no legislation to prohibit child labor or specify a minimum age for employment, with anecdotal evidence to

[20] The ADB project is currently expected to conclude during the first half of FY2020.

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

suggest that children in Tonga currently perform dangerous tasks in the agriculture and fishing sectors.[22]

58. **With the assistance of the International Labor Organization (ILO) and other partners, the Government has finalized a landmark Employment Relations Bill (ERB) that will ensure basic labor protections and reduce gender disparities.** This legislation has been under preparation on an on-and-off basis for a number of years, but has benefited more recently from a concerted push by Government to consult with all stakeholders and adequately account for the views of all who will be affected, while also being supported by Tonga's joining of the ILO in 2016. The Bill provides legislative backing for fundamental rights and principles at work, including freedom from discrimination, equal remuneration for work of equal value, freedom of association, and a prohibition on forced labor. It establishes an entitlement to various forms of leave, including a right to 30 consecutive working days of maternity leave and a requirement that women returning to work after such leave are appointed to the same or equivalent position held prior to taking maternity leave, without any loss of salary, wages, benefits or seniority. The Bill sets out stringent conditions around the employment of children, setting the minimum age for employment at 15 years of age, and prescribing that a child under the age of 18 should not engage in any "hazardous" work (though a specific definition of what constitutes "hazardous" work is left for implementing regulations). It also creates a framework for the establishment of minimum wages in Tonga, which would be dependent on the recommendations of a Commission established to consider minimum wages, and the endorsement of the Employment Relations Advisory Committee, which is established by the legislation and would consist of members from Government, employer organizations, and worker organizations.

59. **While several details are left to implementing regulations, overall the Bill represents a substantial improvement on the status quo, to the extent that basic labor rights are now protected in Tongan law**. The authorities have proposed a staged approach to the implementation of this legislation (through the implementation of supporting regulations, transition periods, etc.), which is justified given constrained Government capacity to enforce these reforms and given the long history of unfulfilled attempts to implement labor reform in Tonga. The results indicator targets the number of basic labor rights—including those related to equal remuneration for equal work, gender non-discrimination and availability of maternity leave—that are enshrined in domestic legislation as of June 2020, with the achievement of this target contingent on the approved Bill being enacted by Parliament by that time (and supporting measures being implemented where necessary).

Prior action 6: The Recipient's Cabinet has approved revised foreign investment regulations, which provide clearer and more transparent requirements for foreign investment applications.

60. **While FDI is a critical catalyst for private sector development, inflows to Tonga are very modest, in part due to overly burdensome legislation that is unevenly enforced.** FDI in Tonga has remained low over the past decade and is currently under 3 percent of GDP. Overly burdensome and complex legislation acts as an impediment preventing foreign investors from taking advantage of business opportunities, reducing the extent to which the economy benefits from foreign capital and expertise. In addition, the uneven enforcement of laws has created uncertainty for investors seeking to start businesses in Tonga. Analytical studies and consultations carried out with support from ADB and the World Bank Group (WBG) have helped the government to recognize the importance of regulatory reform to enhance the environment for FDI.

61. **The Foreign Investment Bill 2019 has recently been passed by Parliament, which will act to reduce the uncertainties faced by foreign investors in Tonga**. This reflected the culmination of work that has been ongoing since 2011, with the previous DPO series supporting the development of a new investment policy that provided the analytical underpinnings for the current legislation, and the last DPO in the current series supporting Cabinet approval of this legislation. Subsequently, this Bill has been passed by Parliament in

[22] This is also supported by the 2017 Child Labor and Forced Labor Report of the U.S. Department of Labor.

February 2019 and is awaiting Royal Assent before it can be enacted. Replacing the previous Foreign Investment Act (2002), the Foreign Investment Bill 2019 contains measures to: i) reduce confusion around the definition of foreign investment in the previous Act; ii) provide clearer principles for reviewing reserved and restricted lists; and iii) set out a more transparent framework for screening foreign investment applications.

62. **As a prior action, The Recipient's Cabinet has approved revised foreign investment regulations, which provide clearer and more transparent requirements for foreign investment applications.** As Royal Assent for the Foreign Investment Bill had not yet been received by the end of March 2019, the foreign investment regulations were approved by Cabinet to come into operation once the Bill is enacted. A 2014 review noted that the authorities were attempting to screen foreign investors according to their financial capacity and business plans, creating uncertainty and holding up the application process in many cases. The new regulations will support the implementation of the revised legislation by helping to ensure that the foreign investment registration process is more focused on ensuring applications are compliant with the reserved and restricted lists. These regulations include the reserved and restricted lists, as well as forms containing required information to apply for, transfer, and/or reissue a foreign investment certificate, and forms that collect detailed statistical information about foreign investment activity in Tonga, in line with the requirement in the Bill for foreign investors to report annually on the status of their investments. Due to the technical and consultative efforts required to have the Foreign Investment Bill considered by Parliament and the regulations concerning reserved and restricted lists and foreign investment applications approved, the possibility of new work permit rules has not yet been addressed. The results indicator targets an increase in interest from foreign investors, as measured by the number of vetted applications.

Prior action 7: The Recipient's Cabinet has approved a recommendation that the Ports Authority Tonga adopts a landlord model for Nuku'alofa port.

63. **Over the past decade, the Government has implemented a successful public enterprise (PE) reform program.** The Government's Public Enterprise Reform Policy encourages divestment where it is viable and in the public interest to do so, and improved governance and other forms of private sector participation in those cases where it is determined that the enterprise should remain publicly owned. Under the first operation in the series, the Government consolidated PE boards to boost oversight and reduce management costs. A series of PEs have already been privatized or substantially restructured to increase private sector participation, including Leiola Group Ltd duty-free retailer, the International Dateline Hotel and Tonga Water Board. As supported by DPO2, the government approved the sale of 18 percent of its share in Tonga Cable Limited (TCL) to Digicel, a private sector telecommunications operator in Tonga. The sale resulted in increased private sector participation in the company, with an additional Digicel-appointed director on the TCL board. The most recent ADB "Finding Balance" report (2016) noted that SOE profitability had improved since 2009, supported by the progressive implementation of the government's reform initiatives, with Tonga one of the few countries in the island country sample where the SOEs had made a net positive financial contribution to the government.

64. **Nevertheless, despite these gains in the performance of PEs over time, maintaining reform momentum has been and is likely to remain challenging, given pressures for government to exert more control over PE operations.** The government has recently approved the creation of three new PEs that will focus on: petroleum management and supply; the provision of ICT services; and the management of Tonga's satellite infrastructure. At the same time, amid allegations of poor administration at some PEs, there have recently been several changes to PE boards, with several board members not having their contract renewed, while planned reforms to increase private participation in another PE (the Tonga Communications

Corporation) have been put on hold.[23] Taken together, these developments suggest that the GoT is now seeking to exert a greater influence on the operations of PEs in strategic sectors of the economy.

65. **Currently, PAT assigns considerable resources to port service operations, which has diverted attention from its core functions of port management and regulation, and created unnecessary inefficiencies in port operations.** A PAT strategic review (February 2018) conducted with the support of the ADB noted that current cargo handling practices at Nuku'alofa port—where three private stevedores provide ship-to-shore cargo handling, while PAT unilaterally provides the remaining services to facilitate container transport from wharf apron to terminal yard and then to/from the gate—has meant PAT's attention has been diverted away from its core responsibilities of port regulation and oversight. Furthermore, this fragmentation of cargo handling services is unusual and inhibits efficiency, particularly given the very small container throughput at Nuku'alofa port. Global experience has demonstrated the benefits of port reform that separate the management and regulatory functions (exercised by the state-owned port authority) from the service provision (entrusted to private operators). Commonly, this separation involves the state-owned port authority adopting a landlord port structure, combined with the outsourcing of stevedoring and other port-based services to a private operator.

66. **In line with the recommendations from this review, Cabinet has approved a recommendation that PAT adopt a landlord model for the management of Nuku'alofa port.** Under the Cabinet-approved reform, PAT would maintain responsibility for and refocus on its core functions of port management and regulation, while allowing for greater private sector participation in the provision of all stevedoring and related services at the port. As well as enabling natural operating efficiencies, this reform would mean PAT would no longer incur ongoing operating, maintenance and capital replacement costs associated with cargo handling, and would allow PAT to broaden its revenue base (through the collection of a concession fee). The Ministry of Public Enterprises (MPE) are currently working with the ADB on the operational aspects of how PAT will implement the landlord model, and are preparing a tender process and concession contract, with MPE aiming to sign a concession agreement with a private company for the provision of all port cargo handling services by September 2019.[24] Although the transfer of service delivery from the PAT to a private provider may result in some job losses in PAT, transition arrangements are planned to minimize adverse employment impacts in the near term (including exploring options for redeploying these employees within PAT and offering redundancy payments), and ultimately it is likely that most of the workers not redeployed within PAT will be re-employed by the private operator given their current skills and experience. The results indicator for this prior action targets the number of public enterprises that have been reformed to increase private sector participation as at end-FY20, which effectively provides a basis to monitor continued implementation of this and previously supported actions related to public enterprises in Tonga. This results indicator is currently on track to be met.

67. **While strengthening the regulatory framework of the energy sector remains a key priority for GoT, progress in this reform area has been slower than planned when the trigger was set—largely due to shocks outside of GoT's control—and the finalization of a consolidated and harmonized National Energy Bill is now scheduled to be submitted to Parliament by October.** A planned indicative trigger under this operation was for Cabinet approval for submission to Parliament of a National Energy Bill. A key provision of the Bill is to establish a combined energy sector regulator that will merge the responsibilities of the Electricity Commission and the Tonga Competent Authority for energy products, and clarify regulatory responsibilities in other areas. In 2017 Cabinet provided in-principle approval for the Bill, which was subsequently prepared with technical assistance from the World Bank, but also requested that the current Petroleum, Electricity,

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[23] There are also reports that the Public Enterprise Act is being amended, in part to increase the authority of MPE to request financial statements and reports from PEs. This information will be updated once it becomes available.

[24] The ADB are expected to remain engaged with the PAT over the medium term via a planned project to upgrade the Nuku'alofa Port.

and Renewable Energy Acts be integrated into the Energy Bill to provide an overarching regulatory framework for the sector. Under the original timetable, the consolidated and harmonized legislation was to be prepared and submitted to Parliament by February 2018. However, reform progress was hindered by the unexpected dissolution of Parliament in August 2017 and subsequent national elections in November 2017 (one year earlier than originally expected), and then the impact of TC Gita in February 2018 just as the new government had been established. Furthermore, the new administration required that all in-principle approvals for the preparation of legislative reforms be resubmitted for approval by the new Cabinet. Reflecting the GoT's commitment to finalize the reform, a proposal to prepare the consolidated and harmonized bill was resubmitted for—and received— in-principle Cabinet approval in July 2018, with a view for it to be tabled in the Legislative Assembly as soon as practical. Nevertheless, the preparation of the Bill was again hampered in part due to the rotation of key staff out of MEIDECC, and the desire of new decision-makers to review and reconfirm the scope and terms of the reform plan. The GoT now have a clear timeline for finalizing the reform. In February MEIDECC and the EU finalized and tendered Terms of Reference for technical assistance to support the finalization of the consolidated and harmonized bill by August, and the final Cabinet approval for submission to Parliament by October 2019. While the ministry has expressed their strong commitment to adhere to this timeline for finalizing the Bill, progress in this reform area since the completion of the previous operation in this series was judged to be insufficient to justify the inclusion of any more recent steps as an adjusted trigger.

68. **As noted in the program document for DPO2, new and more restrictive credit reporting laws in Fiji that came into effect in 2017 led to a setback in the operation of the Tonga credit bureau, requiring the National Reserve Bank of Tonga to reassess its credit reporting framework.** A planned indicative trigger under this operation was for NRBT to issue a regulation to mandate credit reporting under the previously-operational Tonga credit bureau, operated out of Fiji. However, new laws requiring a higher level of credit data disclosure to the national (Fijian) authorities previously caused the provider to cease operation of the Tonga credit bureau. While the WBG previously offered support to NRBT in an attempt to find an alternative regional solution for the credit bureau, the Tongan authorities instead decided that they would prefer to locate the credit bureau in Tonga, and a domestically-housed credit bureau has since been re-established. However, given that the WBG was no longer providing assistance to support the establishment of the credit bureau itself, and that the new credit bureau has yet to complete the NRBT accreditation process, it was agreed to remove the indicative trigger from the matrix at an early stage of the preparation of this operation.

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

69. **The World Bank Group's Regional Partnership Framework (RPF) for nine PICs, including the Kingdom of Tonga, is built around four focus areas.** These are: first, fully exploiting the available economic opportunities (including in fisheries, agriculture, and tourism); second, enhancing access to employment opportunities (including by broadening opportunities for labor mobility and improving education outcomes); third, protecting incomes and livelihoods (including through strengthening resilience to natural disasters and climate change, and addressing NCDs); and fourth, strengthening the enablers of growth and opportunities (macro-economic management, infrastructure and addressing knowledge gaps). The proposed operation contributes to the first theme of exploiting economic opportunities through public enterprise reform and by making it easier to invest in Tonga, and the second and fourth focus areas by introducing a legal framework that protects fundamental labor rights, and strengthening fiscal policy so as to build fiscal buffers and improve the resilience of the government to shocks. Actions supported by this DPO are also closely linked to the IDA18 special theme "Governance and Institutions", including in the areas of supporting domestic revenue mobilization and enhancing the performance of SOEs.

70. **The proposed operation builds on a number of technical assistance projects of the World Bank and other development partners.** The World Bank, in coordination with ADB and DFAT, has provided guidance

to the development of an implementation plan and reforms to the public service remuneration and performance management systems, in addition to other assistance the GoT has received. Upgrading of budget systems, including the Chart of Accounts, has been supported by DFAT and the ADB, with technical assistance led by IMF-PFTAC. World Bank supported the development of the original draft of the Energy Framework Bill 2017, and the EU is supporting the integration of the existing Petroleum, Electricity and renewable Energy Acts into that overarching legislative framework for the sector. Foreign investment regulations have been developed with support from ADB-PSDI. Technical assistance for the public enterprise transaction has been provided by ADB-PSDI. Employment relations legislation has been supported by the ILO, while World Bank and DFAT also provided technical reviews of early drafts of the bill.

4.4 CONSULTATIONS, COLLABORATION WITH DEVELOPMENT PARTNERS

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

72. **The proposed operation is the product of close collaboration with other development partners and is part of a coordinated budget support framework.** The World Bank and IMF collaborate closely, and Bank staff have participated in all recent Article IV missions and jointly prepare DSA for Tonga. Based on this cooperation, the Bank and IMF share a common view about Tonga's macroeconomic and structural reform priorities. The World Bank leads development partner representation at the BSMC, which is the key mechanism for coordinated dialogue to select actions and monitor progress. The ADB, DFAT, MFAT and the EU are supporting the same matrix of reforms. 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, ILO and PFTAC have all provided assistance to facilitate the achievement of the proposed program of policy reforms.

5. OTHER DESIGN AND APPRAISAL ISSUES

5.1 POVERTY AND SOCIAL IMPACT

73. **Extreme poverty is rare in Tonga but there are significant levels of material deprivation, particularly in rural areas.** While traditional family and community based social safety nets 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. Preliminary estimates based on the 2015/16 Household Income and Expenditure Survey (HIES) show that less than 1 percent of Tongans live below the international poverty line of $1.90 a day, but around 25 percent of the population are struggling to meet the cost of local basic needs. These rates are even higher in rural and remote areas, with 47 percent of the rural populations in outer islands experiencing material deprivation on average, relative to 14 percent

in urban Tongatapu.

74. **Reforms supported by this operation are expected to help reduce poverty and boost shared prosperity by creating fiscal space to maintain critical public services and through shared proceeds from growth.** The public sector is a key provider of infrastructure and services that low-income households need to improve their opportunities. By supporting fiscal resilience, the reforms under Pillar 1 will help ensure that the government has the fiscal space to respond to future economic shocks and natural disasters (which tend to have a particularly adverse impact on the poor) while maintaining critical health, education, and community services on which the bottom 40 per cent are particularly dependent. The third pillar aims to address poverty by improving the environment for private sector activity, which would help bring jobs and opportunities to Tonga, and supports inclusive growth by setting standards in the labor market which will improve the quality of jobs and narrow gender disparities.

75. **The ERB introduces labor protections that are in line with international norms and standards, and includes institutional controls and transitional measures that will provide for a gradual implementation process.** The ERB is expected to improve work conditions for all employees, including the most vulnerable, to the extent that basic labor rights will be protected by law once it is enacted. Nevertheless, there is also a risk that the introduction of minimum requirements—such as various forms of paid leave entitlements—could deter enterprises from hiring new workers, insofar as these new requirements increase labor costs to employers. To mitigate this risk, authorities have proposed a staged approach to the implementation of this legislation (through the implementation of supporting regulations, transition periods, etc.). The ERB also provides the legal framework for future regulation to establish minimum wages,[25] a policy which could potentially have negative consequences on the level of employment, particularly to the extent that a selected minimum wage is misaligned with the wage rate that would clear the associated labor market. However, the Bill states that Cabinet can only pass regulation that establishes any minimum wage based on the recommendations of a Commission that is constituted to consider the issue, where the Commission's recommendations have also received prior endorsement from the Employment Relations Advisory Committee (ERAC) and the Minister. The ERAC is a new institution created by the ERB, which will comprise representatives from Government, employer organizations, workers associations, and the Forum of Directors of Education. Importantly, the composition of the ERAC ensures that no recommendation to establish a minimum wage can be made without the support of at least two non-government representatives.[26] Given such mitigating measures and notwithstanding the potential risks to employment, on balance the ERB is judged to be supportive of the more vulnerable in Tonga, to the extent that it ensures basic labor rights and protections that are already standard in other EAP countries.

76. **The ERB is expected to close several gender gaps in the Tongan legal framework that are material to women's economic participation, and that contribute to unequal and discriminatory outcomes.** According to the World Bank's Women, Business and the Law (WBL) 2019 report, laws and regulations that prevent women from entering the workforce or starting a business can have lasting effects on women's economic inclusion and labor force participation. Economies that failed to implement reforms towards gender equality over the past ten years, for example, saw a smaller increase in the percentage of women working overall and in the percentage of women working relative to men. While Tonga has some legal and regulatory instruments in place that are designed to support gender equality, there are still a number of important gaps, both in the coverage of the legal framework and in women's access to their rights in practice. Consequently, the 2019 Women, Business and the Law (WBL) index—which scores the workplace rights of

[25] The ERB provides for a minimum wage to apply nationally, or to a specific occupation, industry or geography.

[26] The ERB also sets out clear criteria for assessing whether to establish any minimum wage, which includes consideration of the needs of employees, the cost of living, economic factors (including productivity and employment levels) and information submitted by representatives of employees and employers related to the reasonableness of wages.

women relative to men on eight indicators—assessed that Tongan women have only around half the workplace rights of their male counterparts (Tonga scored 58.75, where an index of 100 is complete gender equality of workplace rights). This ranked Tonga equal 150th out of 187 countries assessed, and the equal second lowest-performing nation in the Pacific (of the 8 PICs that are included in the WBL 2019 index). This operation seeks to close a number of these gaps by supporting the submission to Parliament of an Employment Relations Bill that enshrines in law: (i) nondiscrimination in employment based on gender; (ii) a definition of sexual harassment in the workplace and a definition of employer liability (while also providing the legal framework for the development and implementation of a National Code of Practice and workplace policies to prevent sexual harassment in the workplace); (iii) equal remuneration for work of equal value; (iv) the prohibition of the dismissal of pregnant workers; and (v) the right to maternity leave for 30 consecutive working days. Consequently, the enactment of the ERB is expected to lead to a substantial improvement in the coverage of women's basic workplace rights, and could see Tonga's WBL index score rise to over 76, placing it at above the 2018 global average (74.7) and the 2018 EAP regional average (70.7).

77. **The PAT restructuring has been designed to minimize potential negative impacts on employment, and the social impacts of the reform will be monitored as it proceeds.** There is the potential for job losses in the transition of cargo transporting, marshalling and storage responsibilities from PAT to the concessionaire, to the extent that a private company improves labor productivity and reduces the number of workers required to deliver these services. However, transition arrangements are planned to minimize adverse employment impacts in the near term, and ultimately it is likely that most if not all affected workers will be re-employed by the private operator given their current skills and experience. PAT management are investigating options for: (i) redeploying affected employees within PAT that are not offered a position with the concessionaire; and (ii) offering redundancy payments. Future revenue from the concession fee will help to offset the costs of retaining these employees and/or redundancy payments. PAT management is developing an approach for managing this process and has already begun to communicate the broad outlines to the affected staff.

5.2 ENVIRONMENTAL ASPECTS

78. **The policy actions supported under the operation are not expected to have a significant impact on Tonga's environment.** In light of the focus of the this operation on prior actions that strengthen revenues and customs legislation, introduce employment relations legislation, implement foreign investment regulations, strengthen budget reporting systems and public sector performance management, and reform the management model of an important public enterprise, it is considered that direct and indirect environmental impacts should be minimal, and that—to the extent that there could be downstream environmental impacts—adequate protection would be provided by the existing legal and administrative frameworks for environmental assessment and land management in Tonga.

79. **Tonga has a well-established environmental impact assessment (EIA) process administered by the Ministry of Environment and Climate Change.** It is noted that the Transport Sector Consolidation Project (TSCP) has been implemented using the Tongan legislation and to date, the project is being implemented effectively and no environmental issues have been identified. Nevertheless, although the legal framework is reasonably sound, capacity for monitoring and enforcement is relatively thin and the quality of EIAs can be variable. Legislation includes the Environmental Impact Assessment Act 2003 which provides for the application of environmental impact assessment to the planning of development in Tonga. The Act is structured in five parts, starting with definitions of key terms in Part I and clarifying functions and powers in Part II. Part III outlines the EIA process. Part IV deals with cases of non-compliance with the previous provisions and Part V contains further miscellaneous provisions. Secondly, the Environmental Impact Assessment Regulations 2010 regulates major development projects and the application of notifications consistent with the EIA Act 2003. Finally, the Environment Management Act 2010 established the Ministry

of Environment & Climate Change which is now the principal Ministry responsible for the protection and proper management of the environment and the promotion of sustainable development.

5.3 PFM, DISBURSEMENT AND AUDITING ASPECTS

80. **Reflecting reform efforts over the recent years, Tonga's policy and institutional performance is now above average for IDA countries.** The 2010 PEFA showed that the legal and regulatory framework for PFM in Tonga provides a solid basis for budgeting, spending and accountability, but indicated areas of weaknesses in accounting, recording and reporting and in external scrutiny and audit. Satisfactory ratings were received on all indicators and sub-indicators pertaining to the credibility of the budget and on comprehensiveness and transparency. The annual budget, as approved by Parliament, is publicly disclosed and available on the MOF website. Within the area of accounting, recording and reporting, unsatisfactory ratings were issued on the availability of information on resources received by service delivery units and the quality and timeliness of Annual Financial Statements (AFS). Other weaknesses were identified in external scrutiny and audit: the scope, nature and follow-up of external audit; legislative scrutiny of the annual budget law; and legislative scrutiny of external audit reports. A number of these failures have since been addressed, supported by the budget support program. Authorities are planning to conduct a PEFA Self-Assessment during FY2020 with support from IMF-PFTAC. DFAT are also planning to complete an analysis of the robustness of GoT's financial systems as part of their Assessment of National Systems during FY2019.

81. **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 FY2017 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.

82. **There is no indication of substantial issues within the foreign exchange environment.** Until an IMF Safeguards Assessment is concluded, however, there is insufficient information available to draw any substantiated conclusions, so while country-level financial management risk for Tonga is generally rated as Moderate, the lack of an IMF Safeguards Assessment does not provide the required insights regarding the Central Bank's foreign currency management environment. The Fiduciary risk for this specific operation is therefore assessed as "Substantial" due to the inadequate knowledge of the foreign exchange control environment. To mitigate this risk, the World Bank is requiring additional measures for this operation as detailed in paragraphs 83 to 85.

83. **The disbursement measures proposed are to ensure that the grant funds disbursed by the Bank are deposited in a dedicated account of the NRBT, and then an amount equivalent to the grant 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 will be disbursed against: (i) satisfactory completion of the specified policy actions as listed in Annex 1; (ii) an adequate macroeconomic framework and; (iii) the Government agreement, as summarized in the Letter of the Development Policy. It is not tied to any specific purchases. Once the grant is approved by the Board and becomes effective, the proceeds of the grant 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.

84. **Flow of funds (including foreign exchange) is subject to Tonga's regular Financial Management processes.** It is not possible to track the ultimate use of the foreign exchange provided by the development policy operation proceeds, but grant proceeds will, within 30 days of the IDA disbursement, flow from the dedicated Foreign Currency Deposit Account at the NRBT into a local currency bank account of the

government used to finance budgeted government expenditures. The Government will provide confirmation to the Bank when an amount equivalent to the grant amount has been credited to a local account used to finance budgeted expenditures by way of a letter within 30 days of the crediting of the funds into the local account. The proceeds of the operation would not be used to finance expenditures excluded under the General Conditions for IDA Financing: Development Policy Financing (2018) ('General Conditions"). If, after being deposited in a government deposit account, the proceeds of the operation are used for ineligible purposes as defined in the General Conditions, IDA will require the Recipient to refund the amount directly to IDA. Any such amounts refunded to IDA shall be cancelled.

85. **The Bank will retain the right to request the Government to arrange a special audit of the dedicated Foreign Currency Deposit Account established in the NRBT.** The audit should cover the following: (i) the accuracy of the summary of the transactions of this account, including accuracy of exchange rate conversions; (ii) that this account was only used for the purposes of the operation and that no other amounts were deposited into this account, including confirmation from corresponding bank(s) involved in the funds flow; and (iii) that payments from this dedicated Foreign Currency Deposit Account were in a timely manner (normally within 30 days of disbursement) transferred to a local account available to finance budgeted expenditure, with an equivalent amount in Tonga Pa'anga accounted for in the Recipient's budget management system, in a manner acceptable to the Association. 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 date of the Association's request for such audit, and will be made publicly available in a timely fashion.

5.4 MONITORING, EVALUATION AND ACCOUNTABILITY

86. **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 MOF 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 MOF will also be ultimately responsible for reporting progress and coordinating actions among other concerned government agencies.

87. **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.

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

6. SUMMARY OF RISKS AND MITIGATION

The overall risk level for the proposed program is substantial.

Table 7: Standardized Operational Risk-Rating Tool

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

89. **The risks around limited institutional capacity are "High", but are being mitigated by strong dialogue between the Bank and the Government, the selection of a limited number of reform actions, and the coordination of technical assistance**. As outlined in paragraph 12, thin public service capacity means that program implementation can be directly affected by the performance or departure of a few key officials, and the occurrence of shocks which divert attention from the reform agenda to immediate priorities (such as TC Gita and the associated recovery effort). Through the course of the DPO program the Government and the Bank have carefully selected a limited number of policy actions that are key government priorities and have had substantive discussions around the implementation requirements for each action, to ensure that expectations regarding capacity and timing are realistic. Dedicated technical assistance from one or more of the JPRM development partners has been provided to support the achievement of nearly all prior actions, while the results framework accounts for limitations to data availability. Complex reform areas such as public service remuneration that require ongoing consultation and continued government commitment have a higher level of implementation risk, but this has been mitigated through the gradual, phased approach and an upfront investment in analytical design and consensus-building.

90. **While the frequency and magnitude of potential shocks leads to macroeconomic risks that are rated as "Substantial", these risks are being mitigated by prudent fiscal management on the part of the government, and prior actions that further strengthen fiscal resilience.** Ongoing macroeconomic stability is highly dependent on external factors, including the occurrence of natural disasters, sources of remittances and external demand, development assistance from donors, and imported commodity prices. Natural disasters can have substantial negative impacts of economic activity and livelihoods, and can put significant strain on GoT's fiscal position—with TC Gita the most recent example. The effects of TC Gita could also expose the financial sector to increased vulnerabilities, to the extent that damages to property and lost income could lead to higher default rates on loans. Risks to the global economy could further tilt domestic risks to the downside, particularly to the extent that growth in advanced economies leads to lower remittances and FDI inflows. Remittance flows will be largely determined by labor market conditions in the US, New Zealand and Australia, which are the major sources of remittances, making Tonga's economic outlook susceptible to a deterioration in economic activity in those countries. Similarly, the sustainability of Tonga's public finances 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. The risks associated with these various external vulnerabilities are being mitigated by: i) government investment projects (supported by development

partners) to enhance the economy's resilience to natural disasters[27]; ii) the government's record of prudent fiscal management and adherence to its debt management strategy in recent years; iii) the accumulation of foreign exchange reserves to manage shocks; iv) GoT's ongoing collaboration with development partners and continued interest in pursuing reforms via budget support operations; and v) the revenue, public remuneration, debt management, and fiscal anchor reforms supported by the development policy program.

91. **Political and governance risks are assessed as "Substantial", though these are being mitigated by strong dialogue between the Bank and the Government at both the political and administrative levels.** In August 2017, Parliament was dissolved by the King unexpected, and there have been several petitions to again dissolve Parliament in 2019. There are also indications that Cabinet Ministers are seeking to exert more control in administrative areas that were previously led by senior public officials, and policy decision-making is becoming more concentrated, with a recently-formed Government Reform Committee (chaired by the Prime Minister and comprised of a small cadre of senior ministers) assuming responsibility for a range of leadership, strategy, policy, and monitoring functions. These political developments have contributed to somewhat greater unpredictability in policy decision-making, and may risk introducing bottlenecks into the functioning of government, to the extent that public service operations are delayed while awaiting direction from the political level. These developments could impact the direction and speed of progress on reform efforts, particularly in terms of the public sector's role in strategic sectors of the economy. This risk is being mitigated by ongoing strong dialogue between the Bank and the GoT, both at the political level (particularly through the Minister of Finance), and at the administrative level (through the Budget Support Management Committee, led by the CEO of MoF).

92. **While the policy framework includes major reforms that may meet with opposition from vested interests—meaning stakeholder risk is judged to be "Substantial"—this is mitigated by extensive and ongoing consultation processes and the provision of transition periods for some groups.** A focus of this program is to strengthen inclusive institutions, and policy reforms focused on increasing domestic competition via foreign investment, introducing fundamental labor rights into the private-sector workplace and supporting controlled and earned public pay increases may give rise to opposition from individuals that benefit from existing systems. This risk is mitigated through an extensive public consultation process on these reforms led by the GoT, and through the provision of transition periods which can provide particular groups with extra time to implement the new policy (such as the implementation of the PMS by the Ministry of Education) and to gradually enhance their capacity to meet the new standards (such as for small and medium enterprises becoming subject to the full extent of the ERB legislation).

93. **There is a "Moderate" risk that policy actions could have negative social impacts for some groups, although there is strong government commitment to ensure mitigating measures are in place.** As noted in paragraph 66, the restructuring of PAT—where the PE will focus on its core competency of port regulation and management—is expected to lead to the signing of a concessionaire contract for the delivery of all cargo handling services. Thus, while the adoption of a landlord model by PAT is not expected to have any direct social impacts, there is a potential for limited indirect social impacts to emerge, contingent upon the negotiated arrangements reached between PAT and the concessionaire responsible for the delivery of cargo services. To mitigate this risk, PAT are exploring options for redeploying any employees that choose to stay with PAT rather than join the concessionaire, and for offering redundancy payments.

[27] Such as the World Bank-supported Climate Resilient Transport Project and Pacific Resilience Project, and ADB-supported projects in water and urban infrastructure, and disaster risk management.

ANNEX 1: POLICY AND RESULTS MATRIX

Completed actions, prior actions and triggers			Results
Actions completed under DPO 1	**Actions completed under DPO 2**	**Prior Actions DPO 3**	
Pillar I – Supporting fiscal resilience			
The Recipient has increased the rate of fuel excise tax by TOP$0.06 per liter (an increase in the rate of 12%) and other excise tax and import duty rates in order to improve revenue mobilization and strengthen incentives to consume healthy foods, as evidenced through the Excise Amendment and the Customs Amendment[28]	The Recipient has increased the rate of fuel excise tax by TOP$0.09 per liter (an increase in the rate of 16%) and other excise tax and import duty rates in order to improve revenue mobilization and strengthen incentives to consume healthy foods, as evidenced through the Excise Amendment and the Customs Amendment[29]	The Recipient's Cabinet has approved for submission to Parliament a revised Revenue Services Administration Bill that introduces additional avenues for revenue recovery and sets updated and graduated penalties The Recipient's Cabinet has approved for submission to Parliament a new Customs Bill that aligns with international standards (including the Revised Kyoto Convention and World Customs Organization recommended practices) and simplifies customs administration	**Outcome: Domestic revenue as a proportion of GDP** Indicator: Domestic revenue as a proportion of GDP. Baseline (average FY14-FY16): 21.8 percent Target (average FY18-FY20): > 25 percent
The Cabinet has approved a new Medium-Term Debt Strategy which has been made public	The Recipient's Cabinet has approved a transparent, target-based fiscal anchor system and monitoring framework that supports medium-term fiscal sustainability and a more efficient mix of public spending		**Outcome: Ensure that annual budget estimates are consistent with medium term fiscal anchors, and that any divergences are adequately explained.** Baseline (FY13-FY17): No analysis of consistency between annual Budget estimates and medium-term fiscal anchors in Budget documents. Target: (FY18-FY20): Analysis included in Budget documents **Outcome: Proportion of borrowing that is highly concessional** Indicator: External borrowing that is above 35 percent concessionality as a proportion of all external borrowing. Baseline (FY13-FY15): 100 percent Target (FY16-FY20): 100 percent

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

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

Completed actions, prior actions and triggers			Results
Actions completed under DPO 1	**Actions completed under DPO 2**	**Prior Actions DPO 3**	
(a) The Recipient's Remuneration Authority has completed a remuneration review of the public service in order to ensure equitable, competitive and fiscally-sustainable remuneration and submitted its recommendations to Cabinet; and (b) the Recipient's Cabinet has reviewed the said recommendations	The Recipient's Cabinet has approved and begun to implement a new public service remuneration structure and performance management system to ensure effective public service delivery, adequate pay, and consistency with fiscal sustainability	The Recipient has: (i) realigned the performance management system year; (ii) provided target performance-rating distributions to public institutions; and (iii) clarified the eligibility of public sector employees to receive performance rewards and the application of procedures to manage poor performance, based on a review of its new public service remuneration structure and performance management system	**Outcome: Increases in public sector wages are based on performance as measured by an annual moderated performance assessment process** Indicator: Annual moderated performance process completed and ratings used in the determination of public sector wages. Baseline (FY14): No Target (FY18 to FY20): Yes. **Outcome: Improve wage bill affordability** Indicator: Public wage bill as a proportion of domestic revenue. Baseline (average of FY14-FY16): 62 percent Target (average of FY18-FY20): 53 percent or lower
Pillar II – Government accountability			
The Recipient's Cabinet has approved a revised set of Procurement Regulations, and prepared standard bidding documents and procurement manuals in support of the Regulations A new biannual report of audit recommendations and actions for all ministries and agencies has been prepared, and a new Audit Oversight Committee of Cabinet established and tasked with ensuring timely and thorough follow-up of audit recommendations	The Recipient has implemented a new procurement tracking database and adopted compliance and performance indicators and associated targets for monitoring system performance, to be publicly disseminated	The Recipient has removed the non-economic items from the economic segment of the Chart of Accounts, which will improve the accuracy and integrity of budget reporting	**Outcome: Increased compliance with requirements for public procurement** Indicator: Proportion of contracts above the small purchases threshold that are subject to open competition.[30] Baseline (FY14): 35 percent of contracts subject to open competition Target (FY20): At least 50 percent of contracts subject to open competition **Outcome: External audit recommendations acted upon** Indicator: Proportion of public accounts audit recommendations noted as 'outstanding' in the following year's audit report. Baseline (FY17): 60 percent (6 of 10 audit matters raised in FY16 with respect to the public accounts were still outstanding as of the FY17 Audit). Target (FY19 and FY20): 40 percent (no more than 40 percent of audit matters raised in FY18 with respect to the public accounts are still outstanding as of the

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

Completed actions, prior actions and triggers			Results
Actions completed under DPO 1	**Actions completed under DPO 2**	**Prior Actions DPO 3**	
			FY19 Audit, and no more than 40 percent of audit matters raised in FY19 with respect to the public accounts are still outstanding as of the FY20 Audit) **Outcome: Chart of Accounts revision reflected in budget systems** Indicator: New economic segment is utilized in the budget systems. Target (end FY20): New economic segment is reflected in budget reporting
Pillar III – Supporting a more dynamic and inclusive economy			
The Recipient's Legislative Assembly has approved a new Communications Commission Act that will establish an independent regulator	The Recipient's Cabinet has approved for public consultation a National Energy Bill, which includes provisions for multi-sector regulation for all energy sub-sectors (electricity, gas, petroleum)	Dropped	**Outcome: Effective oversight of regulated sectors** Indicator: Regulators for the communication and energy sectors are established and operational. Baseline (2015): Neither exists Target (end FY20): Both are established and operational
		The Recipient's Cabinet has approved for submission to Parliament the Employment Relations Bill, which will ensure fundamental labor rights are enshrined in domestic law	**Outcome: Key labor market protections are in place** Indicator: Number of basic labor rights (including equal remuneration for equal work, gender non-discrimination and right to maternity leave) enshrined in domestic legislation.[31] Baseline (2015): None of seven in place Target (end FY20): Equal remuneration for equal work, gender non-discrimination and right to maternity leave enshrined in domestic legislation. Three of the remaining four basic labor rights also enshrined in domestic legislation.
	The Recipient's Cabinet has approved the Foreign Investment Bill for submission to the Recipient's Parliament, which includes provisions	The Recipient's Cabinet has approved revised foreign investment regulations, which provide clearer and more transparent requirements for foreign investment	**Outcome: Increase in interest from foreign investors** Indicator: Vetted applications from foreign investors.

[31] Where the basic rights consist of: As measured in the annual WBG Ease of Doing Business index. The 7 basic labor rights measured are: i) paid annual leave; ii) notice period for redundancy; iii) severance pay for redundancy; iv) equal remuneration for equal work; v) gender non-discrimination; vi) right to maternity leave; vii) paid sick leave.

Completed actions, prior actions and triggers			Results
Actions completed under DPO 1	**Actions completed under DPO 2**	**Prior Actions DPO 3**	
	to facilitate foreign investment in the Recipient's territory	applications	Baseline (FY15): 21 applications Target (FY20): 30 applications or greater
The Recipient's Cabinet has approved the appointment of shared boards of directors of public enterprises in the information, communications, and technology sector, and the utilities sector in order to streamline the number of Directors and achieve greater efficiency	The Recipient's Cabinet has directed the Ministry of Public Enterprises to proceed with a sale of shares in Tonga Cable Ltd	The Recipient's Cabinet has approved a recommendation that the Ports Authority Tonga adopts a landlord model for Nuku'alofa port	**Outcome: Public enterprises reformed to introduce private sector participation** Indicator: Number of public enterprises that have been reformed since 2015. Target (end FY20): At least two

ANNEX 2: LETTER OF DEVELOPMENT POLICY

OFFICE OF THE MINISTER FOR FINANCE

MINISTRY OF FINANCE, NUKU'ALOFA
TONGA

Reference: MF. 14/33

4th April 2019

Ms. Kristalina Georgieva
Interim-President
World Bank Group

Mr. Takehiko Nakao
President
Asian Development Bank

Dear President Georgieva and President Nakao,

Letter of Development Policy

Despite a number of challenges in recent years, including Tropical Cyclone Gita which swept our country in early 2018, the Government of Tonga continues to focus on reforms to achieve inclusive, sustainable growth and development. In this we are guided by the *Tonga Strategic Development Framework (TSDF), 2015–2025: A more progressive Tonga: Enhancing Our Inheritance*, which provides an overarching strategic framework for our efforts to support a better quality of life for all.

Since the global financial and economic crisis in the late 2000s, the Kingdom of Tonga has embarked on an ambitious reform program. Reforms implemented to date have strengthened our public financial management systems, increased tax collections and improved public enterprise performance. As a result of the reforms, our debt position has stabilized, our allocation of public resources is more strategic, and their use is more efficient. Efforts to improve the policy and regulatory environment for the private sector have led to substantial improvements in the ease of doing business. Successive governments have persisted in efforts to implement reforms, which has resulted in substantial achievements despite limited administrative capacity in our small country.

In pursuing these efforts we have very much appreciated the ongoing support from our development partners. Since 2011 the Government and development partners have been working together through the Joint Policy Reform Matrix (JPRM) process to prioritize, implement and monitor reforms that are critical for Tonga's sustainable and inclusive development. This year marks the continuation of a reform program that was interrupted last year by the impact of Tropical Cyclone Gita, during which time we were again grateful for the quick and substantial response from our development partners in support of our recovery efforts. The current year's budget support operations continue to support us by providing fiscal resources to support public service

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Member of Parliament of Tongatapu 10

delivery, and technical assistance to guide the formulation of sound policies and reforms that help us to achieve our goals.

Closely aligned to the priorities of Government as reflected in the TSDF, the JPRM aims at building macroeconomic resilience, supporting accountability, and driving inclusive growth and improved living standards.

In the first two years of this program we undertook tax reforms to raise collections and provide incentives to consume healthy foods by raising the price of some unhealthy foods while cutting duty rates on healthy alternatives. A new medium-term debt management strategy was put in place, and we introduced a set of fiscal anchors to support our efforts to maintain revenue collections, keep external debt to a manageable level, and ensure a sustainable wage bill, so that sufficient resources can be allocated to critical spending for public services and infrastructure. A new public service remuneration framework was approved and implemented, which ensures that good performance is rewarded and that skills and expertise receive a fair and attractive return, while at the same time helping to secure the sustainability of the overall public sector wage bill. New procurement regulations were introduced and a procurement database was launched to help monitor key performance indicators. New institutions and processes were put in place to manage and ensure appropriate government follow-up of audit recommendations. A new ICT regulator was established in law, and work on a new Energy Bill was progressed to create an integrated regulatory framework for the entire sector. New foreign investment legislation was approved by Cabinet to provide more clarity and certainty for foreign investors looking to invest in our country. The governance of public enterprises was overhauled by introducing new and more professional shared boards, and the Government agreed to a transaction to sell a minority share of Tonga Cable Limited to a private telecommunications operator, which has provided us with new capital for investments in high-speed and affordable internet connectivity throughout the country.

The current, final year of the program has seen steps being taken to extend and strengthen many of these reforms. Domestic revenues have increased dramatically over the last eight years, in large part due to policy reforms supported by previous budget support engagements, and we have recently approved sweeping revisions to the Revenue Services Administration Act and to our customs legislation, to improve the effectiveness of our domestic revenue collection practices and to align our customs operations with best practice internationally. We have reviewed the first year of implementation of the new public service performance management system, and undertaken several measures to respond to the most pressing recommendations of this review. We have updated our Chart of Accounts, which will improve the quality of our budget reporting and help us to better monitor trends in our public spending. After several years of concerted reform effort, our Parliament has now passed the Foreign Investment Act and we have approved foreign investment regulations that will help make applying for a foreign investment certificate simpler and more transparent. We have also approved a Private Sector Development Strategy to guide our efforts to ensure Tonga is a country in which businesses – small and large – can grow and flourish. To continue our successful public enterprise reform program, we have approved a recommendation to adopt a landlord model for Nuku'alofa port, which will directly promote increased private sector participation in the provision of cargo handling services, improve the efficiency of the port operations, and allow Ports Authority Tonga (PAT) to concentrate on its core functions of managing and regulating port activities. In pursuing this reform we will ensure that transition arrangements are put in place to reduce any adverse impact on PAT employees.

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Notably, and after many years of consultations and preparation, the Government has now finalized employment relations legislation to ensure that the fundamental labor rights of all workers are protected in Tonga, including the most vulnerable. Up until now our country has not had any laws around private sector employment conditions, creating risks of reduced participation in the labour market (particularly for women) and exploitation of workers by unscrupulous employers. This new legislation therefore fills a critical gap in helping to ensure that the benefits of economic growth are shared broadly among the population.

Having now completed such a substantive series of policy reforms, the Government remains firmly committed to implementing this JPRM reform program, which will be instrumental to achieve the country's ambitious development goals. The Government looks forward to the continued active engagement of its major development partners, including the Asian Development Bank and the World Bank, in Tonga's reform and development efforts.

Sincerely,

Dr. Pohiva Tu'i'onetoa
Minister for Finance

MINISTER FOR FINANCE
TONGA

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ANNEX 3: FUND RELATIONS ANNEX

DOCUMENT OF INTERNATIONAL MONETARY FUND AND FOR OFFICIAL USE ONLY

FOR INFORMATION

FO/DIS/19/24

February 12, 2019

To: Members of the Executive Board

From: The Acting Secretary

Subject: **Tonga—Assessment Letter for the World Bank**

Board Action:	Executive Directors' **information**
Publication:	Yes*
Questions:	Ms. Loukoianova, APD (ext. 39694)

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

Tonga—Assessment Letter for the World Bank

February 12, 2019

This letter provides the IMF staff's assessment of Tonga's macroeconomic conditions, prospects, and policies.

1. **As expected, Tropical Cyclone Gita (TCG) caused a slowdown in economic activity in FY2018,[1] straining Tonga's external position.**

- The post-disaster rapid assessment, conducted by the World Bank, ADB, UN, and EU, estimated total damages and losses at T$356 million (about 35 percent of estimated FY2018 GDP). [2] TCG impacted approximatively 75 percent of Tonga's population, and the housing and agriculture sectors were most affected.
- Real GDP growth is estimated to bottom out in FY2018 at 0.1 percent, with rapid recovery work having started soon after February's TCG. After moderating earlier in the year, average inflation picked up, reaching 7 percent in June 2018. The authorities postponed some of the investment projects in the aftermath of TCG, which resulted in a budget surplus of 1.6 percent of GDP in FY2018. The debt sustainability analysis (DSA) conducted in 2017 raised Tonga's risk of external debt distress to "high," due to risks stemming from large natural disasters. The external current account deficit for FY2018 was broadly stable at 6.7 percent of GDP, reflecting donor grants received in June 2018.

2. **Despite the damage from TCG, the short-term macroeconomic outlook remains positive.** Real GDP growth is projected to recover to 3.5 percent and 5.5 percent in FY2019 and FY2020, respectively. Inflation is forecast to decline and average 5.8 percent in FY2019 because of lower global oil prices and partly reflecting an expansion of the CPI basket in September 2018. The fiscal position is expected to deteriorate in FY2019 to a small overall deficit of 1.2 percent of GDP, mainly because of larger infrastructure spending and reconstruction activities. The external current account deficit is projected to widen to 14.9 percent of GDP in FY2019 owing to an expected increase in reconstruction-related imports and still subdued exports of agricultural products and tourism services. Gross international reserves are expected to decline in FY2019 to US$187.8 million (about 5.5 months of projected imports) mainly reflecting the first principal payment of an external debt, as well as the need to finance increased imports and the remaining financing gap.

[1] Fiscal year in Tonga runs from July 1 to June 30. The value of the T$ is determined based on a weighted average basket of four currencies, comprising the United States, Australian, Fijian, and New Zealand dollars; the current exchange rate is about T$2.29 per US dollar.

[2] See Disaster Recovery Framework – TC Gita, Kingdom of Tonga, June 2018. Of the estimated total, some US$91.7 million is attributable to damages and US$64.7 million to economic losses.

3. **The speed of Tonga's growth recovery will be determined by the vigor of its reconstruction efforts and the availability of external resources.** Although bilateral and multilateral donors have thus far committed substantial financing in the form of cash and in-kind grants of T$145 million (US$64.5 million) for FY2019-FY2021, overall reconstruction needs still leave a cumulative financing gap of T$146 million (US$64 million), equivalent to about 35 percent of projected foreign reserves for FY2019. This financing gap can be set against total reconstruction needs of T$333.5 million (US$147.5 million) or 80 percent of projected foreign reserves for FY2019. In the absence of additional external resources, this financing gap will not be closed. Thus, the authorities would need to come up with a plan to close the financing gap, through either drawing down foreign reserves, cutting spending, or applying for an IMF financing arrangement. Coordination among donors and enhanced absorptive capacity are important to ensure an effective reconstruction effort.

- To avoid excessive reserve losses and maintain an adequate level of reserves, the National Reserve Bank of Tonga (NRBT) enforced a new Foreign Exchange Control (FEC) Act from November 2018.[3]
- Large-scale imports related to public and private sector reconstruction will strain Tonga's external position, despite Tonga securing (in November 2018) a new five-year grace period for the People's Republic of China's Exim Bank principal loan repayments. The pace of public sector reconstruction will importantly depend on the receipt of substantial additional aid flows. The largest challenge in the reconstruction effort is likely to be implementation capacity, as rebuilding most of the country will severely stretch its resources even if funding is available.
- Private sector reconstruction is expected to be largely driven and financed by inflows of remittances, which have averaged about 25 percent of GDP over the last decade.

4. **Downside risks dominate the macroeconomic outlook.** Beside domestic risks associated with financing reconstruction, weaker-than-expected global growth and inward-looking policies by key trading partners could lead to lower grant and remittance inflows, larger external imbalances, and reduced household consumption. While the banking sector remains profitable and stable, and the level of non-performing loans is relatively low, the widespread TCG-related damage to property could expose the financial sector to additional vulnerabilities. TCG may also have a detrimental effect on household incomes and default rates on mortgages may rise.

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[3] The FEC Act 2018 came into force on 10th July 2018 and was enforced from November 2018. The NRBT has the power to impose requirements to repatriate any gold and foreign exchange that is due or has accrued to any person resident in Tonga, if foreign reserves would fall below 2 months of imports. This relates to the proceeds of exports and offshore investments or holdings by Tongan residents. The applicable requirements are set out by the NRBT through its Exchange Control Policy Guidelines. The FEC Act does not violate Article VIII Section 2, if the repatriation is conducted at the market exchange rate.

5. **Following TCG, policy actions to maintain fiscal sustainability remain urgent.** As in the 2017 IMF Article IV consultation and May 2018 IMF Assessment Letter, key recommendations include:

- *Staff advice for fiscal policy* in the 2017 Article IV consultation was to accomplish fiscal consolidation through achieving a primary surplus of one percent of GDP in the medium term, with the adjustment relying on expenditure restraint, especially on wages, and thereby stabilize debt. This advice remains valid. The authorities should reorient part of the planned capital expenditure towards reconstruction and should avoid slippages that would result in non-concessional external borrowing.

- *The current accommodative monetary stance remains appropriate.* The NRBT's monetary policy has supported credit growth, mainly through financing owner-occupied dwellings. With credit growth projected to remain strong at 19.4 percent and average inflation of 5.8 in FY2019, the authorities should continue their close monitoring of credit growth developments to preserve financial stability. The NRBT should consider introducing macroprudential tools based on the recommendations of the recent IMF technical assistance mission to ensure that vulnerabilities do not build up in the financial sector.

6. **Structural reforms will be essential to promote sustained high and inclusive growth and achieve the Sustainable Development Goals.** Boosting potential growth requires improvements in competitiveness and the business climate, as well as in building infrastructure resilient to natural disasters. In Tonga's National Infrastructure Investment Plan FY2013-23, priority has been given to 13 projects in the energy supply system, telecommunications, water and waste management, and transportation. Efforts would need to focus on strengthening the government's policymaking and implementation capacity, creating a conducive environment for domestic and foreign investment, and accelerating implementation of donor-supported projects.

7. **IMF Relations**

- The 2017 Article IV consultation was concluded by the IMF's Executive Board on January 17, 2018. Tonga was then placed on a 24-month Article IV consultation cycle (moving from a 12-month cycle) at the request of the authorities. Staff is planning a Staff Visit at the end of February 2019, and the 2019 Article IV consultation is planned for December 2019. Following TCG and as of February 2019, the Fund has not received a request for financial support.

- In recent years, the IMF has been providing a significant amount of technical assistance in the areas of public financial management, banking supervision, foreign reserve management, macroprudential policy, and macroeconomic statistics. Tonga is served by a Regional Resident Representative, Ms. Leni Hunter, based in Fiji. The Pacific Financial Technical Assistance Centre (PFTAC), based in Fiji, provides technical assistance and facilitates regular exchange with the Tongan authorities.

Table 1. Tonga: Selected Economic Indicators, FY2016–FY2021 1/

Population (2018): 101 thousands
GDP per capita FY2018: US$4200
Major exports: fish, root crops, vanilla, squash
Key export markets: Australia, Japan, New Zealand, United States
Quota: SDR 13.8 million

			Est.	Proj.		
	FY2016	FY2017	FY2018	FY2019	FY2020	FY2021
Output and prices			(Annual percent change)			
Real GDP 2/	3.3	5.0	0.1	3.5	5.5	4.3
Consumer prices (period average) 3/	-0.6	7.2	7.0	5.8	5.0	4.2
Consumer prices (end of period) 3/	0.2	9.8	6.7	5.0	4.9	3.4
GDP deflator	2.4	3.9	3.1	3.5	2.2	2.1
Central government finance			(In percent of GDP)			
Revenue and Grants	40.6	42.5	44.4	51.9	50.3	47.1
Revenue	30.4	29.3	29.7	29.9	29.7	29.9
Grants in-kind	10.2	13.2	14.7	22.0	20.6	17.2
Expenditure	41.1	40.4	42.8	53.0	51.4	47.6
Expense (current exp.)	31.8	29.9	33.2	36.3	34.2	31.2
Transactions in Nonfinancial Assets (Net) (capital exp.)	9.3	10.5	9.6	16.7	17.1	16.4
Overall balance	-0.4	2.1	1.6	-1.2	-1.1	-0.5
Net Acquisition of Financial Assets	1.8	2.9	4.3	0.9	0.6	0.8
External financing (net)	0.2	0.2	2.6	1.9	1.9	1.8
Domestic financing (net)	2.0	0.5	0.1	0.2	-0.2	-0.5
Debt						
Public debt (external and domestic)	51.5	46.4	47.4	46.4	44.6	43.3
External debt	43.7	39.5	41.8	40.9	39.8	39.1
Debt service ratio	1.6	1.4	1.4	2.0	1.2	1.2
Money and credit			(Annual percent change)			
Total liquidity (M3)	16.7	13.7	7.6	10.4	10.9	10.8
Of which: Broad money (M2)	15.0	13.0	9.4	10.4	11.3	11.1
Domestic credit	8.3	4.8	-6.5	19.4	14.6	13.3
Of which: Private sector credit	17.5	18.0	6.7	7.9	12.0	12.0
Interest rates (end of period)						
Average deposit rate	2.1	2.3	2.3	...	...	...
Average lending rate	8.7	8.6	8.5	...	...	...
Balance of payments			(In millions of U.S. dollars)			
Exports, f.o.b.	25.2	20.8	14.4	13.6	14.0	14.4
Imports, f.o.b.	-192.7	-206.0	-218.9	-285.4	-275.0	-277.5
Services (net)	4.4	-15.7	-17.0	-42.7	-31.6	-30.3
Investment income (net)	8.8	18.3	32.8	16.0	11.2	7.4
Current transfers (net)	127.0	153.1	160.4	233.4	230.0	238.7
Of which: Remittances	111.3	125.1	138.6	142.5	147.2	146.5
Of which: Official grants	28.7	37.5	29.1	95.8	88.4	83.9
Current account balance	-27.3	-29.5	-28.3	-65.1	-51.5	-47.2
(In percent of GDP)	-6.5	-6.9	-6.7	-14.9	-11.2	-9.9
Overall balance	23.9	25.8	17.1	-21.5	-10.1	-6.3
(In percent of GDP)	5.6	6.0	4.0	-4.9	-2.2	-1.3
Terms of trade (annual percent change)	2.1	2.9	-1.8	-0.5	0.0	0.5
Gross official foreign reserves						
In millions of U.S. dollars	166.4	192.2	209.3	187.8	177.8	171.4
(In months of next year's goods and services imports)	6.6	7.1	5.9	5.5	5.2	5.1
Exchange rates						
Exchange Rate- US dollars per Tongan pa'ang (Period Av.)	98.8	0.5	0.4	...	...	...
Real effective exchange rate (2005=100)	96.8	103.2	110.3	...	...	...
Memorandum items:						
Remittances (in percent of GDP)	26.4	29.3	32.8	32.5	32.0	30.6
Tourism (in percent of GDP)	16.3	16.1	19.8	20.4	20.0	19.5
FDI (in percent of GDP)	1.3	-1.3	2.0	1.1	1.1	1.0
Nominal GDP (millions of US$)	403.7	452.0	450.2	463.8	485.3	505.4

Sources: Tongan authorities; and IMF staff estimates and projections.
1/ Fiscal year beginning July.
2/ Including preliminary data.
3/ CPI basket and methodology changed in September 2018.

ANNEX 4: ENVIRONMENT AND POVERTY/SOCIAL ANALYSIS TABLE

Prior actions	Significant positive or negative environment effects (yes/no/to be determined)	Significant poverty, social or distributional effects positive or negative (yes/no/to be determined)
Operation Pillar 1: Supporting fiscal resilience		
Prior action #1	No	Positive. Help sustain key service delivery spending by bolstering domestic revenue collection.
Prior action #2	No	Positive. Help sustain key service delivery spending by bolstering domestic revenue collection.
Prior action #3	No	Positive. Improved management of the wage bill will be important to ensure that payroll pressures do not crowd out essential service delivery spending or compromise fiscal sustainability.
Operation Pillar 2: Government accountability		
Prior action #4	No	No
Operation Pillar 3: Supporting a more dynamic and inclusive economy		
Prior action #5	No	Possibly positive. By enshrining basic labor rights in law, the ERB should improve work conditions for all employees, and particularly for vulnerable groups and women. However, new minimum requirements, such as paid leave, may increase labor costs to employers and deter job creation at the margin.
Prior action #6	No	Positive. Greater regulatory certainty and transparency is expected to encourage greater foreign investment, which should support job creation and income generation.
Prior action #7	No	Possibly negative. The PAT restructuring and signing of a concession contract may lead to job losses, to the extent that the concessionaire can deliver the services more efficiently than PAT. However, PAT management are exploring options to redeploy affected employees within PAT, or to offer redundancy payments, to any staff that are not employed by the concessionaire.