



The World Bank

Tonga First Fiscal, Disaster, and Climate Resilience Development Policy Operation with a Catastrophe Deferred Drawdown Option (P179813)

Program Information Document (PID)

Appraisal Stage | Date Prepared/Updated: 23-Apr-2023 | Report No: PIDA35896

BASIC INFORMATION

A. Basic Project Data

Country	Project ID	Project Name	Parent Project ID (if any)
Tonga	P179813	Tonga First Fiscal, Disaster, and Climate Resilience Development Policy Operation with a Catastrophe Deferred Drawdown Option (P179813)	
Region	Estimated Board Date	Practice Area (Lead)	Financing Instrument
EAST ASIA AND PACIFIC	22-Jun-2023	Macroeconomics, Trade and Investment	Development Policy Financing
Borrower(s)	Implementing Agency		
Kingdom of Tonga	Ministry of Finance		

Proposed Development Objective(s)

The proposed Development Policy Operation supports the Government of Tonga to: i) strengthen fiscal and debt sustainability. ii) enhance resilience to climate change and disasters.

Financing (in US\$, Millions)

SUMMARY

Total Financing	25.00
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DETAILS

Total World Bank Group Financing	25.00
World Bank Lending	25.00

Decision

The review did authorize the team to appraise and negotiate

B. Introduction and Context

Country Context

Tonga is among the most exposed countries to climate change and natural disasters in the world. It is ranked as the second most at-risk nation globally for natural hazards due to its high exposure and vulnerability to extreme natural events (Bündnis Entwicklung Hilft, 2020). Tonga is also ranked in the bottom third of countries for climate change preparedness (Notre Dame Global Adaptation Initiative, 2020). Catastrophic risk modelling estimates suggest that Tonga experiences an average annual loss of 4.3 percent of Gross Domestic Product (GDP) due to damage from natural disasters (Pacific Catastrophe Risk Assessment and Financing Initiative - PCRAFI Country Risk Profile, 2017). Climate change is further exacerbating these losses. Building resilience to natural disasters and enhancing adaptation to climate change will improve Tonga's growth prospects and will foster its development. Tonga has been experiencing an increasing number of highly disruptive weather events. The impact of these shocks has been broad-based and severe, especially among the poorest and most vulnerable households. Natural disasters disproportionately impact women and girls and exacerbate existing gender inequalities. Disasters impact women's livelihood because of their high dependence on agriculture; a sector that is the hard-hit during disasters.

Tonga's economy contracted by 2.7 percent in FY21 reflecting economic damage caused by the Tropical Cyclone (TC) Harold and border closures. This was followed by an estimated two percent output contraction in Fiscal Year (FY)22 owing to the dual shock—the Hunga-Tonga-Hunga-Ha'apai (HT-HH) volcanic eruption and tsunami, and the first community transmission of COVID-19 and related lockdowns. Growth rebounded in mid-2022 following the relaxation of domestic mobility restrictions, reopening of the borders to international visitors, and the extraordinary support from the development partners. The recovery gained momentum in FY23 helped by reconstruction spending largely financed by the development partners.

Output expanded by an estimated 2.5 percent in FY23. There are signs that inflation has peaked. The current account deficit widened from 6.3 percent of GDP in FY22 to an estimated 9.2 percent of GDP in FY23 owing primarily to a substantial increase in imports related to the economic recovery. A significant increase in grants from development partners helped to contain fiscal deficit in FY23. Total domestic revenue increased in FY23, but tax revenue remained below its pre-pandemic level because of the reduced economic activity. Total public spending increased to 53.9 percent of GDP in FY23 due to high reconstruction costs. Despite recent shocks, the banking sector remains well-capitalized and highly liquid. The macroeconomic policy framework for the proposed operation is adequate. Barring any unexpected shock, growth is projected to be sustained at around 2.4 percent on average over the medium term driven by reconstruction spending and a gradual recovery of tourism and services. Public debt is sustainable, but the risk of debt distress is high.

Relationship to CPF

The proposed operation addresses key development challenges articulated in the WBG's Systematic Country Diagnostic (SCD) for nine Pacific Island Countries (PIC9), including the Kingdom of Tonga. Among others, the PIC9 SCD highlighted the following focus areas as high priorities for Tonga, 1) ensuring macroeconomic, fiscal and debt sustainability, 2) strengthening climate and disaster risk policies and building resilient systems, 3) developing adaptive social protection systems, and 4) enhancing economic infrastructure and investment climate under Green, Resilient, and Inclusive Development (GRID). The first focus area is addressed by Prior Action (PA)#1 and PA#2 which increases domestic revenue mobilization by increasing consumption tax compliance and introducing fiscal and debt responsibility principles through a

Public Financial Management (PFM) Bill. The second focus area is addressed through PA#3 and PA#4 which introduces a comprehensive and proactive disaster risk management through the introduction of a Disaster Risk Management (DRM) Policy and reforms to the National Emergency Fund (NEF). The third focus area is addressed by PA#5 and which introduces a National Social Protection Policy aimed to strengthen the social protection system and to support a timely and efficient disaster response. The reform program is consistent with the Global Crisis Response Framework (GCRF), which provides the World Bank's operational response to multiple current crises. PA#5 on social protection systems aligns with Pillar 1: responding to food insecurity. PA#3 on the DRM policy, PA#4 on the NEF reforms, and PA#5 on strengthening social protection systems align with Pillar 3: strengthening resilience by promoting climate resilience and macro-fiscal and debt sustainability. Finally, PA#1 on improving domestic revenue mobilization and PA#2 on the PFM Bill align with Pillar 4: strengthening policies, institutions, and investments for rebuilding better by improving domestic revenue mobilization and promoting climate smart policies. Actions supported by this Development Policy Operation (DPO) are also closely linked to the International Development Association (IDA) replenishment cycle IDA20's overarching framework of "Building Back Better from the Crisis—Toward a Green, Resilient and Inclusive Future". The proposed operation builds on reforms supported previously, as well as several investment projects and technical assistance activities.

C. Proposed Development Objectives

The Development Objectives (DO) of the proposed Development Policy Operation is to support the Government of Tonga (GoT) to: i) strengthen fiscal and debt sustainability. ii) enhance resilience to climate change and disasters.

Key Results

Pillar 1: Strengthening fiscal and debt sustainability

Building on the previous reform efforts, this pillar focus on the modernization of the revenue policy and administration and aims at improved domestic revenue mobilization. This pillar also supports reforms aimed at upgrading of the overall fiscal and debt policy frameworks for creating more fiscal space.

Strengthening Domestic Revenue Mobilization

Expected result: The implementation of the regulations is expected to increase tax compliance and result in higher collections of consumption tax revenues.

Improving the Effectiveness of Public Debt Management and Achieving a Sustainable Fiscal Policy

Expected result: The implementation of this reform is expected to improve fiscal and debt sustainability.

Pillar 2: Enhancing Resilience to Climate Change and Disasters

Strengthening Tonga's resilience to climate change and disasters requires measures to support adaptation, enhance preparedness, and bolster capacity to respond to disasters when they strike.

Supporting a Comprehensive, Proactive, and Integrated Model of Disaster Risk Management

Expected result: These reforms will support stronger institutional and regulatory systems for climate resilience and DRM within Tonga.

Enhancing Preparedness and Response to Natural and Climate-related Hazards

Expected result: The implementation of these reforms will support a more comprehensive and integrated system for DRM in Tonga, particularly for ex ante preparation for climate induced disasters.

Strengthening the Social Protection System

Expected result: Increasing the coverage of the database to map out the needs and location of those most vulnerable in Tonga, (including those who are most vulnerable to the effects of climate change), will be a key step towards the National Social Registry.

D. Project Description

This DPO with a Catastrophe Deferred Drawdown Option (Cat DDO) is designed to strengthen the foundations for achieving the Tonga Strategic Development Framework (TSDF) II. The proposed reform program builds on the previous DPO series.¹ This DPO deepens reforms to support fiscal sustainability, enhance resilience to climate change and disaster, and achieve inclusive and sustainable growth. Pillar 1 supports strengthening domestic revenue mobilization through the adoption of regulations for the Electronic Sales Register System and enhancing fiscal and debt sustainability through a revised Public Financial Management bill and ensuing regulations. Pillar 2 supports enhancing resilience to natural and climate-change related disasters through more comprehensive, proactive, and integrated model of disaster risk management by introducing a new Disaster Risk Management Policy, strengthens ex ante disaster preparedness through a new Guideline for the National Emergency Fund, and building resilience at the household-level through a National Social Protection policy.

The proposed operation has the following features: (i) Upfront financing: SDR 3.7 million (US\$5 million equivalent) would be provided as DPO grant financing once the operation has been declared effective. (ii) Contingent (Cat DDO) financing through a DRM Development Policy Grant: Subject to the drawdown trigger conditions for the Cat DDO being met a grant of up to SDR 14.9 million (US\$20 million equivalent). The Cat DDO resources for this operation will be funded through, 25 percent from Tonga's Country Allocation, 25 percent from the Crises Response Window (CRW) and the remainder of up to 50 percent from the IDA general resources. The Cat DDO would be available for full or partial disbursement at any time within a three-year drawdown period, which may be renewed once, for a maximum of six years in total. The closing date for the proposed operation is 30 June 2026 and is not affected by the timing of any drawdown of the Cat DDO component.

E. Implementation

Institutional and Implementation Arrangements

The existing institutional structure for aid management will be used to implement and monitor the policy actions supported by the operation. Through the Budget Support Management Committee, the MoF will provide overall guidance for the development financing policy operation, and will assume overall responsibility for coordinating the implementation, monitoring, and evaluation of the operation. The MoF will also be ultimately responsible for reporting on 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. The Bank will also work with the Government to monitor the specific indicators associated with each of the policy areas supported by the proposed operation. The Bank will play a coordinating role among development partners to ensure that there is a single, agreed assessment of the implementation of the policy actions and a single, agreed evaluation of the monitoring indicators. This will reduce the administrative burden on Government.

F. Poverty and Social Impacts, and Environmental, Forests, and Other Natural Resource Aspects

Poverty and Social Impacts

The reforms supported by this DPO are expected to have a positive impact on poverty in the medium- and long-run. The main channels will be through stronger public finance and enhanced resilience to climate, environment, and health-

¹ Tonga Second Resilience DPO with a Cat-DDO Option (P172742).



related disasters. The effect of the prior actions supported by the first pillar is indirect and conditional on the allocation of increased revenues and broadened fiscal space to, among other things, public services and social programs benefiting the poor. By contrast, the prior actions under the second pillars are expected to have direct and positive impacts on poverty.

Prior actions under the first pillar improve the government’s revenue collection and broaden fiscal space, which is likely to support the allocation of resources into pro-poor investments and programs. The policy supported by Prior Action #1 facilitates the installment of the Point-of-Sale system among formal and relatively large businesses. This policy change will increase revenues from consumption taxes owing to the improved tax compliance. According to the preliminary analysis, based on the Household Income and Expenditure Survey (HIES) 2021, the low-income households are less likely to purchase from those businesses and tend to rely more on own production. The direct impact of this policy change on these households will likely be insignificant. According to the preliminary analysis, the overall impact of this policy change on poverty through indirect negative impact on low-income households will likely be small and will be mitigated by policy reforms supported by PA#5 which aim at strengthening the social protection system in Tonga. If managed well, the increased revenue could help the government sustain or expand social programs that target poor and vulnerable populations. Similarly, improved public finance management supported by Prior Action #2—implementation of key fiscal responsibility principles and a numerical limit on the stock of government-guaranteed debt—could contribute to allocating more public funds to public services and social programs.

Prior actions under the second pillar are expected to have a positive impact on poverty, by enhancing resilience against climate, extreme weather events, and health-related shocks among the poor and vulnerable population. Poorer people tend to be more vulnerable to climatic stressors due to their limited disposable income to cope with shocks. Indeed, the HT-HH disaster severely damaged the livelihood of poor and vulnerable households, as female, informal, and/or poorer workers had not recovered well even 6 months after the disaster.² Poorer households were also more likely to have lost their productive assets, such as canoes and boats, because of the disaster, resorting to unsustainable coping strategies that could have considerable impacts on their human capital development, such as spending from savings and reducing food consumption.³ Improvement of the government’s disaster risk management, through a proactive policy framework and an associated newly created policy to reduce risk (Prior Actions #3) is expected to target the poor and vulnerable and enhance their preparedness for natural and climate-related hazards. The National Social Protection Policy, supported by Prior Action #5, is expected to have direct, positive impact on poverty by providing the poor and vulnerable with a cushion against economic shocks from disasters. Improved coordination through the Adaptive Social Protection Framework and its linkage with DRM policy will enable quick responses to shocks and will build the resilience for those living in poverty and vulnerability.

Environmental, Forests, and Other Natural Resource Aspects

The policy actions supported under the operation, including those related to climate and disaster resilience, are not expected to create negative impact on Tonga’s environment, natural resources or forests compared with the status quo. Policy actions under Pillar 1 are not expected to have any significant impact on the environment. Pillar 2 and PAs related to enhancing resilience to climate change and disasters are likely to have positive effects on Tonga’s environment and climate change adaptation and mitigation efforts. This would likely have positive impacts through the encouragement of

² World Bank (2022). Economic and Social Impacts of the Recent Crises in Tonga: Insights from the July-August 2022 Round of High Frequency Phone Surveys.

³ World Bank (2022). Economic and Social Impacts of the Recent Crises in Tonga: Insights from the April-May 2022 Round of High Frequency Phone Surveys.

sustainable risk reduction investments. Existing legal and administrative frameworks for environmental and land management in Tonga, including for impact assessments, will mitigate downstream environmental impacts (such as infrastructure investments for risk reduction). PA#3 with focus on supporting a comprehensive, proactive, and integrated model of disaster risk management, which will help provide more informed decisions on development and response in areas of high risk from floods, and/or landslides. Use of such information ensures reduced risk of damage or loss of assets and, as a result, provides for better use of environmental resources, such as building materials as well as reduce likelihood of pollution from disaster waste. PA#5 with focus on strengthening the nation's social protection system will help support the poor and vulnerable and it could have positive effects on the environment, forests, and natural resources, as social protection can contribute to prevent environmental degradation, climate adaptation and build communities' resilience. These actions will also contribute to climate adaptation co-benefits.

G. Risks and Mitigation

After accounting for mitigation measures, the overall risk level for the proposed program is moderate. The risk assessment is based on residual risk. That is, the level of risk to the operation after considering mitigation measures. The overall risk rating is justified based on extensive mitigation measures related to all key risks to the achievement of the DO. Nevertheless, GoT's weak institutional capacity and the nation's high vulnerability to external shocks (including the risk of COVID-19 resurgence, natural disaster, climate-related, and macroeconomic shocks) mean that some residual risk to the operation remain. Macroeconomic risk is rated as moderate, despite the GoT's strong commitment to ongoing reforms supported by this operation and ample foreign reserves. The risks associated with these vulnerabilities are being mitigated through i) GoT's constrictive partnership with development partners (including the International Monetary Fund) and commitment to pursuing reforms via development policy operations; ii) the fiscal and debt management reforms supported by this programmatic DPO; and iii) ample foreign exchange reserves for mitigating shocks. Despite these mitigation measures, there remains substantial residual risk to achievement of the PDO. Environmental and social risk is rated as substantial despite mitigation measures, given Tonga's high degree of vulnerability to disasters and the effects of climate change. This risk is mitigated somewhat by the selection of a limited number of high-priority actions, but in the event of a major disaster, implementation of the reform program may be delayed while disaster response and recovery take precedent. Fiduciary risks are substantial. Currently a new PFM roadmap 2023-2028 is being developed, focusing from improving the existing legislative and regulatory framework, revise chart of account, develop an integrated financial management information system (IFMIS), decentralization, program-output budgeting, PFM governance and staff capacity strengthening. Other risks, including potential COVID-19 resurgence are rated as moderate. GoT is mitigating the risk of a local outbreak through widespread vaccination and investment in public health facilities. The risk rating related to institutional capacity is moderate, after accounting for selectivity in the number of reform actions and the provision of dedicated technical assistance. To mitigate this risk, the GoT and the WB 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.

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APPROVAL

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