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IDA/R2018-0194/1

June 6, 2018

Closing Date: Friday, June 15, 2018 at 6 p.m.

FROM: Vice President and Corporate Secretary

Tonga - Second Inclusive Growth Development Policy Operation: Supplemental Financing

Supplemental Financing Document

Attached is the Supplemental Financing Document regarding a grant from the International Development Association (IDA) Crisis Response Window (CRW) to Tonga for a Second Inclusive Growth Development Policy Operation: Supplemental Financing (IDA/R2018-0194), which is being processed on an absence-of-objection basis.

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The World Bank

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Report No: 125384-TO

INTERNATIONAL DEVELOPMENT ASSOCIATION
SUPPLEMENTAL FINANCING DOCUMENT FOR A PROPOSED

GRANT

IN THE AMOUNT OF SDR 7.0 MILLION (EQUIVALENT TO US $10 MILLION)
FROM THE IDA CRISIS RESPONSE WINDOW RESOURCES

TO THE

KINGDOM OF TONGA

FOR THE

SECOND INCLUSIVE GROWTH DEVELOPMENT POLICY OPERATION

June 4, 2018

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 30 April 2018)

Currency Unit	Tongan Pa'anga
US$ 1.00	TOP$ 2.21
SDR 1.00	US$ 1.43806

ABBREVIATIONS AND ACRONYMS

ADB	Asian Development Bank
BBB	Build Back Better
CoA	Chart of Accounts
CoE	Compensation of Employees
CRW	Crisis Response Window
DFAT	Department of Foreign Affairs and Trade
DPF	Development Policy Financing
DPO	Development Policy Operation
DSA	Debt Sustainability Analysis
EU	European Union
ERB	Employment Relations Bill
FY	Fiscal Year
GDP	Gross Domestic Product
GoT	Government of Tonga
GRS	Grievance Redress Service
HIES	Household Income and Expenditure Survey
IDA	International Development Association
IFC	International Finance Corporation
ILO	International Labor Organization
IMF	International Monetary Fund
JPRM	Joint-Policy Reform Matrix
MCCTIL	Ministry of Commerce, Consumer, Trade, Innovation & Labour
MFAT	Ministry of Foreign Affairs and Trade
MFNP	Ministry of Finance and National Planning
MTDS	Medium-term Debt Strategy
NEMO	National Emergency Management Office
NGO	Non-Government Organization
NRBT	National Reserve Bank of Tonga
PCRIC	Pacific Catastrophe Risk Insurance Company
PE	Public Enterprise
PEFA	Public Expenditure and Financial Accountability
PFM	Public Financial Management
PFTAC	Pacific Financial Technical Assistance Centre
PREP	Pacific Resilience Program
PSDI	Private Sector Development Initiative
RDLA	Rapid Damage & Loss Assessment
RSAA	Revenue Services Administration Act
SDR	Standard Drawing Right
SME	Small and Medium Enterprises
SPC	The Pacific Community
SORT	Standardized Operational Risk-Rating Tool
TA	Technical Assistance
TBC	Tonga Broadcasting Commission
TC	Tropical Cyclone
TCL	Tonga Cable Limited
TOP	Tongan Pa'anga
WTO	World Trade Organization

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KINGDOM OF TONGA

SECOND INCLUSIVE GROWTH DEVELOPMENT POLICY OPERATION: SUPPLEMENTAL FINANCING

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SUMMARY OF PROPOSED FINANCING AND PROGRAM

BASIC INFORMATION

Project ID	Parent Project
P167330	P159262

Proposed Development Objective(s)

The Program Development Objectives are to: i) Support fiscal resilience by means of strengthened revenue mobilization and strategic fiscal and debt policies; ii) support improved government accountability and private sector regulation by improving compliance with public procurement regulations, improving budgetary classifications, improving the adequacy of responses to external audit, and introducing new regulatory frameworks into selected sectors; and iii) support a more dynamic and inclusive economy by adopting investor-friendly foreign investment legislation, extending coverage of the credit bureau, improving oversight and private participation in public enterprises, and introducing regulation to private sector labor markets.

Organizations

Borrower:	Kingdom of Tonga
Implementing Agency:	Ministry of Finance and National Planning

PROJECT FINANCING DATA (US$, Millions)

SUMMARY

Total Financing	US$10 million

DETAILS

IDA Grant	US$10 million

INSTITUTIONAL DATA

Climate Change and Disaster Screening

This operation has been screened for short and long-term climate change and disaster risks

Overall Risk Rating

Substantial

Results

Indicator Name	Baseline	Target
1) Increase in excise tax revenue as a proportion of domestic revenue	19.0 percent (average FY11-FY14)	Increase of 0.5 percentage points of domestic revenue (FY19)
2) Analysis of relationship between current fiscal outcomes, budget projections, and the path toward fixed medium-term fiscal targets conducted as part of Budget preparations	No such analysis in Budget documents (FY13-FY17)	Analysis included in Budget documents (FY18-FY20)
3) Reduction in public wage-bill as a proportion of domestic revenue over time	57 percent (FY14)	53 percent or lower (FY19)
4) All new external debt taken on is highly concessional	100 percent (FY13-FY15)	100 percent (FY16-FY19)
5) Increase in proportion of contracts above the small purchases threshold that are subject to open competition	35 percent (FY14)	At least 50 percent (FY19)
6) Improvement in the proportion of audit recommendations acted on (Proportion of outstanding audit recommendations 12 months after submission of the audit report to the Legislative Assembly)	85 percent (FY15)	50 percent (FY19)
7) Monitoring reports for regulated sectors published on at least an annual basis	No baseline report (2015)	Reporting issued by regulators that covers all sectors under their oversight (2018)
8) Number of basic labor rights enshrined in domestic legislation	None of eight in place (2015)	At least six of eight in place (2018)
9) Increase in vetted applications for foreign investment	21 applications (FY15)	30 applications or greater (FY19)
10) Increase in number of Credit Bureau checks for new loan requests for; i) sole male applicants; ii) female applicants or joint applications.	i) 636; ii) 588 (FY15)	i) 800 or more; ii) 750 or more (FY19)
11) Public enterprises reformed to increase private participation	None (FY15)	At least two (FY19)

IDA SUPPLEMENTAL FINANCING DOCUMENT FOR A PROPOSED GRANT TO THE KINGDOM OF TONGA

1. INTRODUCTION AND COUNTRY CONTEXT

1. **The proposed operation provides US$10 million in supplemental financing for the Second Inclusive Growth Development Policy Operation (DPO2) to help the Government of Tonga (GoT) cover an unanticipated financing gap that has arisen due to the impact of Tropical Cyclone (TC) Gita**. On April 27, 2017, the Board approved DPO2 – valued at US$5 million – which had the development objectives of: i) supporting fiscal resilience; ii) supporting improved government accountability and private sector regulation; and iii) supporting a more dynamic and inclusive economy. The request for supplemental financing is consistent with the World Bank policy on Development Policy Financing.

2. **A severe tropical cyclone hit Tonga in February 2018, leading to significant damages and losses.** On February 12 the islands of Tongatapu and 'Eua were hit by TC Gita, a level 4 cyclone with average wind speeds of 130 km/h and gusts of up to 195 km/h – the strongest tropical cyclone to impact these islands since TC Isaac in March 1982. An accompanying storm surge reached one meter above normal high tide levels, and 200mm of rainfall fell over a 24-hour period, resulting in localized flooding. The cyclone caused widespread damage to power lines, schools, crops and fruit trees, and public infrastructure including 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), and caused damages and losses of TOP$356 million (US$164 million, or around 38 percent of 2017 GDP). TC Gita was a further example of Tonga's significant exposure to natural disasters including cyclones, earthquakes, droughts, floods and storm surges, which together have caused average annual damages of over 4 percent of GDP. Climate change is exacerbating many of these vulnerabilities: as well as increasing average temperatures, changing rainfall patterns, and triggering coastal erosion and saline intrusion, climate change is also expected to increase the intensity of tropical cyclones in coming decades.

3. **Despite budget reallocations, and pledged support from development partners, recovery and reconstruction needs have created a substantial unanticipated financing gap which the GoT does not on its own have the capacity to fill.** The government's Disaster Recovery Framework estimates the total value of public financing required for cyclone recovery and reconstruction to be TOP$246 million (US$113 million) over the four years from FY2018 to FY2021. After accounting for substantial donor commitments and some reprogramming of GoT spending, an unanticipated government financing gap of TOP$82.4 million (US$38.0 million) remains over the period, including a gap of TOP$23.7 million (US$10.9 million) for FY2018. Together with a modest drawdown in cash reserves (TOP$2 million, US$0.9 million, 0.5 percent of FY2017 revenues), the proposed US$10 million in supplemental financing provided by this operation would be sufficient to fill this unanticipated financing gap in FY2018.

4. **The proposed US$10 million supplemental financing is needed to support the GoT in its recovery efforts, given the inability of the government to obtain sufficient funds from other sources in the required timeframe and on sufficiently concessional terms.**[1] Tonga is already at a high risk of debt distress and has no access to international capital markets, limiting the alternative sources of funding available. While DPO funds are not earmarked for specific purposes, quick disbursement of the supplemental financing would allow government the fiscal space to potentially pursue near-term recovery priorities that currently remain unfunded (if it so chooses), including support for housing repair and

[1] In April 2018, a request was made for US$20 million in IDA Crisis Response Window (CRW) support for recovery from TC Gita in Tonga. The CRW funds are proposed to be channeled through two operations: (i) US$10 million for this supplemental DPO financing; and (ii) US$10 million for additional financing to the Tonga: Pacific Resilience Project under the Pacific Resilience Program (PREP). The overall additional financing to PREP is expected to be US$16.25 million, and will support a range of activities including school recovery and reconstruction needs. US$4 million is expected to come from Tonga's national IDA allocation, with the remaining US$2.25 million to come from other sources and to support other activities. The estimates of the financing gap presented in this document assume that the expected additional financing to PREP is committed.

rebuilding through cash or in-kind assistance, support for agriculture sector recovery, and support for recovery activities targeted at women and girls[2], among others. On the other hand, in the absence of further budget support, fiscal resilience – the first development objective of the DPO program – would be significantly weakened, with the government forced to run down cash balances and/or increase debt to potentially unsustainable levels to meet its recovery needs. Moreover, completion of the reforms supported by the current DPO series could face an increased risk of substantial delays due to competing budgetary and capacity priorities arising from the post-disaster recovery effort.

5. **Overall, the program encapsulated by the three-DPO programmatic series remains broadly on track, and the government remains committed to the implementation of the supported actions in DPO2.** The GoT has a history of committing to and successfully completing development operations, with seven DPOs approved by the Board between FY2011 and FY2017. Through its continued efforts to implement the reform actions undertaken in DPO2, the government remains on track to achieve the development objectives of the current program, which is being implemented in compliance with the provisions of the legal agreement with the Bank. As outlined in Table 7, the government has also taken significant steps toward completion of the indicative triggers for DPO3, despite several factors beyond its control recently acting to hinder progress, including 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. Supplemental financing for DPO2 is a preferable option to accelerating the processing of DPO3, given that several reforms supported by DPO3 involve substantial legislative changes that will require considerable government attention to complete. Requiring progress on these reforms to be accelerated in the months following the cyclone would be inconsistent with the GoT's current need to focus on post-cyclone recovery.

2. THE IMPACT OF TC GITA ON THE MACRO-FISCAL OUTLOOK

6. **When DPO2 was approved in April 2017, Tonga's macroeconomic outlook was positive, but subject to downside risks.** The projections in DPO2 indicated that the economy would expand by 2.5 percent in FY2018 and 2.9 percent in FY2019 (Table 1). Other key macroeconomic indicators were expected to remain stable over the projection period, with inflation forecast to be around 3 percent, the budget deficit to remain below 1 percent of GDP, and the current account deficit to be around 10 percent of GDP. Despite a slight decline, foreign reserves were expected to remain at adequate levels (over 6 months of imports cover), supported by continued development assistance.

7. **The outlook for economic growth improved over the remainder of 2017.** The IMF Article IV, based on consultations in September-October 2017, noted a favorable economic outlook, with forecast growth of 3.4 percent in FY2018 and 3.0 percent in FY2019 driven by construction, agriculture, and tourism, albeit subject to risks related to weaker global growth, an increase in the cost of remittances, compromised fiscal sustainability (particularly if reforms fail to contain public sector wage growth), and future natural disasters. Immediately prior to TC Gita, the government's forecast was for 3.0 percent growth in FY2018, picking up to 3.9 percent in FY2019 before moderating to around 3 percent in FY2020, underpinned by continued strong growth in tourism receipts and construction related to government and donor-funded investment projects.

8. **TC Gita will have a substantial effect on the outlook for economic activity over the next two to three years.** Growth is now expected to slow to less than 1 percent in FY2018, reflecting the impact of the cyclone on agricultural production, tourism, and the commercial sector, which together account for a 3.5 percentage point reduction in FY2018 growth relative to the government's pre-cyclone baseline (this reduction is partially offset by initial repair and reconstruction activity which is expected to add 0.8 percentage points to FY2018 growth). Losses in agriculture, tourism and commerce are also expected to be substantial in FY2019, but diminish rapidly from FY2020 onwards. These losses will

[2] These include measures to support the reactivation of handicraft production – which predominantly involves women – and improvements to women's safety and sanitation in evacuation centers.

be offset by reconstruction and repair activity for housing, public buildings, and schools, which is projected to ramp up over the next two years before scaling back from FY2021 onwards. Together with a recovery in the agriculture and services sector, reconstruction is thus expected to drive a strong rebound in growth to around 4.3 percent and 6.5 percent in FY2019 and FY2020, respectively (Table 1, Figure 1).[3] Nevertheless, total losses in output relative to the pre-cyclone baseline are expected to amount to around 4.3 percent of 2017 GDP, or US$17 million, over the next four years.

Table 1: Evolution of GDP growth forecasts (percent)

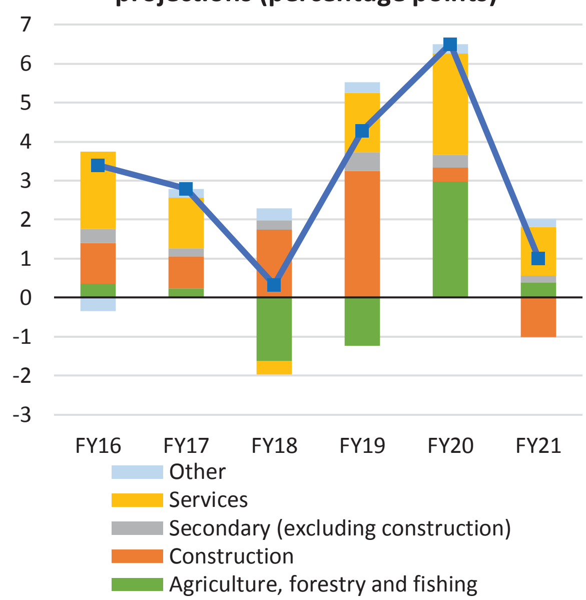
	FY2016	FY2017	FY2018	FY2019	FY2020	FY2021
At Board Approval of DPO2 (April 2017)	3.1	2.3	2.5	2.9	1.8	1.8
IMF Article IV (October 2017)	3.4	2.7	3.4	3.0	2.9	1.9
Government, pre-cyclone (December 2017)	3.4	2.8	3.0	3.9	3.1	2.2
Post-cyclone	3.4	2.8	0.3	4.3	6.5	1.0

Source: Estimations by RDLA Team based on GoT figures and Program Document of parent project.

9. **Inflation spiked in FY2017 due to one-off factors, but relatively fast inflation may persist for longer than expected due to TC Gita.** 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. Over the medium term, the IMF expected inflation to moderate to around 2.5 percent.

10. **TC Gita will put some upward pressure on food prices in the short term**, with anecdotal evidence of local market shortages of some fruits and vegetables. Relatively fast inflation may persist for longer than previously expected, depending on the extent to which these shortages persist and on the pace of increases in imported food and fuel prices. Nevertheless, inflation should eventually return to more modest rates as domestic production picks up.

Figure 1: Contributions to Growth, Post-Cyclone projections (percentage points)



Source: Bank staff based on GoT figures.

11. **The current account deficit was estimated at 12 percent of GDP in FY2017, but was largely financed by capital transfers.** 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 over the three years FY2017-FY2019. Notwithstanding the increase in imports, the strong performance of exports (particularly squash), increased donor grants, and rising remittances had kept foreign reserves at relatively comfortable levels (at around 6 months of imports). Nevertheless, reserves had been expected to decline slightly in the medium term due to continued strength in imports and large scheduled principal repayments of external debt.

12. **As a result of TC Gita, the current account deficit is expected to deteriorate due to an increase in imports and a decline in exports of agricultural products and tourism services, although an increase in transfers will offset part of**

[3] Post-cyclone projections from the IMF suggest a larger decline in economic growth in FY2018, due to a higher estimated effect of cyclone-related damages on the productive capacity of the economy, but a stronger rebound in the following year, with a relatively higher proportion of reconstruction activity assumed to occur in FY2019. Real GDP at the end of FY2019 is broadly similar under both sets of projections.

these effects. Imports of building materials will pick up in the near term to meet the most urgent repair and reconstruction needs, while shortages of locally-produced fruit and vegetables will also cause imports of food to increase. Exports of agricultural produce will likely decline, in line with the projected effects on economic activity in the agricultural sector. Looking further forward, imports will likely remain higher than previously expected, in line with the additional public and private sector reconstruction activity now forecast to take place over the next three to four years. To the extent that foreign currency needs are not met by increased aid and remittance flows, this could put some additional pressure on the balance of payments. Nevertheless, grants (both capital and current) are expected to be higher over the projection period (FY2019 – FY2021) than in recent years, due to increased donor support for cyclone recovery.[4]

13. **Prior to TC Gita, authorities had maintained a generally prudent fiscal stance.** The deficit had been contained at around half a percent of GDP in FY2016 and FY2017, and despite some volatility, Tonga's fiscal balance averaged a modest deficit of only 1 percent of GDP over the last eight years. Domestic revenues increased by 5.4 percentage points of GDP between FY2013 and FY2017, and government cash buffers had been built to 5.3 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 fiscal anchors with targets for debt, revenue, and the wage bill.

14. **Nevertheless, the FY2018 budget was comparatively expansionary, and prior to TC Gita higher deficits were forecast over the next few years**. The government forecast a deficit of 1.3 percent of GDP in FY2018 based on optimistic domestic revenue projections, with the IMF forecasting a deficit of 2.3 percent of GDP based on a less sanguine revenue outlook (the Fund's projections are taken as the pre-cyclone baseline in the analysis that follows). Due to projections of declining grants and higher own-financed capital expenditure, the IMF forecast deficits of 1.9 percent and 4.4 percent of GDP respectively for FY2019 and FY2020, while at the same time noting risks around growth in the wage bill. While the introduction of the new remuneration framework and performance management system has been subject to some teething issues (motivating the adjustment of the indicative trigger for DPO3 – see Table 7), the IMF projected compensation of employees (CoE) to fall below the fiscal anchor of 53 percent of domestic revenues in FY2018, albeit while expanding from 14.6 to 15.0 percent of GDP. CoE was then expected to decline over the following two years as a proportion of GDP and of revenues, in part as a result of the ongoing implementation of these reforms. Moreover, the government has demonstrated its willingness to control own-financed capital spending by freezing various sports and leisure-related investments earlier this year, which together with freezes to staff hiring have saved around TOP$35 million from the FY2018 budget.

15. **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, and to have created an *additional* public financing need of TOP$246 million (US$113 million, 26 percent of GDP) for cyclone recovery.** Estimated damages of TOP$209 million (US$96 million) were mainly sustained in the housing, tourism and commerce & industry sectors, while estimated losses of TOP$147 million (US$68 million) were primarily in the agriculture and commerce & industry sectors (Table 2). The GoT's Disaster Recovery Framework estimates the total recovery and reconstruction needs to be TOP$369 million (US$170 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 around two-thirds of the costs (TOP$246 million, US$113 million). Table 3 shows the breakdown of these

Table 2: Summary of Damages and Losses by Sector (TOP$ millions)

	Damage	Losses	Total
Productive Sectors	**54.9**	**138.5**	**193.4**
Agriculture	5.1	92.4	97.5
Commerce & Industry	23.5	31.8	55.3
Tourism	26.3	14.3	40.6

[4] While these projections are broadly consistent with IMF projections, there are modest differences in the projections of goods and services exports, due to differences in the estimated impact of the cyclone and subsequent recovery on the agriculture and tourism sectors.

public financing recovery needs by sector. In the productive sectors, the costs of repairs and reconstruction will be largely borne by the private sector. In housing, the GoT is expected to cover around one quarter of the reconstruction costs, with households assuming the remaining three-quarters.[5] The GoT intends to fully cover the costs of damages in the infrastructure sectors, and in health and education. Note that energy sector recovery needs are much larger than the estimated damages sustained in the sector, reflecting plans to adopt a Build Back Better (BBB) strategy for the damaged parts of the electricity network and to boost the overall network's resilience to natural disasters.

Social Sectors	**131.5**	**2.7**	**134.2**
Housing	111.6	0.0	111.6
Education	19.8	2.2	22.0
Health	0.1	0.6	0.7
Infrastructure Sectors	**22.5**	**6.1**	**28.5**
Energy	13.4	3.7	17.1
Public and Buildings	5.5	1.0	6.5
Transport	2.3	0.8	3.1
Water and Sanitation	1.3	0.6	1.9
Total	**208.8**	**147.3**	**356.1**
As a % of FY2017 GDP	***22.2***	***15.6***	***37.8***

Source: Estimations by RDLA Team based on GoT figures.

Table 3. Summary of Recovery and Reconstruction Needs, by Sector (TOP$ millions)

	To be financed by public sector				**Total Recovery Needs (Public & Private)**
	Immediate Recovery Needs (to June 2018)	**Short-term Recovery Needs (FY2019)**	**Medium-term Recovery Needs (FY2020–FY2021)**	**Total Recovery Needs**	
Productive Sectors	**4.8**	**12.6**	**6.6**	**24.0**	**54.3**
Agriculture	1.0	2.7	5.1	8.8	8.8
Commerce and Industry	1.8	7.0	1.5	10.3	10.3
Tourism	2.0	2.9	0.0	4.9	35.4
Social Sectors	**14.6**	**25.7**	**8.0**	**48.3**	**140.7**
Housing	5.8	20.2	0.0	26.0	118.4
Education	8.5	5.5	8.0	22.0	22.0
Health	0.3	0.0	0.0	0.3	0.3
Infrastructure Sectors	**21.2**	**22.7**	**87.8**	**131.7**	**131.7**
Energy	13.4	0.0	86.2	99.6	99.6
Public and Community Buildings	0.3	20.0	0.7	21.0	21.0
Transport	0.7	1.6	0.9	3.1	3.1
Water, Health and Sanitation	5.2	1.1	0.0	6.3	6.3
Telecommunications	0.5	0.0	0.0	0.5	0.5
Waste Management	1.1	0.0	0.0	1.1	1.1
Employment, Safety, Gender and Social Protection	**5.2**	**2.5**	**15.5**	**23.2**	**23.2**
Disaster Risk Management	**19.0**	**0.0**	**0.0**	**19.0**	**19.0**
Total	**64.8**	**63.5**	**117.8**	**246.2**	**369.1**
As a % of FY2017 GDP	***6.9***	***6.7***	***12.5***	***26.1***	***39.2***

Source: Estimations by RDLA Team based on GoT figures.

[5] While a final decision will be announced as part of the FY2019 budget, authorities have indicated this is the likely level of financial assistance that the GoT will provide to households to undertake their own repairs and reconstruction (TOP$26 million over FY2018 & FY2019), leaving around TOP$92 million to be borne by households. Should the GoT decide to assume the total costs of housing repairs and reconstruction (TOP$118 million), then the total public financing recovery need would equal TOP$339 million, and the unmet public financing gap would increase substantially.

16. **The immediate recovery needs associated with TC Gita create a substantial *unanticipated* financing gap in FY2018, on top of the pre-cyclone deficit forecast of 2.3 percent of GDP**. Public-sector recovery and reconstruction financing needs for immediate recovery (to June 30, 2018, i.e. the end of FY2018) are estimated at TOP$64.8 million. In the immediate aftermath of the cyclone, cash contributions from donors (TOP$16.2 million) and an insurance payout (TOP$7.6 million) helped to meet recovery needs, while in kind support of TOP$19 million was also received to assist with the immediate relief effort. In addition, the GoT reprogrammed TOP$1.3 million of recurrent spending from education[6], and drew down the TOP$2 million available from the National Emergency Fund. Cabinet also approved a consumption tax exemption in Tongatapu and 'Eua for: (i) imports of food, clothing and household tools, until the end of June 2018; and (ii) imports of construction materials and capital goods (i.e. machinery, equipment, vehicles and tools), for two years. These exemptions are estimated to reduce tax collection by TOP$5 million in FY2018 and a further TOP$5 million over FY2019-FY2020. Overall, while many of the immediate relief and recovery needs have already been met by donors and government reprogramming, an unanticipated public financing gap of TOP$23.7 million remains in FY2018 (Table 4).

17. **Short to medium-term recovery needs are also only partially covered by pledged donor support and feasible reprogramming of public spending, leaving an even larger *unanticipated* additional financing gap for the period FY2019 to FY2021.** Public sector recovery and reconstruction financing needs over the FY2019-FY2021 period are estimated at TOP$181.4 million. Meeting these needs will depend in part on the extent to which the GoT can reorient future spending toward cyclone recovery activities. As a rough estimate, it is assumed that the GoT reallocates all previously-planned domestically-financed capital spending (equivalent to TOP$25.9 million) towards cyclone recovery over the next three years, which would be between 1 and 2 percent of revenues per year. As noted above, the government has already demonstrated a willingness to adjust own-financed capital spending in FY2018, but there would likely be very limited scope for further budget reallocations without adversely affecting the quality and coverage of public service delivery. Development partners have pledged TOP$101.8 million (US$46.9 million) to support the medium-term recovery effort. Despite these commitments, the government requires a further TOP$58.7 million (US$27.0 million) over FY2019-FY2021 to fund its cyclone recovery efforts.

Table 4: Unanticipated public financing needs associated with cyclone recovery (TOP$ millions)

	FY2018	FY2019 - FY2021	TOTAL
Recovery Needs	**64.8**	**181.4**	**246.2**
Available Funds	**41.1**	**122.7**	**163.8**
GoT	-1.7	20.9	19.2
Budget reallocation and emergency fund drawdown	3.3	25.9	29.2
Foregone revenues from consumption tax exemptions	-5.0	-5.0	-10.0
Donor grant contributions and PCRIC insurance payout (a)	42.8	101.8	144.6
Unmet Need (Financing Gap)	**23.7**	**58.7**	**82.4**
GoT financing (cash reserves, new debt issuance)	**2.0**	**58.7**	**60.6**
World Bank Supplemental DPO Financing	**21.7**	**0.0**	**21.7**

Source: Bank staff based on GoT figures. **Note**: (a) Includes PCRIC insurance payout of TOP$7.6 million (US$3.5 million) in FY2018, TOP$21.7 million (US$10 million) of World Bank CRW resources and TOP$8.3 million (US$4 million) of Tonga's reallocated national IDA for the expected additional financing to PREP in FY2019.

[6] Anecdotal evidence suggests many other ministries, including health, agriculture, defense, and the National Emergency Management Office (NEMO) also used existing operational budget to finance immediate relief efforts. However, at the time of writing, MFNP were still finalizing the value of these expenditures, and the amount that would be required to be reimbursed to ensure essential service delivery is not adversely affected later in the financial year.

18. **The substantial recovery costs combined with lower domestic revenues are expected to place a significant strain on GoT's *overall* fiscal position in FY2018, in the absence of supplemental financing through the proposed operation.** Compared to the pre-cyclone baseline (i.e. the IMF Article IV projections, which already adjust for the over-optimism of the revenue projections in the FY2018 budget) domestic revenue collection in FY2018 is likely to be around TOP$34 million lower than previously thought. This comprises a TOP$21.7 million shortfall due to delayed disbursement of budget support[7], and a TOP$12.2 million shortfall in line with the projected slowing in economic activity in FY2018 and the consumption tax exemption measures (On the **basis of the conservative assumptions outlined above, the debt trajectory is projected to worsen due to the economic effects of TC Gita, but not to the extent indicated by the natural disaster scenario in the 2017 DSA.** Assuming that GoT close the remaining fiscal gap (attributable to the cyclone and otherwise) by first drawing down cash reserves to their target minimum level, and subsequently by issuing new debt, total public debt would increase by around 10 percentage points of GDP by FY2021, to 58.3 percent of GDP (**Error! Not a valid bookmark self-reference.**). About 60 percent of this increase would be attributable to the unanticipated cyclone-related financing gap. The present value of Tonga's external debt to GDP ratio is projected to breach the DSA threshold of 40 percent more quickly than under the 2017 DSA baseline scenario (Figure 2). 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 already 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 limit drawdowns of cash reserves; 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 2.

19. **Table 6**). Combined with the TOP$64.8 million in cyclone-related expenditure needs, and accounting for the budget deficit expected prior to the cyclone, there is a total budget financing need of TOP$121.6 million (US$56.0 million) in FY2018. These needs are covered by government efforts to reduce and reprogram planned expenditures; additional donor grants, including the supplemental financing proposed under this operation; and cash reserves, as well as a limited amount of new debt (TOP$2 million). The proposed US$10 million in supplemental financing is therefore a critical element to close the fiscal gap in FY2018 (with the forecast deficit increasing to 4.2 percent of GDP in its absence, compared to 1.9 percent of GDP assuming it is disbursed by the end of FY2018). Even if the spending associated with some of the 'immediate' cyclone-related spending needs tagged for FY2018 spills over into the following year, the supplemental financing will remain critical to help cover the financing gap associated with these needs.

Table 5: Projected FY2018 Budget Financing Needs and Sources (TOP$ millions)

[7] As noted in section 1, this was due to delays in the completion of the agreed triggers, which were largely caused by events outside of GoT's control – namely, 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.

	Jan. 2018	May. 2018
Total Revenue & Grants	532.7	563.3
Domestic Revenue	319.0	306.8
Grants-in-kind	213.7	256.5
Total Expenditure & Net Lending	555.5	582.0
Deficit (including grants)	-22.9	-18.8
Financing	22.9	18.8
External Financing (net)	21.0	2.0
Domestic Financing (net)	1.9	16.8
Estimation of Budget financing gap in FY18		
A. Original Gap to be Financed	22.9	
B. Unanticipated revenue decline	33.9	
of which: Reduced tax collection	12.2	
Delayed budget support	21.7	
C. Cyclone-related financing needs	64.8	
New Gap (A + B + C)	**121.6**	
Financed By:		
Above the line adjustments	***102.8***	
Reductions in planned expenditure (wages, capital spending)	35.0	
Reprogramming of planned expenditure to meet cyclone-related needs	3.3	
Additional Grants	64.5	
of which		
---World Bank	29.3	
---PCRIC payout	7.6	
---Supplemental Financing to DPO2	21.7	
--- ADB	15.2	
--- Other	20.0	
Below the line financing	***18.8***	
Foreign financing	2.0	
Domestic financing	16.8	
Total	**121.6**	

Source: Bank staff based on GoT figures.

20. **Under conservative assumptions, Tonga's fiscal position over the short to medium-term will weaken further, though in practice deficits and debt will likely not increase to the extent projected in Table 6 and Figure 2**. Covering the entirety of the additional unanticipated financing gap of TOP$58.7 million over this period (which is backloaded in the latter two years as pledged donor support is assumed to cover most of the needs tagged for FY2019) would boost the projected budget deficit to 7.6 percent of GDP in FY2020 and 4.7 percent of GDP in FY2021 (On the **basis of the conservative assumptions outlined above, the debt trajectory is projected to worsen due to the economic effects of TC Gita, but not to the extent indicated by the natural disaster scenario in the 2017 DSA.** Assuming that GoT close the remaining fiscal gap (attributable to the cyclone and otherwise) by first drawing down cash reserves to their target minimum level, and subsequently by issuing new debt, total public debt would increase by around 10 percentage points of GDP by FY2021, to 58.3 percent of GDP (**Error! Not a valid bookmark self-reference.**). About 60 percent of this increase would be attributable to the unanticipated cyclone-related financing gap. The present value of Tonga's external debt to GDP ratio is projected to breach the DSA threshold of 40 percent more quickly than under the 2017 DSA baseline scenario (Figure 2). 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 already 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 limit drawdowns of cash reserves; 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 2.

21. **Table 6**). However, the assumptions underpinning these projections are conservative in the sense that: i) it is assumed that government fully meets its estimated recovery needs over the period to FY2021; and ii) it is assumed that there are no additional donor grants forthcoming to help finance these needs, beyond those already pledged. As a result, it is assumed that the government is forced to take on additional debt to meet the majority of these needs (available cash reserves could meet only around one sixth of the total financing gap over the period FY2018 to FY2021 without being depleted to levels below the targeted minimum[8]). However, in practice the government will likely seek as much additional grant financing as possible in coming years, and then carefully weigh whether or not to take on available domestic or (concessional) external debt financing to meet any further needs, with the likelihood that several will remain unmet. This implies that government deficits may not expand to the extent set out in Table 6.[9]

22. **Prior to TC Gita, generally prudent fiscal management had 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 impact of natural disasters in the IMF/World Bank Debt 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 (MTDS).

23. **On the basis of the conservative assumptions outlined above, the debt trajectory is projected to worsen due to the economic effects of TC Gita, but not to the extent indicated by the natural disaster scenario in the 2017 DSA.** Assuming that GoT close the remaining fiscal gap (attributable to the cyclone and otherwise) by first drawing down cash reserves to their target minimum level, and subsequently by issuing new debt, total public debt would increase by around 10 percentage points of GDP by FY2021, to 58.3 percent of GDP (**Error! Not a valid bookmark self-reference.**). About 60 percent of this increase would be attributable to the unanticipated cyclone-related financing gap. The present value of Tonga's external debt to GDP ratio is projected to breach the DSA threshold of 40 percent more quickly than under the 2017 DSA baseline scenario (Figure 2).[10] 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 already 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 limit drawdowns of cash reserves; 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 2.

Table 6: Selected Macroeconomic Indicators, Pre- and Post-Cyclone

[8] The MFNP aims to retain a minimum coverage of two months of recurrent expenditure (around TOP$40 million).

[9] The IMF post-cyclone projections indicate higher fiscal deficits in FY2018 and FY2019, due to different assumptions regarding the proportion of total recovery needs to be funded by government, the profile of recovery-related spending and donor flows over the next four to five years, and the size of government spending adjustments already implemented in FY2018.

[10] The projections assume additional future debt over this period is external and contracted on semi-concessional terms.

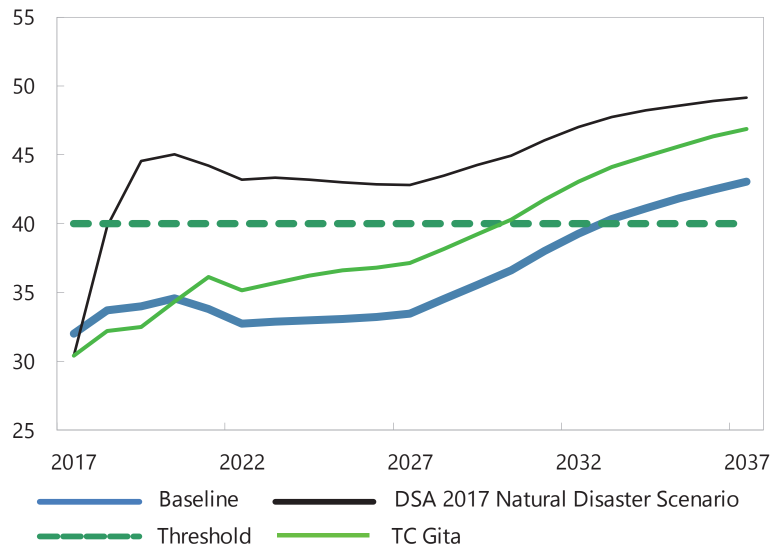
	Actual	Pre-Cyclone			Post-Cyclone			
	FY16	FY17 Est.	FY18 Proj.	FY19 Proj.	FY18 Proj.	FY19 Proj.	FY20 Proj.	FY21 Proj.
Output and prices	(Annual percent change)							
Real GDP	3.4	2.7	3.4	3.0	0.3	4.3	6.5	1.0
Consumer prices (period average)	-0.6	7.2	5.3	2.5	6.3	3.5	2.5	2.5
GDP deflator	1.7	3.1	2.1	2.1	3.0	1.8	1.3	1.3
Central government finance	(In TOP$ millions)							
Total Revenue	363.8	419.1	532.7	549.7	563.3	601.3	579.4	577.0
(In percent of GDP)	40.9	44.5	53.6	52.6	58.0	58.3	52.1	50.7
Revenue (excluding grants in-kind)	272.2	287.2	319.0	316.7	306.8	309.4	331.8	347.6
Grants in-kind	91.6	131.9	213.7	233.1	256.5	291.9	247.6	229.4
Total Expenditure	368.2	422.9	555.5	569.6	582.0	625.6	664.0	630.6
(In percent of GDP)	41.4	44.9	55.9	54.5	59.9	60.7	59.7	55.4
Expenses	284.6	321.2	408.5	414.9	392.5	414.9	419.4	438.7
Transactions in Nonfinancial Assets	83.6	101.7	147.1	154.7	189.6	210.7	244.6	191.9
Overall balance	-4.4	-3.8	-22.9	-19.9	-18.8	-24.3	-84.6	-53.6
(In percent of GDP)	-0.5	-0.4	-2.3	-1.9	-1.9	-2.4	-7.6	-4.7
Money and credit	(Annual percent change)							
Total liquidity (M3)	16.7	18.8	11.7	11.3	8.5	14.6	…	…
Of which: Broad money (M2)	15.0	19.1	12.1	11.7	8.9	15.3	…	…
Domestic credit	8.8	5.8	16.6	14.1	16.4	19.9	…	…
Of which: Private sector credit	18.0	18.9	13.0	12.0	19.0	16.0	…	…
Interest rates (end of period)								
Average deposit rate	2.1	2.3	…	…	…	…	…	…
Average lending rate	8.7	8.6	…	…	…	…	…	…
Balance of payments	(In US$ millions)							
Exports, f.o.b.	24.1	25.3	26.4	27.0	19.0	20.5	27.2	27.3
Imports, f.o.b.	-202.8	-235.1	-258.4	-281.2	-297.9	-329.1	-319.8	-330.8
Services (net)	-9.1	-14.4	-17.3	-21.7	-24.3	-41.7	-20.2	-20.3
Investment income (net)	2.5	6.8	8.7	11.6	8.7	11.6	13.0	13.6
Current transfers (net)	129.7	166.0	190.5	207.5	201.7	237.8	217.8	224.6
Of which: Remittances	112.2	117.4	124.3	130.4	127.5	133.6	136.0	141.5
Of which: Official grants	33.0	53.1	69.6	80.5	77.6	107.6	85.2	86.5
Current account balance	-55.6	-51.3	-50.1	-56.7	-92.8	-100.9	-82.0	-85.6
(In percent of GDP)	-13.2	-12.0	-11.8	-12.9	-20.7	-21.2	-16.0	-16.3
Overall balance	23.9	3.5	15.4	-8.5	-27.3	-52.7	-34.4	-32.9
(In percent of GDP)	5.7	0.8	3.6	-1.9	-6.1	-11.1	-6.7	-6.3
Terms of trade (annual percent change)	2.0	3.1	-1.8	-0.5	-1.8	-0.5	-0.7	0.0
Debt	(In percent of GDP)							
Public debt (external and domestic)	51.8	48.0	49.2	50.3	49.4	50.5	55.2	58.3
External debt	44.0	41.8	43.2	44.6	43.4	44.8	49.6	52.7
Debt service ratio	1.6	1.6	1.5	3.8	2.9	3.3	3.1	3.0
Memorandum items:								
Nominal GDP (TOP$ millions)	889.4	941.8	993.8	1045.1	971.4	1031.2	1112.5	1138.2
Nominal GDP (US$ millions)	422.3	427.7	422.9	438.3	447.6	475.2	512.7	524.5
TOP$ per US$ (period average)	2.1	2.2	2.3	2.4	2.2	2.2	2.2	2.2
Cash Reserves (TOP$ millions)		69.8	…	…	53.0	40.0	40.0	40.0
(In months of recurrent expenditure)		3.5	…	…	2.7	2.0	2.0	2.0

Source: Bank staff based on GoT figures.

24. **The current macroeconomic policy stance is adequate for the proposed supplemental financing, but outcomes**

remain subject to uncertainty and are contingent on continued prudent fiscal management and the extent of additional contributions from development partners, beyond what has already been pledged. 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 para 13. Despite a projected weakening of the fiscal position over FY2018 and FY2019, 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. More recently, the government has demonstrated fiscal discipline in its decision to freeze various sports and leisure related investments, in its intention to cover only a fraction of total housing reconstruction and repair costs, and through its continued commitment to the revenue, spending, and debt management reforms supported by the current DPO series. Nevertheless, in the near term the cyclone will have a sharp negative impact on growth, and will likely widen the current account deficit and increase inflation 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 likely 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 progress on implementing DPO-supported policy reforms, the readiness of development partners to provide additional financial support, and the proposed allocation of CRW resources to Tonga, of which this supplemental financing is a critical component.

Figure 2: Debt Sustainability Analysis, Present Value of External Debt-to-GDP Ratio under various scenarios



Source: Bank staff calculations based on Tonga 2017 DSA.

3. RESPONSE TO THE CRISIS

3.1. THE GOVERNMENT'S RESPONSE

25. **The GoT, with humanitarian and development partners, has been providing emergency assistance to affected communities since the start of the disaster.** The Government declared a State of Emergency for 28 days on 12 February 2018, prior to TC Gita making landfall, encouraging people to seek shelter. Following the cyclone, the declaration was extended to April 9, 2018. In total 108 shelters were activated in Tongatapu and 'Eua, while 12 were activated in the Ha'apai group of islands. Other precautionary measures were undertaken, such as shutting down the power grid on Tongatapu, and evening curfews in the Nukualofa CBD. In the immediate aftermath of the disaster, and despite logistical challenges, the GoT, humanitarian and development partners provided affected communities with food, fuel, generators, medical supplies, shelter kits, construction materials and tools to assist with the clean-up of debris.

26. **The National Emergency Management Committee (NEMC) shared a draft government response plan with Cabinet on 16 February to facilitate coordination of the humanitarian and recovery efforts through the sector clusters, which are led by government ministries.** These clusters include: shelter, education, water and sanitation (WASH), food security and livelihood, safety and protection, telecommunication, essential services (waste management, water and

electricity), early recovery and logistics, and economic and social recovery. Humanitarian partners, international and national non-government organizations (NGOs), foreign governments, donors and civil society are also supporting the government-led response.

27. **To assess the socioeconomic impact of TC Gita, formulate a reconstruction and recovery plan, and assist in mobilizing the resources needed for recovery, the GoT requested that a Rapid Damage and Loss Assessment (RDLA) be conducted and a Disaster Recovery Framework prepared.** Conducted from 5–23 March 2018, the RDLA provided the basis for determining required reconstruction and recovery needs, summarized in the GoT's Disaster Recovery Framework. The drafts of both the RDLA and the Recovery Framework were presented by the GoT to donors at a coordination meeting on 6 April, less than eight weeks after the cyclone hit.

28. **TC Gita has created a substantial public financing need, which the GoT does not have the capacity to meet without significant additional support**. The RDLA estimated damages and losses of TOP$356.1 million (US$164.1 million, 37.8 percent of 2017 GDP). The GoT's Disaster Recovery Framework estimates the total value of public financing required for recovery and reconstruction needs to be TOP$246 million (US$113 million) over the four years FY2018-FY2021. As outlined in Table 4, despite considerable grants pledged by donor partners, TC Gita reconstruction and recovery needs create a substantial unanticipated public financing gap. This gap can be closed, however, through a combination of prudent reprogramming of public spending, drawdowns of cash reserves, the issuance of a moderate amount of new debt, and the disbursement of US$10 million in supplemental DPO financing. Additional donor commitments would reduce the amount of new debt issuance required.

29. **To help mitigate the effects of TC Gita on the most vulnerable, the GoT for the first time used its existing social protection system to disburse disaster assistance to vulnerable households.** Under the government's two core social assistance programs (for the elderly and disabled, respectively) 3,500 existing beneficiaries in the two affected areas of Tongatapu and 'Eua received a one-time top-up payment, in addition to their regular monthly payment, to meet their most pressing needs in the immediate recovery phase. It is estimated that the disaster assistance reached over 3,500 beneficiaries, or 20,000 people (20% of population), for a budget amount of approximately TOP$800,000.

30. **GoT's has also implemented measures to support household and private sector reconstruction efforts, and to create fiscal space to help finance the large recovery needs**. To support the importation of construction materials and food, the Cabinet approved an exemption of the consumption tax for imported food and clothing until the end of June 2018, and for construction materials and equipment for two years. To create fiscal space, soon after TC Gita struck the GoT froze all new staff hiring, as well as various planned sports & leisure-related investments, saving around TOP$35 million from the FY2018 budget.

3.2. THE BANK'S RESPONSE, STRATEGY, AND COLLABORATION WITH DEVELOPMENT PARTNERS

31. **On February 16, four days after TC Gita hit, the GoT requested the World Bank to take the lead in coordinating partners to produce a Rapid Damage & Loss Assessment (RDLA), and to assist in mobilizing the resources needed for recovery and reconstruction**. Preparation of the RDLA involved representatives from GoT, ADB, EU, UN agencies, the Pacific Community and the World Bank, and close collaboration with the governments of Australia and New Zealand. Technical assistance has also been provided to help the government complete its Recovery Framework, which will help guide and coordinate decisions on recovery and rebuilding over the next three years. Both the Rapid Assessment and the Recovery Framework will provide key inputs into the government's FY2019 budget which is currently under preparation.

32. **Seven days after TC Gita hit, Tonga received a payout of US$3.5 million from the Pacific Catastrophe Risk Insurance Company (PCRIC), which was established as part of a World Bank regional project.** This was the first payout made by the region's first catastrophe risk insurance platform established in 2016. This funding was funneled into the government's Emergency Fund, which has been used to finance many of the most urgent recovery needs. Additionally,

the Contingency Emergency Response Component (Part 3(a)) of the Pacific Resilience Project under the Pacific Resilience Program (PREP) (Credit No. 5689-TO and Grant No D078-TO) has been triggered, whereby US$0.5 million has been provided to fund emergency equipment and an assessment of the damage to school infrastructure in support of the government's rapid response to the disaster.

33. **Subsequently, the GoT has requested that donors, including the World Bank, provide additional financial support, and a donor meeting to discuss recovery funding was held in April 2018**. Specifically, the government has requested SDR13.7 million (approximately US$20 million) from the IDA Crisis Response Window (CRW) to support Tonga's recovery and reconstruction needs. The government has requested additional financing for the Pacific Resilience Project under the PREP to respond quickly to school recovery and reconstruction needs, as well as needs related to other public infrastructure. The proposed additional financing of US$16.25 million, of which US$10 million has been requested from the CRW, and US$4 million would be reallocated from Tonga's core IDA allocation, is expected to be submitted for World Bank Board approval in June 2018.

34. **Supplemental DPO financing will help to fill the estimated financing gap, complementing other sources of finance.** Other development partners – including the ADB, Australia, New Zealand, the EU, Japan and others – have already provided TOP$35.1 million to support the immediate relief effort, and have pledged a further TOP$93.1 million to support medium-term reconstruction and recovery. These resources will be predominantly directed to the energy, education and water & sanitation sectors. While DPO funds are not earmarked for specific purposes, quick disbursement of the supplemental DPO financing would allow government the fiscal space to potentially pursue near-term recovery priorities that currently remain unfunded (if it so chooses), including support for housing repair and rebuilding through cash or in-kind assistance, support for agriculture sector recovery, and support for recovery activities targeted at women and girls, among others.

35. **The proposed operation is consistent with the Bank's Regional Partnership Framework (RPF) for nine Pacific island countries, which includes Tonga (Report #124079).** The operation is in line with the RPF's third focus area on protecting incomes and livelihoods, which is focused on strengthening preparedness and resilience to natural disasters and climate change. By providing authorities with the fiscal space to respond quickly to the cyclone and pursue recovery efforts, this operation will support outcomes that are directly aligned with the Bank's RPF. Options for directly supporting policy reforms to improve Tonga's resilience to natural disasters and climate change will be discussed in future DPOs.

4. THE REFORM PROGRAM SUPPORTED THROUGH ORIGINAL OPERATION: AN UPDATE

36. **The second DPO supported reforms to support fiscal resilience, improve government accountability and private sector regulation, and provide the basis for a more dynamic and inclusive economy.** These included reforms to: (i) adopt a new rule-based fiscal strategy; (ii) strengthen revenue collection and health promotion through excise tax increases; (iii) implement a new public-sector remuneration framework and performance management system; (iv) introduce a new procurement monitoring system; (v) improve the efficiency of energy regulation; (vi) introduce clearer and more streamlined foreign investment legislation; and (vii) further private sector involvement in public enterprises.

37. **In some cases, these reforms are already having a positive impact.** Excise tax revenues have continued to increase, while follow-up World Bank analysis suggests there have also been positive impacts in terms of reduced consumption of alcohol, cigarettes, turkey tails and mutton flaps. The fiscal targets are being used to guide the Budget preparations and the outlook for revenues, debt, and the wage bill is evolving in line with these targets. Key procurement indicators are being tracked and the proportion of contracts subject to open competition is increasing, while improvements to the Chart of Accounts are being used in the current Budget preparations and should help government to better track spending over time. Progress on the public enterprise reform agenda continues apace.

38. **The government remains committed to the implementation of the supported actions and to the overall reform**

agenda as encapsulated by the three-DPO programmatic series. In line with lessons learnt from previous budget support engagements, a sequenced approach to reform has been adopted in those areas that are most demanding in terms of capacity and need for consultations, for example in foreign investment, employment relations, and energy regulation. In these areas, ongoing reform efforts (generally supported by prior actions in DPOs 1 and 2) will culminate in the approval and implementation of new legislation to be supported by the third and final DPO in the series. The government has taken significant steps toward completion of the indicative triggers for DPO3, despite several factors beyond its control acting to hinder progress, including 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. The elections returned the previous prime minister and the incumbent government, ensuring continued commitment to the reform agenda. Progress on implementation of the DPO2 prior actions and toward completion of the indicative triggers for DPO3 is summarized in Table 7.

Table 7: Summary of Implementation Progress on Policy Actions and Triggers from DPO2 & DPO3

Prior Actions and Triggers	Progress Update
Pillar I – Supporting fiscal resilience	
Prior action (DPO2): The Recipient has increased the rate of fuel excise tax by 0.09 Tongan Pa'anga per liter (an increase in the rate of 16%) and other excise duty and import duty rates in order to improve revenue mobilization and strengthen incentives to consume healthy foods.	The World Bank is conducting a follow-up study based on pre- and post- surveys of retailers and consumers to determine what effect these tax increases have had on retail prices and consumption. Preliminary findings suggest that prices have increased and that impacts on consumption have been mixed, with price-induced reductions in the consumption of alcohol, cigarettes, turkey tails, and mutton flaps, but limited effects on the consumption of chicken leg quarters and instant noodles, due to the lack of cheaper alternatives: taxes on these latter products may therefore have had a regressive effect on less well-off households and may need to be reviewed. Moreover, substitution toward cheaper or untaxed alternatives was found to be an issue in the case of cigarettes. Discussions are now being held with the GoT about the importance of non-fiscal measures – including health, education, and marketing campaigns – as complements for these tax increases.
Indicative trigger (DPO3): Revise the Revenue Administration Services Act	In progress. A revised Revenue Services Administration Act (RSAA) and new customs legislation have been drafted and should soon be cleared by the Law Committee and submitted to Parliament. The revised RSAA will introduce more avenues for revenue recovery and set more realistic penalties to incentivize enforcement. The new customs legislation would ensure alignment with the Kyoto convention and compliance with WTO requirements, integrating current legislation on tariffs, enforcement, and administration. The legislation is awaiting clearance by the Law Committee and then Cabinet and Parliamentary approval.
Prior action (DPO2): The Recipient's Cabinet has approved a transparent, target-based fiscal anchor system and monitoring framework that supports medium-term fiscal	The three fiscal anchors – relating to domestic revenue, debt, and the wage bill – were approved by Cabinet and reported in the FY18 budget documentation. The budget estimates indicated that the targets regarding revenue and external debt were expected to be met in FY18

sustainability and a more efficient mix of public spending.	and over the next three years. The wage bill target was expected to be met in FY19.
Prior action (DPO2): The Recipient 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. **Indicative trigger (DPO3):** Draft legislation to institutionalize a transparent reward and pay-setting mechanism.	The performance moderation process has been completed, the performance ratings for FY17 have been finalized, and the associated performance payments have been approved and disbursed. Trigger to be adjusted. On further discussions with the authorities, it became clear that the first priority was to review the first year of implementation of the performance management system and remuneration framework, so as to provide recommendations (among other things) on the need for legislative changes as originally envisaged. This review is currently underway. This review and implementation of its recommendations is the proposed replacement trigger for DPO3.
Pillar II – Democratic and government accountability	
Prior action (DPO2): The Recipient has implemented a new procurement tracking database and adopted compliance and performance indicators and associated targets. **Indicative trigger (DPO3):** Approval of a Chart of Account (CoA) revision to accurately reflect standard economic classifications in the Government budget system.	Supported by the World Bank and DFAT, the MFNP is now using a procurement database which allows tracking and reporting of key performance indicators, including (i) time taken for procurement; (ii) compliance with procurement regulations; and (iii) use of competitive methods. In progress. A revision to remove non-economic items from the economic segment of the CoA has been completed. MFNP intends to use the revised clean set of economic classifications in preparing the FY19 Budget. Further adjustments to occur during FY19 and FY20 supported by TA from PFTAC.
Prior action (DPO2): The Recipient's Cabinet has approved for public consultation the National Energy Bill which includes provisions for multi-sector regulation for all energy sub-sectors (electricity, gas and petroleum). **Indicative trigger (DPO3):** Cabinet approval of National Energy Bill for submission to Parliament.	At the same time as the completed version of the Energy Bill was approved by Cabinet for public consultation, a decision was also taken to roll several related pieces of legislation, by-laws and regulation into a single Bill, including the existing Petroleum Act, Electricity Act, and Renewable Energy Act. The Bill will provide regulatory certainty in these areas (e.g. with respect to distribution and storage of petroleum and electricity) as well as codifying targets for renewable energy. In progress. Due to the decision to expand the scope of the National Energy Bill, the GoT has requested additional technical assistance to assist with the drafting. The EU is supporting the procurement of this TA.
Pillar III – Supporting a more dynamic and inclusive economy	

Prior action (DPO2): The Recipient's Cabinet has approved the Foreign Investment Bill for submission to the Recipient's parliament which includes provisions to facilitate foreign investment in the Recipient's territory. **Indicative trigger (DPO3):** Cabinet approval of revised foreign investment regulations, including reserved and restricted lists, and work permit rules.	There have been subsequent delays in this Bill being submitted to Parliament for its consideration. Delayed. Following completion of the prior action, GoT is aiming to have the Foreign Investment Bill considered by Parliament in the coming months, which would then provide a basis for supporting work and the provision of technical assistance on the implementing regulations, particularly the reserved and restricted lists.
Prior action (DPO2): The Recipient's Cabinet has directed the Ministry of Public Enterprises to proceed with a sale of its shares in Tonga Cable Limited. **Indicative trigger (DPO3):** Cabinet has approved the reform of an additional Public Enterprise (PE) in accordance with the PE Reform Plan.	In 2017, 18 percent of the government's TCL shares were sold to Digicel, a private sector telecommunications operator in Tonga, which supports the continued roll-out of high speed internet across the country, and improvements in access in the outer islands. In progress. The Tonga Broadcasting Commission (TBC), the Water Board, and the Ports Authority have been slated to be reconstituted as companies rather than statutory authorities: they have few or no regulatory functions, and this will allow TBC in particular to compete on a more level playing field with other broadcasters. Amendments to the Public Enterprise Act may be required as a precursor to further actions to increase private sector involvement. ADB PSDI is supporting this work.
Indicative trigger (DPO3): Employment Relations Bill that, among others, reduces gender disparities approved by Cabinet for submission to Parliament.	In progress. Cabinet approved the progression of the Employment Relations Bill (ERB) in mid-2017, which has been drafted by MCCTIL with the assistance of the International Labor Organization (ILO), but further work on the Bill stalled due to the dissolution of Parliament. In early 2018, MCCTIL provided an updated schedule for revising the bill and conducting consultations with the Tripartite Committee (comprising representatives from government, employee groups, and employer groups, as well as the church sector and NGOs), which would have seen the ERB being submitted to Cabinet by June 2018. However, the impact of TC Gita will likely mean this timeframe will need to be extended somewhat.
Indicative trigger (DPO3): Central Bank has issued a directive to mandate credit bureau reporting.	Trigger to be removed from matrix. A change in Fijian laws had previously caused the provider to cease operation of the Tonga credit bureau, which was hosted in Fiji. Alternative proposals for a replacement credit bureau are still being considered. The NRBT has expressed a clear preference to host any new credit bureau domestically, although this is likely to be a more expensive option than the previous regional arrangement, and may be dependent on financial support from development partners.

5. RATIONALE FOR PROPOSED SUPPLEMENTAL FINANCING

39. **TC Gita recovery and reconstruction needs have created a substantial unanticipated financing gap which the GoT does not on its own have the capacity to fill.** The request for supplemental financing is consistent with Bank policy on development policy financing. TC Gita represents an exceptional external shock, with estimated damages and losses equivalent to 38 percent of GDP. The cyclone has created an additional unanticipated financing gap of TOP$23.7 million in FY2018, due to urgent new spending needs amounting to TOP$64.8 million, and an additional unanticipated financing gap totaling TOP$82.4 million over the four-year period from FY2018 to FY2021. In the absence of further financial support, fiscal resilience – the first development objective of the DPO program – would be significantly weakened, and the implementation of the government's post-cyclone recovery plan would be placed at risk. Moreover, completion and implementation of the reforms supported by the current DPO series could face substantial delays due to competing budgetary and capacity priorities arising from post-disaster recovery. DPO supplemental financing is the fastest way for the World Bank to provide significant financing to Tonga and has successfully been used to rapidly disburse financing following natural disasters in several other Pacific countries in the past.

40. **The program encapsulated by the three-DPO programmatic series remains broadly on track, and the government remains committed to the implementation of the supported actions in DPO2.** Implementation of the reforms supported under DPO2 is continuing, and the government remains in compliance with all of the covenants embedded in the Legal Agreement for the financing of DPO2. As noted above, an adequate macroeconomic framework has also been maintained, including in response to the impacts of TC Gita. As outlined in Table 7, the government has taken significant steps toward completion of the indicative triggers for DPO3, despite several factors beyond its control acting to hinder progress, including 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. GoT also has a history of strong commitment to budget support programs, as demonstrated by the successful completion of seven DPOs over the period from FY2011 to FY2017.

41. **The proposed US$10 million supplemental financing is needed to support the GoT in its recovery efforts, given the inability of the government to obtain sufficient funds from other sources in the required timeframe and on sufficiently concessional terms.** The GoT has actively sought additional grant financing from the donor community to cover the unanticipated financing gap as noted above, with substantial resources already pledged, and discussions ongoing regarding longer-term support. Tonga is already at a high risk of debt distress and has no access to international capital markets, limiting the alternative sources of funding available. The existing IDA portfolio is already fully programmed, and the large-scale reallocation of IDA18 resources to address cyclone recovery needs would at this stage be highly disruptive and prevent the GoT from implementing a series of well-advanced and transformative projects in the areas of transport, youth employment, fisheries, and e-government. Nevertheless, authorities have requested the reprogramming of US$4 million from Tonga's national IDA allocation to provide additional financing to PREP to support rebuilding and repair of education and other public infrastructure. Supplemental financing to the Second DPO remains the most appropriate instrument for providing quick disbursing budget support to the GoT.

42. **Supplemental financing for DPO2 is a preferable option to accelerating the processing of DPO3, with the need to respond to urgent recovery needs inconsistent with the time required to process a free-standing DPO**. As noted in Section 1, the significance and complexity of several reforms being progressed under DPO3 mean that they will require substantial attention from government to complete. Asking for progress on these reforms to be accelerated at a time when the GoT is understandably focused on post-cyclone recovery would be inconsistent with the capacity constraints currently faced by government. An alternative would be to pursue a lighter set of actions under DPO3 than originally envisaged, but given the importance of the reforms there is interest in all sides – from development partners involved in the Joint Policy Reform Matrix process, including World Bank, ADB, Australia, New Zealand, and the EU, and from government – in ensuring that the program is completed as originally envisaged, even if it takes longer than originally planned. Supplemental financing under DPO2 provides the opportunity to respond more quickly to the urgent needs of the country created by TC Gita, and to contribute to a timely economic recovery.

6. OTHER DESIGN AND APPRAISAL ISSUES

6.1 Poverty, social and environmental impacts

43. **Extreme poverty is rare in Tonga but there are significant levels of material deprivation, particularly in rural areas, which TC Gita is likely to have exacerbated**. 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 are able to 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 (56 percent on 'Eua), relative to 14 percent in urban Tongatapu.

44. **The cyclone is expected to have a disproportionate impact on the poor and vulnerable through its effect on small-scale and subsistence farming activities (particularly agriculture crops and livestock), handicraft production and housing**. Roughly half the nation's poor live in the rural and remote areas directly hit by TC Gita – 37 percent in rural Tongatapu and an additional 12 percent in 'Eua – and in these areas the substantial estimated losses in the agriculture sector are likely to hit livelihoods hardest. Weaker domestic supply will also put upward pressure on food prices, disproportionately affecting those poor and vulnerable who are net consumers, such as those living in urban areas. The poor also have fewer resources available to respond to the impacts of the cyclone. Nevertheless, government responses to date have already mitigated some of these impacts. The temporary consumption tax exemption for imports of food, clothing, household tools, construction materials and capital goods recently approved by GoT should help bolster household budgets in the wake of TC Gita, as will the top-up social assistance payment already disbursed to some of the most vulnerable households in Tongatapu and 'Eua.

45. **The supplemental financing will help further poverty reduction in Tonga, both by safeguarding the development objectives of the program and by directly providing government with the fiscal space necessary to fund its recovery efforts and address the cyclone's impacts on the poorest and most vulnerable.** Each of the development objectives supported by the program is 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 of the program will help ensure that the government has more fiscal space to respond to TC Gita as well 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 have already put the government in a stronger fiscal position than it otherwise would have been to deal with the pressing cyclone recovery needs outlined above. The US$10 million supplemental financing provided by this proposed operation will help to further strengthen the government's fiscal position and support its pro-poor recovery efforts. Reforms under the second pillar of the program should ultimately help to reduce the costs of basic goods and services by helping to facilitate more effective regulation and competition and more efficient procurement, while supporting inclusive growth by setting standards in the labor market which will improve the quality of jobs. Finally, 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.

46. **The reform supported by the programmatic series to introduce a new Employment Relations Bill will also serve to narrow gender disparities in Tonga.** The current lack of labor regulations in the private sector has the potential to have a particularly negative impact on those women who require more flexible working conditions and maternity leave. Under the program the government is taking steps to address this gap, and has recently become a member of the International

Labor Organization (ILO). An indicative trigger for the final operation in the series is the approval of foundational employment legislation that will support women's participation and safeguard employee rights. The results indicator will target the enshrinement of selected basic labor rights in domestic law.

47. **The policy actions supported under the parent operation are not expected to have a significant impact on Tonga's environment.** Tonga has a well-established environmental impact assessment (EIA) process, and the land and environmental legal framework is relatively sound. 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. Capacity for monitoring and enforcement is thin and the quality of EIAs can be variable. The government has the capacity to accept and process permits reasonably well, but tends not to actively police illegal activities nor monitor or enforce permit conditions. As government capacity to manage environmental risks is relatively low, in practice cyclone recovery and reconstruction projects will typically rely on consultants to prepare environmental assessments and to provide supervisory capacity during implementation.

6.2 PFM, disbursement and auditing impacts

48. **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. A number of these weaknesses have since been addressed, as reflected in the 2014 PEFA self-assessment conducted by the authorities. 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, continues to be publicly disclosed and made available on the MFNP website.

49. **While there is no current IMF Safeguards Assessment of the NRBT, as Tonga has not accessed IMF funds, there is also no indication of substantial issues within the foreign exchange environment**. The NRBT publishes its annual report together with the audited accounts and the report of the independent auditors on those accounts. The FY2015/16 annual report has been published and the audited financial accounts were unqualified. Until an IMF Safeguards Assessment is concluded, however, there is insufficient information available to draw any substantiated conclusions. The fiduciary risk for this specific operation is therefore assessed as "Substantial" due to the inadequate knowledge of the foreign exchange control environment.

50. **As was the case for the financing provided by the parent operation, the proposed supplemental financing will follow IDA's disbursement procedures for development policy grants**. Once the grant is approved by the Board and becomes effective, at the request of the Recipient the proceeds will be deposited by IDA in one tranche into a dedicated Foreign Currency Deposit Account at the NRBT, which will form part of Tonga's foreign exchange reserves. It is not possible to track the ultimate use of the foreign exchange provided by the development policy operation, but the 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 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 (2017) (IDA 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 IDA General Conditions, IDA will require the Recipient to refund the amount directly to IDA. Any such amounts refunded to IDA shall be cancelled. As with the parent operation, 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 closing date of the proposed supplemental financing is

December 31, 2018.

6.3 Monitoring, evaluation and accountability

51. **Through the Budget Support Management Committee, the MFNP continues to provide overall guidance for the budget support program, and assumes overall responsibility for coordinating the implementation, monitoring and evaluation of the operation**. The MFNP is also responsible for reporting progress and coordinating actions among other concerned government agencies. The Bank will work with the Government to assess the progress of implementation of the policy actions supported by the proposed operation, including through an assessment of the specific results indicators as set out in Annex 1.

52. **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.

7. SUMMARY OF RISKS AND MITIGATION

53. **The overall risk level remains substantial, in line with the risk assessment for the parent operation; all component risk ratings also remain unchanged.** The main risks stem from external economic shocks (of which TC Gita is the most recent example) and limited institutional capacity for policy reform and implementation. Given the recent impact of TC Gita, there is now a risk that the policy reform agenda supported by the second DPO (and to be continued in DPO3) loses momentum due to competing priorities arising from post-disaster recovery, qualitatively increasing risks around limited institutional capacity. The fiscal costs of financing cyclone recovery also qualitatively increase macroeconomic risks. Nevertheless, the response by government to control spending and the ongoing commitment to seek only highly concessional financing, along with substantial pledges of cyclone-related assistance from donors, have ameliorated the need for material changes to the risk outlook.

54. **While the impact of TC Gita qualitatively increases the macroeconomic risks faced by Tonga, which are still rated as "Substantial", these risks have been mitigated by prudent fiscal management on the part of the government, and prior actions that further strengthen fiscal resilience.** The substantial recovery costs are expected to strain GoT's fiscal position, the outlook for which remains dependent on the timely provision of financial assistance from development partners, including the Bank. A shortfall or substantial delay in the provision of budget support and project-based assistance for recovery and reconstruction could undermine cash management and disrupt service delivery. In the absence of this proposed supplemental financing, the support from the CRW, and additional support from other development partners, macro-fiscal concerns could distract available capacity and resources from implementation of actions supported by the program, and undermine the impact of these actions on shared prosperity. In addition to the proposed supplemental financing itself, which will help bolster government finances, the risks associated with these various external vulnerabilities have been mitigated through: i) the government's record of prudent fiscal management and adherence to its debt management strategy in recent years; and ii) the revenue, public remuneration, debt management, and fiscal anchor reforms supported by the development policy program.

55. **The risks around limited institutional capacity remain rated as "High", but are being mitigated by strong dialogue between the Bank and the Government, the coordination of technical assistance, and the decision to proceed with supplemental financing rather than attempting to accelerate the processing of the third DPO in the series**. 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.

56. **Given there is no current IMF Safeguards Assessment of the NRBT, fiduciary risks are assessed as "Substantial", though there is no indication of substantial issues within the foreign exchange environment**. As noted in Section 6.2, the NRBT publishes its annual report together with the audited accounts and the report of the independent auditors on those accounts. The FY2015/16 annual report has been published and the audited financial accounts were unqualified. However, in the absence of an IMF Safeguards Assessment, there is insufficient information available to draw any substantiated conclusions on the foreign exchange control environment. The fiduciary risk is therefore assessed as "Substantial".

57. **The policy framework includes major reforms that may meet with opposition from vested interests – meaning stakeholder risk is judged to be "Substantial" – while there is also a "Moderate" risk that some policy actions could have unintended social impacts for some groups.** Policy reforms focused on increasing domestic competition via foreign investment, supporting controlled and earned public pay increases, and introducing more equitable employment legislation may give rise to opposition from stakeholders that benefit from the status quo. This risk has been mitigated through an extensive public consultation process on each these reforms led by the GoT, and by retaining flexibility around the indicative triggers when needed to allow extra time to ensure the necessary buy-in. Tax increases on tobacco, alcohol and unhealthy foods may lead to some people who consume these goods being worse off (in the absence of a behavioral response), though the long-term health benefits are expected to outweigh these negative impacts over time.

Table 8: Summary Risk Ratings

Risk Categories	Rating
1. Political and Governance	M
2. Macroeconomic	S
3. Sector Strategies and Policies	M
4. Technical Design of Project or Program	M
5. Institutional Capacity for Implementation and Sustainability	H
6. Fiduciary	S
7. Environment and Social	M
8. Stakeholders	S
Overall	S

Note: H = 'High', S = 'Substantial', M = 'Moderate', L = 'Low'.

ANNEX 1: PARENT PROJECT POLICY AND RESULTS MATRIX

Completed actions, prior actions and triggers			Results
Actions completed under DPO 1	**Prior actions DPO 2**	**Triggers for DPO 3**	
Pillar I – Supporting fiscal resilience			
The Recipient has increased the rate of fuel excise tax by TOP$0.06 per liter (an increase in the rate of 12%) and other excise tax and import duty rates in order to improve revenue mobilization and strengthen incentives to consume healthy foods, as evidenced through the Excise Amendment and the Customs Amendment[11]	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[12]	Revise the Revenue Administration Services Act to set more realistic penalties and introduce more avenues for revenue recovery	**Outcome: Excise duty revenue as a proportion of domestic revenue increases** Indicator: Excise duty revenue as a proportion of domestic revenue Baseline (average FY11-FY14): 19.0 percent Target (FY19): increase of 0.5 percentage points of domestic revenue
The Cabinet has approved a new Medium-Term Debt Strategy which has been made public	The Recipient's Cabinet has approved a transparent, target-based fiscal anchor system and monitoring framework that supports medium-term fiscal sustainability and a more efficient mix of public spending		**Outcome: Analysis of the relationship between current fiscal outcomes, budget projections, and the path toward fixed medium-term fiscal targets conducted as part of Budget preparations** Baseline (FY13-FY17): No such analysis in Budget documents Target: (FY18-FY20): Analysis included in Budget documents **Outcome: Proportion on borrowing that is**

[11] 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.
[12] Excise duty on alcohol and tobacco has been increased, import duty on lamp flags increased to 15% and import duties on education materials, construction materials, sports materials, fruits and vegetables decreased.

Completed actions, prior actions and triggers			Results
Actions completed under DPO 1	**Prior actions DPO 2**	**Triggers for DPO 3**	
			highly concessional Indicator: External borrowing that is above 35 percent concessionality as a proportion of all external borrowing Baseline (FY13-FY15): 100 percent Target (FY16-FY19): 100 percent
(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	The Recipient's Cabinet has approved and begun to implement a new public service remuneration structure and performance management system to ensure effective public service delivery, adequate pay, and consistency with fiscal sustainability	Cabinet has approved draft legislation to institutionalize a transparent reward and pay-setting mechanism to support improved control of the wage-bill and effective performance and motivation of public servants	**Outcome: Improve wage-bill affordability** Indicator: Public wage-bill as a proportion of domestic revenue Baseline (FY14): 57 percent Target (FY19): 53 percent or lower
Pillar II – Democratic and government accountability			
The Recipient's Cabinet has approved a revised set of Procurement Regulations, and prepared standard bidding documents and procurement manuals in support of the Regulations A new biannual report of audit recommendations and actions for all ministries and agencies has	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	Approval of a Chart of Account revision in order to accurately reflect standard economic classifications in the Government budget system	**Outcome: Increased compliance with requirements for public procurement** Indicator: Proportion of contracts above the small purchases threshold that are subject to open competition[13]. Baseline (FY14): 35 percent of contracts subject to open competition Target (FY19): At least 50 percent of contracts subject to open competition

[13] 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	**Prior actions DPO 2**	**Triggers for DPO 3**	
been prepared, and a new Audit Oversight Committee of Cabinet established and tasked with ensuring timely and thorough follow-up of audit recommendations			**Outcome: External audit recommendations acted upon** Indicator: Proportion of outstanding audit recommendations 12 months after submission of the audit report to the Legislative Assembly[14] Baseline (FY15): 85 percent (115 of 136) Target (FY19): 50 percent
The Recipient's Legislative Assembly has approved a new Communications Commission Act that will establish an independent regulator	The Recipient's Cabinet has approved for public consultation a National Energy Bill, which includes provisions for multi-sector regulation for all energy sub-sectors (electricity, gas, petroleum)	The Recipient's Cabinet has approved the National Energy Bill for submission to Parliament	**Outcome: Effective oversight of regulated sectors** Indicator: Monitoring reports for regulated sectors published on at least an annual basis Baseline (2015): No baseline report Target (2018): Reporting issued by regulators that covers all sectors under their oversight
Pillar III – Supporting a more dynamic and inclusive economy			
		Employment Relations Bill that, among others, reduces gender disparities approved by Cabinet for submission to Parliament	**Outcome: Key labor market protections are in place** Indicator: Number of basic labor rights enshrined in domestic legislation[15] Baseline (2015): None of eight in place Target (2018): At least six of eight in place

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

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

Completed actions, prior actions and triggers			Results
Actions completed under DPO 1	**Prior actions DPO 2**	**Triggers for DPO 3**	
	The Recipient's Cabinet has approved the Foreign Investment Bill for submission to the Recipient's parliament, which includes provisions to facilitate foreign investment in the Recipient's territory	Cabinet approval of revised foreign investment regulations, including reserved and restricted lists, and work permit rules	**Outcome: Increase in interest from foreign investors** Indicator: Vetted applications from foreign investors Baseline (FY15): 21 applications Target (FY19): 30 applications or greater
		The Recipient's Central Bank has issued a directive to mandate credit bureau reporting in order to reduce costs of due diligence and support access to finance for SMEs and individuals	**Outcome: Increased utilization of credit bureau for credit checking** Indicator: Number of credit checks for new loan requests for; i) sole male applicants; ii) female applicants or joint applications Baseline (FY15): i) 636; ii) 588 Target (FY19): i) 800 or more; ii) 750 or more
The Recipient's Cabinet has approved the appointment of shared boards of directors of public enterprises in the information, communications, and technology sector, and the utilities sector in order to streamline the number of Directors and achieve greater efficiency	The Recipient's Cabinet has directed the Ministry of Public Enterprises to proceed with a sale of shares in Tonga Cable Ltd	Cabinet has approved the reform of an additional PE reformed in accordance with the PE Reform Plan, where 'reformed' may consist of privatization, liquidation, substantial restructuring, outsourcing or another form of public-private partnership	**Outcome: Public enterprises reformed to introduce private sector participation** Indicator: Number of private enterprises that have been reformed Baseline (FY2015): None Target (FY19): At least two

ANNEX 2: FUND RELATIONS ANNEX

Tonga—Assessment Letter for the World Bank
May 14, 2018

1. **Prior to being hit on February 12 by category 4 Tropical Cyclone Gita (TCG), Tonga's macroeconomic outlook was positive, despite its vulnerability to external shocks:**

- Growth for FY2018 was projected at 3.4 percent,[1] well above its historical average, thanks largely to steady construction activity and an increasing contribution from exports.
- Inflation had started to moderate, reaching 6 percent in January 2018, after a spike in FY2017 due to an increase in domestic food prices and a new import tax.
- The fiscal position had been close-to-balanced until end-FY2017, mainly because of higher tax revenue, but it was projected to deteriorate in FY2018 on account of larger infrastructure spending and a persistently-high and increasing wage bill. 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 position in FY2017 weakened because of increased construction-related imports. The sizeable current account deficit of 12 percent of GDP did not lead to international reserve losses, as a large share of imports was financed by capital grants. Also, Tonga relies heavily on private and official transfers. International reserves rose to US$192.2 million as at end-FY2017, equal to 45 percent of GDP and covering almost 6 months of prospective imports.

2. **Tropical Cyclone Gita is expected to cause a slowdown in economic activity, and will strain Tonga's external and fiscal positions.** For FY2018, staff projects that post-cyclone growth will fall to -0.4 percent, the overall fiscal deficit will widen to more than 6 percent of GDP, while international reserves will shrink to US$167 million (about 4.6 months of prospective imports). The post-disaster rapid assessment, conducted by the World Bank, ADB, UN, and EU, estimated the total disaster effects caused by TCG at approximately TOP356.4 million, equivalent to US$164.2 million, or about 37 percent of GDP (pre-cyclone).[2] The damage to property, which represents some 60 percent of the total damage, has adversely affected productive capacity. The tourism and agriculture sectors—two of the country's three main economic sectors—have also been severely hit. The total recovery needs are estimated at TOP326.8 million, equivalent to US$150.6 million or 90 percent of projected reserves for FY2018. The growth recovery will be determined by the vigor of the reconstruction effort, and there are two components of the expected increase in reconstruction activity:

- The large-scale import needs related to public and private sector reconstruction will strain Tonga's external position. The pace of public sector reconstruction will importantly depend on the amount of external finance that Tonga receives to rebuild. Alternatively, without the mobilization of substantial additional aid, foreign reserves would be expected to fall significantly over the medium term.
- Private sector reconstruction will largely be driven and financed by remittances.

[1] Fiscal years in Tonga run from July to June.

[2] Of the estimated total, some US$85.4 million is attributable to damage and US$78.3 million to losses.

3. **In the medium-term, the recovery will depend on the availability of external resources and the effectiveness of reconstruction.** Although bilateral and multilateral donors have thus far committed substantial financing in the form of cash and in-kind grants of US$59.3 million, the overall reconstruction needs still leave a cumulative financing gap of US$91.3 million, or approximately 21 percent of pre-cyclone GDP, set against total reconstruction needs of 34 percent of pre-cyclone FY2018 GDP. In the absence of additional external resources, this financing gap will not be closed. Coordination among donors and enhanced absorptive capacity are important to ensure an effective reconstruction effort.

4. **Risks to the macroeconomic outlook are tilted to the downside.** The medium-term outlook remains positive with a new reconstruction cycle potentially leading to higher economic growth, as the sectors hit by TCG recover. Beside the risks associated with financing reconstruction, other risks to the outlook stem from weaker global growth, rising global commodity prices, and the potential implementation of inward-looking policies by key trading partners. While the balance sheets of the banking sector are healthy, the widespread TCG-damage to property could expose the financial sector to some vulnerabilities. The banking sector remains profitable and stable, however TCG may have a detrimental effect on households' income and default rates on mortgages may rise, leading to some increase in the non-performing loan ratio and potentially lower lending standards by banks.

5. **Following TCG, policy actions to maintain fiscal sustainability have become more urgent.** Key recommendations include:

- Before TCG, staff advice for fiscal policy in the 2017 Article IV consultation was to consolidate fiscal expenditure, focusing on recurrent expenditure (wages), with the aim of achieving a one percent of GDP primary surplus in the medium term and thereby stabilize debt. This advice remains valid and in addition the authorities should reorient part of the planned capital expenditure towards reconstruction. The authorities should avoid slippages that would result in non-concessional external borrowing.
- The current monetary stance, while accommodative, remains appropriate. The National Reserve Bank of Tonga's monetary policy stance has supported credit growth, mainly through financing for owner-occupied dwellings. However, with credit growth projected to remain strong at 19 percent and inflation remaining close to seven percent on average in FY2018, the authorities should continue their close monitoring of credit growth developments to preserve financial stability. The authorities should consider introducing macroprudential tools to ensure that vulnerabilities do not build up in the financial sector.

6. **IMF relations.** Tonga is a surveillance country. 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. Staff is planning a staff visit in the second half of 2018, and if a request for Fund financial support is received will rapidly undertake a mission. In recent years, the IMF has been providing ample technical assistance in the areas of public financial management, banking supervision, foreign reserve management, and macroeconomic statistics.

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Table 1. Tonga: Selected Economic Indicators, FY2015–19 1/

	FY2015	FY2016	FY2017	FY2018 Pre-Cyclone	FY2018 Post-Cyclone	FY2019
			Est.		Proj.	
Output and prices			(Annual percent change)			
Real GDP 2/	3.7	3.4	3.7	3.4	-0.4	5.5
Consumer prices (period average)	0.1	-0.6	7.2	5.3	6.7	3.9
Consumer prices (end of period)	0.2	0.2	10.3	2.5	5.3	2.5
GDP deflator	1.4	1.7	3.1	2.1	2.7	2.1
Central government finance			(In percent of GDP)			
Total Revenue	34.9	40.9	44.0	53.5	56.6	55.1
Revenue (excluding grants in-kind)	28.1	30.6	30.2	32.1	33.2	31.4
Grants in-kind	6.8	10.3	13.9	21.5	23.5	23.7
Total Expenditure	37.6	41.3	44.5	55.8	62.8	60.1
Expense	31.6	32.0	33.7	41.1	44.4	42.2
Transactions in Nonfinancial Assets (Net)	6.0	9.4	10.7	14.7	18.5	17.9
Overall balance	-2.7	-0.4	-0.4	-2.3	-6.2	-5.0
Net Acquisition of Financial Assets	-1.9	1.8	0.3	1.5	-1.9	-2.1
External financing (net)	-0.4	0.2	0.3	3.6	4.1	2.9
Domestic financing (net)	1.2	2.0	0.5	0.2	0.2	-0.1
Money and credit			(Annual percent change)			
Total liquidity (M3)	9.3	16.7	13.7	11.9	8.5	14.6
Of which: Broad money (M2)	9.0	15.0	13.0	12.4	8.9	15.3
Domestic credit	15.5	8.3	4.8	16.6	16.4	19.9
Of which: Private sector credit	10.6	17.5	18.0	13.0	19.0	16.0
Interest rates (end of period)						
Average deposit rate	2.0	2.1	2.3	...	...	...
Average lending rate	8.7	8.7	8.6	...	...	...
Balance of payments			(In millions of U.S. dollars)			
Exports, f.o.b.	19.4	24.1	25.4	26.4	15.8	18.7
Imports, f.o.b.	-207.7	-202.8	-234.0	-261.1	-293.0	-322.4
Services (net)	-19.4	-9.1	-13.8	-17.7	-34.6	-47.1
Investment income (net)	4.5	2.5	6.8	10.4	10.4	12.0
Current transfers (net)	137.9	129.7	165.4	195.7	212.4	233.5
Of which: Remittances	102.2	112.2	117.1	125.1	125.1	133.7
Of which: Official grants	27.0	33.0	52.9	73.9	90.6	102.7
Current account balance	-65.3	-55.6	-50.2	-46.4	-89.0	-105.4
(In percent of GDP)	-15.0	-13.2	-11.7	-11.0	-21.0	-24.0
Overall balance	-16.2	23.9	25.8	21.9	-25.0	-61.5
(In percent of GDP)	-3.7	5.6	6.0	5.2	-5.9	-14.0
Terms of trade (annual percent change)	-3.5	2.1	3.0	-1.8	-1.8	0.1
Gross official foreign reserves						
In millions of U.S. dollars	142.5	166.4	192.2	214.1	167.2	105.7
(In months of next year's goods and services imports)	6.3	6.3	5.8	6.6	4.6	2.9
Debt (in percent of GDP)						
Public debt (external and domestic)	51.4	51.8	47.5	49.2	50.7	50.0
External debt	45.2	43.9	41.4	43.2	44.6	44.3
Debt service ratio	1.6	1.6	1.6	1.5	1.5	3.7
Exchange rates						
Nominal effective exchange rate (2005=100)	103.0	98.8	98.9	...	...	...
Real effective exchange rate (2005=100)	102.0	96.7	103.1	...	...	...
Memorandum items:						
Remittances (in percent of GDP)	23.5	26.6	27.4	29.6	29.6	30.5
Tourism (in percent of GDP)	11.3	13.0	12.9	15.3	13.0	16.4
FDI (in percent of GDP)	2.4	2.6	2.7	2.8	2.8	2.8
Nominal GDP (in millions of US$)	435.4	422.3	427.7	445.1	422.9	438.3
GDP per capita (thousands of US$)	4.2	4.0	4.1	4.2	4.0	4.2
Population (thousands)	104.1	104.3	104.6	104.8	104.8	105.1

Sources: Tongan authorities; and IMF staff estimates and projections.
1/ Fiscal year beginning July.
2/ Including preliminary data.