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Report No: PGD392

INTERNATIONAL DEVELOPMENT ASSOCIATION

PROGRAM DOCUMENT FOR A

PROPOSED DEVELOPMENT POLICY GRANT

IN THE AMOUNT OF SDR18.7 MILLION (EQUIVALENT TO US$25 MILLION)

COMPRISING

A DEVELOPMENT POLICY GRANT OF SDR3.8 MILLION (US$5 MILLION EQUIVALENT)

WITH

A CATASTROPHE DEFERRED DRAWDOWN OPTION OF SDR14.9 MILLION (US$20 MILLION EQUIVALENT)

TO

KINGDOM OF TONGA
FOR THE

TONGA FIRST FISCAL, DISASTER, AND CLIMATE RESILIENCE DEVELOPMENT POLICY OPERATION WITH A
CATASTROPHE DEFERRED DRAWDOWN OPTION

December 11, 2023

Macroeconomics, Trade And Investment Global Practice
Urban, Disaster Risk Management, Resilience and Land Global Practice
East Asia And Pacific Region

Public Disclosure Authorized

Kingdom of Tonga

GOVERNMENT FISCAL YEAR

July, 1 – June, 30

CURRENCY EQUIVALENTS

(Exchange Rate Effective as of April 30, 2023)

Currency Unit	Tongan Pa'anga
US$ 1.00	TOP$ 2.3546
SDR 1.00	US$ 1.34701

ABBREVIATIONS AND ACRONYMS

ADB	Asian Development Bank	MoRC	Ministry of Revenue & Customs
BSMC	Budget Support Management Committee	MSMEs	Micro, Small & Medium Enterprises
Cat DDO	Catastrophe Deferred Drawdown Option	MTDS	Medium-Term Debt Management Strategy
CBD	Central Business District	MTED	Ministry of Trade and Economic Development
CERC	Contingent Emergency Response Component	NRBT	National Reserve Bank of Tonga
CRW	Crisis Response Window	PA	Prior Action
DFAT	Department of Foreign Affairs and Trade	PCRIC	Pacific Catastrophe Risk Insurance Company
DPO	Development Policy Operation	PDO	Program Development Objective
DRM	Disaster Risk Management	PFM	Public Financial Management
DSA	Debt Sustainability Analysis	PIC	Pacific Island Country
DSSI	Debt Service Suspension Initiative	PIC9 SCD	Systematic Country Diagnostic for 9 small PICs
EIA	Environmental Impact Assessment	PPA	Performance and Policy Actions
FY	Fiscal Year	PV	Present Value
GDP	Gross Domestic Product	RCF	Rapid Credit Facility
GoT	Government of Tonga	RPF	Regional Partnership Framework
GRS	Grievance Redress Service	SDFP	Sustainable Development Finance Policy
HIES	Household Income and Expenditure Survey	SDR	Special Drawing Rights
HSRO	Housing Sector Resilience Office	SET	WB's Skills and Employment for Tongans Project
HRRP	Housing Recovery and Resilience Policy	SORT	Standardized Operational Risk-Rating Tool
IDA	International Development Association	TC	Tropical Cyclone
IMF	International Monetary Fund	TOP	Tongan Pa'anga
MoF	Ministry of Finance	TSDF II	Tonga Strategic Development Framework 2015-2025
MoH	Ministry of Health	WB	World Bank
MoI	Ministry of Infrastructure	WBG	World Bank Group

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TONGA FIRST FISCAL, DISASTER, AND CLIMATE RESILIENCE DEVELOPMENT POLICY OPERATION WITH A CATASTROPHE-DEFERRED DRAWDOWN OPTION
KINGDOM OF TONGA

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SUMMARY OF PROPOSED FINANCING AND PROGRAM

BASIC INFORMATION

Operation ID	Programmatic	If programmatic, position in series
P179813	Yes	1st in a series of 2

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.

Organizations

Borrower:	Kingdom of Tonga
Implementing Agency:	Ministry of Finance

PROJECT FINANCING DATA (US$, Millions)

Maximizing Finance for Development

Is this an MFD-Enabling Project (MFD-EP)? No

Is this project Private Capital Enabling (PCE)? No

SUMMARY

Total Financing	**25.00**

DETAILS

World Bank Group Financing

International Development Association (IDA)	25.00
IDA Grant	25.00

IDA Resources (US$, Millions)

	Credit Amount	Grant Amount	SML Amount	Guarantee Amount	Total Amount
Crisis Response Window (CRW)	0.00	5.00	0.00	0.00	5.00
National Performance-Based Allocations (PBA)	0.00	20.00	0.00	0.00	20.00
Total	**0.00**	**25.00**	**0.00**	**0.00**	**25.00**

PRACTICE AREA(S)

Practice Area (Lead)

Macroeconomics, Trade and Investment

Contributing Practice Areas

CLIMATE

Climate Change and Disaster Screening

Yes, it has been screened and the results are discussed in the Operation Document

OVERALL RISK RATING

Overall Risk	Moderate

Results

Indicator Name	Baseline	Target
1. Consumption tax revenue as share of Gross Domestic Product (GDP)	13.6 percent (Average FY15-19)	15 percent (FY25-27)
2. Public and Publicly Guaranteed (PPG) debt as share of GDP	46.3 percent (Average FY15-19)	42 percent (FY25-27)
3. Share of population covered by Disaster Risk Management (DRM) Plans which include planning for climate induced disasters and essential gender-based violence (GBV) support services	0 (FY22-23)	75 percent (FY27)
4. Budget allocations to National Emergency Fund (up to 0.5 percent of GDP) and implementation progress reporting are consistent with revised legal framework	No (FY23)	Yes (FY27)
5. Share of poor and vulnerable households registered in the Conditional Cash Transfer (CCT) database disaggregated by sex and vulnerability status	42 percent (FY23)	At least 75 percent (FY27)

IDA PROGRAM DOCUMENT FOR A PROPOSED GRANT TO KINGDOM OF TONGA

1. INTRODUCTION AND COUNTRY CONTEXT

1. **The proposed Development Policy Operation (DPO) with a Catastrophe-Deferred Drawdown Option (Cat DDO) supports the Government of Tonga (GoT) to build resilience to shocks.** This is the first of a programmatic series of two operations. The operation builds on reforms supported by the Resilience DPO with a Cat DDO Series (P171071; P172742). The operation is designed around two Program Development Objectives (PDO) and Pillars. Pillar 1 aims at building fiscal resilience through strengthening fiscal and debt sustainability. Pillar 2 supports the government's capacity to prepare for and respond to climate change and disasters. The DPO with Cat DDO is proposed as an International Development Association (IDA) Grant in the amount of 25 million U.S. dollars. The Cat DDO will be funded from the following sources according to the following proportion: 25 percent from Tonga's County Allocation, 25 percent from the Crises Response Window (CRW), and the remainder of up to 50 percent from the IDA general resources.

2. **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 among the bottom third of countries for climate change preparedness (Notre Dame Global Adaptation Initiative, 2020). Catastrophic risk modelling estimates suggest that Tonga suffers a 4.3 percent Gross Domestic Product (GDP) average annual loss due to damage from natural disasters, with climate change further exacerbating these losses (Pacific Catastrophe Risk Assessment and Financing Initiative (PCRAFI) Country Risk Profile, 2017). The majority of disasters in Tonga are climate-related, and climate change will likely worsen disasters wrought by cyclones, storm surges, and heat waves, among others.

3. **Building resilience to natural disasters and enhancing adaptation to climate change will improve Tonga's growth prospects.** These goals are also articulated in Tonga's Strategic Development Framework (TSDF II). The proposed operation focuses on preparing Tonga for future natural disasters and climate change through building fiscal buffers and strengthening ex ante measures for disaster preparedness and response. Pillar 1 supports measures to improve domestic revenue mobilization through regulations that establish an Electronic Sales Register System (ESRS) for businesses. This Pillar also enhances fiscal and debt sustainability through new Public Financial Management (PFM) Bill, which introduces fiscal responsibility principles and a numerical limit on government guaranteed debt. Pillar 2 supports a suite of reforms to strengthen disaster risk management through a shift to more proactive approach for disaster preparedness.

4. **Tonga has been experiencing an increasing number of highly disruptive weather events.** Two successive natural disasters hit the country in April 2020 and January 2022. The related fallout combined with the lingering Covid-19 delayed the recovery from the pandemic-induced shock. While global economic growth rebounded in 2021, Tonga's economy contracted by 2.7 percent in Fiscal Year FY21 reflecting economic damage caused by the Tropical Cyclone (TC) Harold (2020) and border closures. This was followed by an estimated 2 percent output contraction in FY22 owing to the dual shock—the Hunga-Tonga-Hunga-Ha'apai (HT-HH) volcanic eruption and tsunami (2022), and the first community transmission of COVID-19 and related lockdowns.

5. **The impact of these shocks has been most severe among the poorest and most vulnerable households.** Agriculture, livestock, and fishing—which together employ more than half of the Tongan population—were among the most severely affected by the shocks. According to the surveys, 60 percent of households employed in plant agriculture and 70 percent of those occupied in raising livestock and fishing activities were not earning any income from those occupations in FY22.[1] Rising commodity prices have exacerbated the impact of supply disruptions pushing up inflation and the cost of living. These adverse developments led to a substantial increase in food insecurity last year, with around 63 percent of people reporting not having enough food—an increase of 22 percentage points compared to the pre-crisis level.

6. **Natural disasters disproportionately impact women and girls and exacerbate existing gender inequalities**. This is related to multiple factors, including lack of access to and control over resources such as land and information which make women vulnerable to natural disasters. Disasters impact women's livelihood because of their high dependance on agriculture; a sector that is hard-hit during disasters. Climate-related disasters are associated with further increase in Gender Based Violence (GBV) from already high levels. 15.2 percent of all women aged 15-49 reported having experienced physical violence from a non-partner and 19.1 percent of ever married women reported physical violence from a partner.[2] The government has an institutional set up, with standards and protocols to address GBV yet, cases are not reported due to lack of trust or from fear of being shamed.[3]

7. **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**. Domestic mobility restrictions were put in place in early 2022 after Tonga faced its first COVID-19 community transmission following the HT-HH volcanic eruption and tsunami. Agricultural production was also hampered in early 2022 due to volcanic ash which had detrimental effects on crops and livestock. Due to high vaccination rates, Tonga was able to ease domestic restrictions in April 2022 and re-open borders to international visitors in August 2022. The recovery gained momentum in FY23 helped by strong domestic demand, pick-up in tourist arrivals, and reconstruction spending largely financed by the development partners. Following two consecutive years of contraction, output expanded by an estimated 2.6 percent in FY23.

8. **The macroeconomic policy framework for the proposed operation is adequate.** Barring any unexpected shock, growth is projected to be sustained at around 2.1 percent on average over the medium term driven by reconstruction spending and a gradual recovery of tourism and services. Inflation is expected to fall below the reference rate of 5 percent in the medium-term amid continued monetary policy tightening. Foreign exchange reserves are projected to remain adequate and consistent with Tonga's financial stability objectives. The exchange rate peg will continue to provide a credible nominal anchor. The financial system is expected to remain stable with a well-capitalized banking sector and ample liquidity. The GoT is committed to adhere to its established practice of prudent macroeconomic management and return to balanced budget by FY26. It will continue building fiscal resilience through mobilizing domestic revenue, improving expenditure efficiency, and targeting, and avoiding any new non-concessional external borrowing.[4] Public debt is sustainable, but the risk of debt distress is high.

[1] World Bank. 2022. "*Economic and Social Impacts of the Recent Crises in Tonga: Insights from the April-May Round of High Frequency Phone Surveys*".
[2] United Nations Children's Fund. 2019. Multiple Indicator Cluster Survey.
[3] UN Women. 2022.
[4] There has been no new non-concessional external borrowing since FY11.

2. MACROECONOMIC POLICY FRAMEWORK

2.1. RECENT ECONOMIC DEVELOPMENTS

9. **Output grew by 2.6 percent in FY23, rebounding from a 2 percent contraction in FY22 (Table 1).** The January 2022 HT-HH volcanic eruption and tsunami inflicted significant damage, costing around 38 percent of FY22 GDP. A February 2022 COVID-19 outbreak, and subsequent lockdowns slowed recovery. Borders reopened in August 2022, normalizing activity. Strong domestic demand and pick up in tourist arrivals bolstered growth. Inflation seems to have peaked. Inflation surpassed 14 percent in September 2022, but eased thereafter as global energy and food prices stabilized. FY23's average consumer price inflation was about 10 percent, up from 8.5 percent in FY22 due to domestic disruptions from the volcano. The National Reserve Bank of Tonga (NRBT) raised the reserve deposit ratio to 15 percent in February 2023 to curb inflation, signaling more tightening if needed. The exchange rate peg held steady, though the real effective exchange rate rose by 9.7 percent due to local inflation.[5],[6]

10. **The FY23 current account deficit expanded to around 7.9 percent of GDP from 6.3 percent in FY22 due to increased imports during recovery.** Weak exports, especially from damaged agriculture and tourism, worsened the trade deficit from 53.9 percent of GDP in FY22 to 63.3 percent in FY23. Remittances have declined after a substantial increase in FY21 and FY22 fueled by the Tongan diaspora support during the crises. The level of remittances declined to its pre-pandemic levels, while grants remained elevated. The high level of grant inflows in FY23 reflecting a time-lag in mobilization and disbursement of post-disaster grant financing. The capital and financial account which surged in FY22 on account of the International Monetary Fund (IMF) Special Drawing Rights (SDR) allocation also normalized to its pre-pandemic level.[7] The balance of payments surplus declined from 11.6 percent of GDP in FY22 to around 2.3 percent in FY23. Foreign exchange reserves remain adequate at US$388 million- or 10.9-months' imports.

11. **Development partner grants helped cushion the fiscal accounts in FY23.** The fiscal account showed a surplus of 0.4 percent of GDP in FY23, primarily due to increased grants and slower-than-expected execution of expenditures related to reconstruction. Total revenue and grants increased by 2.5 percentage points compared to their FY22 level and reached 24.4 percent of GDP in FY23 helped by higher grants from development partners. Domestic revenues experienced a slight uptick, primarily driven by increased proceeds from the consumption tax following the implementation of the electronic sales system and other measures aimed at enhancing tax administration. However, despite the increase, they collection remains significantly below pre-pandemic level. Total public spending in FY23 amounted to 47.4 percent of GDP. Capital expenditure saw a modest increase, rising from 5.9 percent of GDP in FY22 to 7.2 percent in FY23, despite delays in execution, which was particularly notable given the pressing reconstruction needs.

12. **Wage bill declined**. As COVID-19-related spending tapered off, the wage bill, as a proportion of domestic revenues, decreased to 54 percent of GDP in FY23, down from 57 percent in FY22, although it still exceeded the indicative target of 53 percent. Other fiscal anchors remained stable, including the domestic revenue anchor, which stood at 23.3 percent of GDP, surpassing the 22 percent target.

[5] The appreciation in the REER has had only limited adverse impacts on agricultural exports which suffered large damage to their productive capacity from the HT-HH disaster, and the recovery of which has been gradual.

[6] Australia, New Zealand, and the United States are Tonga's top three main trading partners.

[7] The decrease in the capital account was driven by lower capital grants. Financial account inflows were high in FY22 as Tonga received an IMF SDR allocation of US$18.7 million (3.8 percent of GDP) in August 2021.

Table 1: Selected macroeconomic indicators

		Est.			Proj.		
	FY20	**FY21**	**FY22**	**FY23**	**FY24**	**FY25**	**FY26**
Real Economy	Annual percentage change, unless otherwise indicated						
GDP (nominal Pa'anga m)	1,119.7	1,068.7	1,136.5	1,283.1	1,391.4	1,480.7	1,544.8
Real GDP growth	0.5	-2.7	-2.0	2.6	2.5	2.2	1.6
Per Capita GDP (in current US$)	4,654	4,431	4,701	5,157	5,463	5,696	6,021
GDP deflator	-4.2	-1.9	8.5	10.0	5.8	4.1	2.7
Inflation (CPI, average)	0.4	1.4	8.5	10.0	5.8	4.1	2.7
Fiscal Accounts	Percent of GDP, unless otherwise indicated						
Total Revenues and Grants	44.2	48.3	45.2	47.7	46.3	44.6	40.8
Total Expenditures	38.8	49.3	46.0	47.4	48.3	46.1	40.5
General Government Balance	5.3	-0.9	-0.7	0.4	-2.0	-1.5	0.3
Selected Monetary Accounts	Annual percentage change, unless otherwise indicated						
Money Supply (M2)	0.7	25	13.4	2	2.1	2.6	
Credit to Private Sector	1.1	1	-1	4.3	1.3	1.2	
Balance of Payments	Percent of GDP, unless otherwise indicated						
Overall Balance	4.9	17.2	11.6	2.3	5.0	1.3	0.2
Current Account Balance	-5.3	-5.3	-6.3	-7.9	-7.1	-7.4	-9.1
Trade Balance	-43.3	-50.1	-53.9	-63.3	-54.1	-51.1	-44.3
Goods Exports	3.7	3.5	3.0	3.0	3.2	3.2	3.7
Goods Imports	-43.2	-45.8	-43.2	-54.0	-49.2	-48.6	-44.0
Services (net)	-3.8	-7.7	-13.7	-12.2	-8.1	-5.7	-4.0
Investment Income (net)	7.7	5.9	4.7	4.3	5.4	4.7	3.8
Current Transfers (net)	30.3	38.9	42.8	51.1	41.7	39.0	31.5
Capital and Financial Accounts	10.2	22.5	17.9	10.2	12.0	8.7	9.3
Foreign Direct Investment	0.7	1.4	0.5	1.2	1.4	1.5	1.5
Gross Reserves (in US$ m, e.o.p)	237.2	317.9	375.5	388.1	401.4	409.2	410.5
In months of next year's imports	9.6	11.7	10.3	10.9	10.9	10.8	10.8
Other Memo Items							
Nominal public sector debt (% GDP)	43.6	47.5	44.0	45.3	41.6	40.8	38.9
Exchange rate (TOP per US$, average)	2.3	2.3	2.3	2.3	2.4	2.4	2.4
Personal Remittances (% of GDP)	29.3	38.4	36.3	35.6	30.8	28.2	25.8

13. **Despite multiple shocks, Tonga's banking sector remains well-capitalized and liquid.** Prior to the shock, the sector displayed strong capital and liquidity positions, displaying a mere 3.5 percent non-performing loans (NPLs). However, in the aftermath of the shock, NPLs surged, doubling to over 6 percent by the end of 2022, while provisioning decreased. Despite this development, banks maintained their robust

capitalization, registering a 33.6 percent capital adequacy ratio by late 2022. The escalation of NPLs poses a significant risk to the banking sector, especially as COVID-19 relief measures conclude and the impacts of the HT-HH disaster ripple through borrowers. The NRBT is diligently monitoring the situation and is prepared to take measures to prevent any severe financial constraints. If NPLs continue to rise, banks may find it necessary to increase provisions to cover potential losses.

Table 2: Selected fiscal indicators

		Est.			Proj.		
	FY20	**FY21**	**FY22**	**FY23**	**FY24**	**FY25**	**FY26**
	Percent of GDP, unless otherwise indicated						
Overall Balance (including grants)	5.3	-1.0	-0.7	0.4	-2.0	-1.5	0.3
Overall Balance (excluding grants)	-13.7	-23.4	-23.1	-24.0	-24.8	-21.5	-15.8
Primary Balance	6.1	-0.6	-0.2	1.0	-1.5	-1.0	0.7
Total Revenues and Grants 1/	**44.2**	**48.3**	**45.2**	**47.7**	**46.3**	**44.6**	**40.8**
Domestic Revenues	25.1	25.9	22.9	23.3	23.5	24.6	24.7
of which: Consumption Tax	14.4	16.2	13.7	14.8	14.1	14.7	15.1
Taxes on Income and Profits	4.7	4.5	4.9	4.0	4.0	4.5	4.1
Other Tax Revenue	2.3	2.1	2.2	2.3	2.2	2.6	2.7
Non-tax Revenues	3.8	3.0	2.1	2.2	3.1	2.8	2.8
Grants	19.1	22.4	22.3	24.4	22.8	20.0	16.2
Total Expenditure 1/	**38.9**	**49.3**	**45.9**	**47.4**	**48.3**	**46.1**	**40.5**
Current Expenditure	33.7	41.8	40.0	40.1	37.3	35.1	32.1
Wages and Compensation 2/	13.3	15.0	13.1	12.7	12.5	12.0	11.7
Goods and Services	15.2	21.9	19.5	19.4	17.5	15.8	15.1
Interest Payments	0.7	0.4	0.6	0.6	0.5	0.5	0.4
Current Transfers	2.4	2.3	4.5	4.3	4.7	4.4	2.9
Other Expenses	2.2	2.2	2.3	3.1	2.1	2.3	1.9
Development Expenditure	5.2	7.5	5.9	7.2	11.0	11.0	8.5
General Government Financing	**-5.3**	**1.0**	**0.7**	**-0.4**	**2.0**	**1.5**	**-0.3**
Domestic (net)	-4.4	-0.5	2.3	-0.6	5.4	4.8	2.9
External (net)	-1.0	1.5	-1.5	0.2	-3.4	-3.3	-3.2
Memorandum Items							
Cash Reserves (Pa'anga m)	97.6	87.5	79.3	42.9	43.3	43.3	41.3
In months of current expenditure	3.1	2.4	2.1	1.0	1.0	1.0	1.0
Wages and Compensation							
as % domestic revenues	53.0	57.8	57.4	54.4	53.1	49.0	47.4
as % current expenditure	39.5	35.9	32.8	31.6	33.4	34.3	36.6
Source: GoT, IMF and WB staff estimates							

1/ Excludes in-kind development grants and expenditure

2/ Includes employer contributions to defined-contribution pension scheme

2.2. MACROECONOMIC OUTLOOK AND DEBT SUSTAINABILITY

14. **Growth in Tonga is poised to average 2.1 percent over the period spanning FY24-26 before tapering off to 1.2 percent in the long run**. The short-term growth trajectory is underpinned by the recovery from the HT-HH event, coupled with a resurgence in agriculture and tourism. In FY24, growth is projected to maintain its upward momentum, reaching 2.5 percent, subsequently easing to 2.2 percent in FY25, and further down to 1.6 percent in FY26. Remittances are expected to remain at elevated levels before gradually reverting to their pre-crisis norms, approximately 26 percent of GDP by FY26. Tonga's long-term growth prospects are relatively modest, with an estimated potential growth rate of around 1.2 percent. This is due to the nation's susceptibility to natural disasters, its geographical remoteness, and a limited production base that constrains its growth outlook. Over the medium term, agriculture, and services, including tourism and retail sales, will remain the primary drivers of growth, collectively constituting approximately 80 percent of the country's GDP. To bolster long-term growth, structural reforms are imperative.

Table 3: Contributions to real growth by sector (percentage point)

Sector		Est.			Proj.		
	FY20	FY21	FY22	FY23	FY24	FY25	FY26
Agriculture, forestry and fishing	0.5	0.0	-0.5	0.8	0.6	0.6	0.4
Construction	-0.8	0.8	-0.4	0.3	0.6	0.2	0.1
Secondary (ex. construction)	0.4	-0.6	-0.3	0.3	0.1	0.2	0.1
Services	-0.2	-4.0	1.5	1.1	0.9	0.9	0.4
Other	0.6	1.1	-2.4	0.2	0.3	0.4	0.6
Total	**0.5**	**-2.7**	**-2.0**	**2.6**	**2.5**	**2.2**	**1.6**

Source: GoT and WB staff estimates

15. **Inflation is anticipated to subside in FY24, falling below the NRBT's 5 percent reference rate by FY25.** Core inflation remains elevated, primarily fueled by robust demand, underpinned by remittances, while supply-side constraints begin to emerge. To anchor inflation expectations, there may be a necessity for additional monetary tightening. Such measures are not expected to have a significant impact on growth, given the existing surplus of liquidity and robust international reserves. International reserves are expected to maintain their strength, remaining at a level equivalent to around 10 months of imports throughout the projected period.[8]

16. **The current account deficit is forecasted to persist at a high level, driven by an unfavorable trade balance.** Goods trade deficit is expected to remain elevated, reflecting the substantial demand for imports related to reconstruction, coupled with modest export performance. Additionally, grants and remittances are projected to decline, reaching pre-shock levels by FY26, contributing to an increased current account deficit. By contrast, service trade deficit is expected to narrow with tourism recovery.

17. **The fiscal balance is anticipated to swing back into a deficit during FY24-25, primarily due to the reduction in grants and the upsurge in expenditures related to reconstruction efforts**. Following a period of sluggish execution in FY23, reconstruction projects are expected to gather momentum in FY24, with this

[8] This level of reserves exceeds the international reserve adequacy metrics from the 2022 Article IV report of 4.1 months of imports under a standard shock probability scenario, and 6.6 months of imports under a higher shock probability scenario.

trend continuing into FY25. Moreover, grants are foreseen to gradually return to their pre-crisis levels from the exceptional heights seen during the COVID and disaster shocks. The deficits during this phase are expected to be financed through the drawdown of cash reserves and the issuance of domestic bonds. Over the medium term, fiscal adjustments will bolster the fiscal balance, riding on the wave of economic recovery and the implementation of revenue-enhancing measures. These measures encompass the rationalization of tax exemptions and the strengthening of tax administration.

18. **Tonga is expected to achieve a balanced budget by FY26 as current spending progressively normalizes, including prudent control of the wage bill.** In the medium term, the dynamics of the debt burden will be significantly influenced by the repayment of non-concessional loans from the Chinese EXIM Bank, which will amount to around 3 percent of GDP or 10 percent of domestic revenue annually from FY24-29. To ensure fiscal resilience that supports Tonga's development spending needs while mitigating debt risks, it is imperative to refrain from incurring new non-concessional external debt. Effectively using the dedicated repayment fund, specifically designed to ensure timely loan repayment, is imperative. Additionally, commitment to transparency and accountability through Public Financial Management (PFM) reforms is vital in this pursuit.

Table 4: Balance of Payments needs and financing sources

US$		Est.			Proj.				Est.			Proj.		
	FY20	FY21	FY22	FY23	FY24	FY25	FY26	FY20	FY21	FY22	FY23	FY24	FY25	FY26
			in US $ million							*in percent of GDP*				
Total financing needs	**30.8**	**27.4**	**37.3**	**52.1**	**60.6**	**64.4**	**77.7**	**6.2**	**5.9**	**7.5**	**9.5**	**10.4**	**10.6**	**12.1**
Current account deficit	26.1	24.7	31.5	43.0	41.0	45.0	58.5	5.3	5.3	6.3	7.9	7.1	7.4	9.1
Scheduled debt amortization	4.8	2.8	5.8	9.1	19.6	19.5	19.2	1.0	0.6	1.2	1.7	3.4	3.2	3.0
								0	0	0.0	0.0	0.0	0.0	0.0
Total financing sources	**30.8**	**27.4**	**37.3**	**52.1**	**60.6**	**64.4**	**77.7**	**6.2**	**5.8**	**7.5**	**9.5**	**10.4**	**10.6**	**12.1**
FDI inflows	3.5	6.6	2.5	6.6	8.1	9.1	9.7	0.7	1.4	0.5	1.2	1.4	1.5	1.5
External debt disbursements	0.0	9.5	-1.9	10.2	-0.3	-0.5	-1.1	0.0	2.0	-0.4	1.9	-0.1	-0.1	-0.2
Other net inflows on capital & financial account	51.7	92.0	94.3	47.9	81.8	63.6	70.5	10.5	19.7	19.0	8.8	14.1	10.5	11.0
Use of FX reserves	-24.4	-80.7	-57.6	-12.6	-13.3	-7.8	-1.3	-4.9	-17.2	-11.6	-2.3	-2.3	-1.3	-0.2

Note: Change in reserves: "-" denotes an accumulation; "+" denotes a reduction.

Source: NRBT; Ministry of Finance; World Bank staff projections

19. **The government's several critical fiscal measures are closely tied to Tonga's Performance and Policy Actions (PPAs) for FY23 and FY24, as part of the World Bank's Sustainable Development Finance Policy (SDFP).** The approval of the Public Financial Management Bill, featuring provisions such as the introduction of fiscal responsibility principles and the establishment of a numerical limit on government guarantees, has been carried over to FY24. Given the heightened risk of debt distress, Tonga's PPAs include a commitment to maintaining a zero limit on non-concessional external borrowing, a pledge that Tonga has consistently upheld since its introduction. The third PPA for FY24 outlines the commitment to regularly publish a quarterly debt bulletin, to enhance transparency and accountability in debt management.

20. **Even in the face of frequent and severe economic shocks, the sustainability of public debt is upheld through the government's steadfast dedication to prioritize grant financing and only turning to highly concessional debt as a last resort.** According to the October 2023 IMF/WB Post-mission DSA, Tonga maintains at a high risk of external and overall debt distress. The PV of external debt-to-GDP and public debt-to-GDP ratios are predicted to breach DSA thresholds by FY33 (Figures 1 and 2). In addition to the assumed

gradual normalization of grant level under current commitment, this debt dynamic is also driven by the growing spending needs for sustainable development goals (SDG) and climate resilience. Debt service will rise notably from FY24 due to larger principal repayments, necessitating refinancing with new borrowing in the medium term. Tonga's public debt is deemed sustainable, assuming grant access, concessional financing, and significant fiscal adjustments. The government aims to secure grant financing, negotiate debt relief with non-concessional creditors, and maintain its policy against new non-concessional external debt (with a grant element below 35 percent) for sustained fiscal stability.

Table 5: Sources of Financing (Percent of GDP)

	FY21	FY22	FY23	FY24
Overall Balance (excluding grants)	**-23.4**	**-23.1**	**-24.0**	**-24.8**
Budget support grants	10.8	8.0	8.5	3.6
of which: WB DPO/Cat-DDO	*6.4*	*3.8*	*0.0*	*0.8*
WB Supp. Financing		*0.0*	*3.6*	*0.0*
ADB	*0.0*	*3.1*	*0.0*	*1.6*
Australia	*2.3*	*0.6*	*4.2*	*0.5*
New Zealand	*1.5*	*0.5*	*0.5*	*0.4*
European Union	*0.5*	*0.0*	*0.2*	*0.2*
Project grants & In-Kind	11.6	14.3	15.9	19.2
Other external financing (net) (a)	1.5	-1.5	0.2	-3.4
External grants and financing	**23.9**	**20.8**	**24.6**	**19.4**
Domestic financing (net)	**-0.5**	**2.3**	**-0.6**	**5.4**
Total grants and financing	**23.4**	**23.1**	**24.0**	**24.8**

(a) FY23 includes the IMF RCF.

21. **A large natural disaster would lead to an earlier breach of the threshold, with public debt-to-GDP surpassing 70 percent in FY2030.**[9] Following Low-Income Country DSA IMF/WB guidance, the baseline scenario (blue line) assumes regular credit terms for IDA and ADB financing that have not already been committed throughout the projection, affecting projected primary deficits. Debt dynamics improve if IDA and ADB financing continue under current grant terms.

22. **Downside risks prevail.** High public and external debt distress risk persists for Tonga. Limited productive capacity and high global demand for Tongan workers elevate inflation risks. Rising commodity prices could reduce purchasing power, worsen the current account balance, and strain resources. Monetary tightening's effect on growth is limited due to ample liquidity. Frequent natural disasters strain resources and raise fiscal deficits. Correspondent banking relationship loss could disrupt transfers and remittance. On a positive note, recovery might outpace expectations if tourism recover swiftly.

[9] The baseline scenario incorporates the effect of natural disasters and climate change over the longer-term, with no natural disaster assumed between FY23-25. The natural disaster shock assumes a one-off shock of 14 percentage points to the debt to-GDP ratio in FY2023 with real GDP growth and exports are lowered by 3 and 7 percentage points, respectively, in the year of the shock. According to the DSA guideline, this natural disaster shock should be exercised for countries that are vulnerable to natural disasters and experience at least 2 disasters every 3 years, such as Tonga.

Figure 1: Present Value (PV) of External Public and Publicly Guaranteed (PPG) Debt-to-GDP Ratio

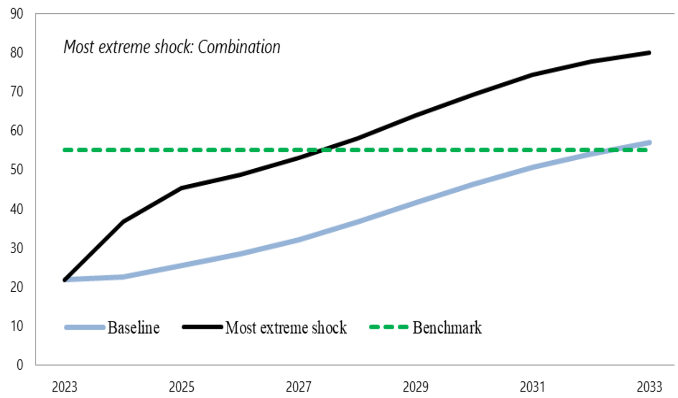
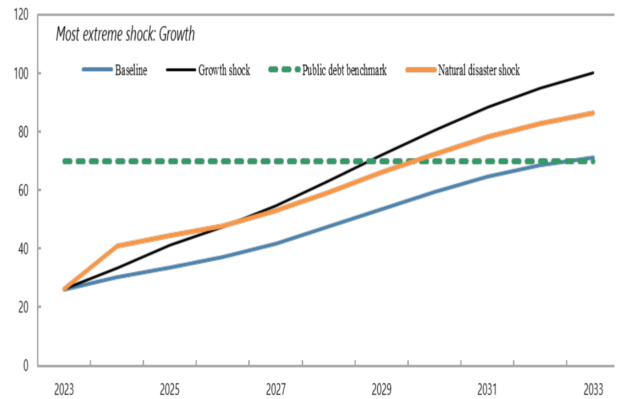


Figure 2: Present Value of Public Debt-to-GDP Ratio



Source: October 2023 IMF/WB Post-mission DSA

23. **The proposed operation's macroeconomic policy framework is adequate.** Average growth of 2.1 percent in FY24-26 stems from reconstruction and tourism recovery. FY26 should see fiscal surplus after two years of expected deficits (averaging 1.8 percent of GDP). Prudent fiscal management, increased domestic revenue, controlled spending, and avoidance of new non-concessional external borrowing enhance resilience. While debt distress risk is high, public debt is sustainable. NRBT is prepared to tighten monetary policy against persistent price pressures. Stable exchange rate peg anchors policy, and foreign reserves remain sufficient for Tonga's financial stability goals.

2.3. IMF RELATIONS

24. **In July 2022, Tonga received a US$9.03 million (1.9 percent of GDP) loan from the IMF's RCF, equal to 50 percent of Tonga's IMF quota.** These resources lifted balancing payments pressure, supported reconstruction needs, and provided social assistance to mitigate the impact of the HT-HH and COVID-19 shocks. In January 2023, the IMF visited Tonga to assess progress in economic recovery. In July 2023, Article IV mission was conducted. The IMF and WB have a history of effective collaboration, with WB's participation in IMF Article IV missions, information exchange on macroeconomic stance and challenges, and common views on priorities. This teamwork facilitated coordination in providing balance of payments and development policy financing post HT-HH and COVID-19. The WB and IMF recently collaborated on the macroeconomic policy assessment for this operation and the joint IMF/WB DSA.[10]

3. GOVERNMENT PROGRAM

25. **Tonga's national development strategy, the Tonga Strategic Development Framework 2015—25 (TSDF II), aims to enhance quality of life, sustainability, governance, and prosperity.** Developed through extensive consultation, TSDF II focuses on seven National Outcomes and 29 organizational outcomes in five priority areas. Governance is emphasized for effective implementation. The TSDF II envisions a progressive Tonga with improved quality of life, sustainability, and prosperity. It targets seven National Outcomes

[10] Post-mission DSA is expected to be approved by IMF Board, as part of the Article IV report, in October 2023.

spanning economic, social, political, infrastructure, and environmental areas. Governance is vital for public service and implementation. Tonga is strengthening resilience to climate change and disasters through the Disaster Risk Management (DRM) framework. TSDF II, Tonga Climate Change Policy, and Joint National Action Plan provide strategic vision. The newly approved Disaster Risk Management Act (2021) focuses on proactive risk reduction.[11]

26. **The Ministry of Finance administers pre-arranged and post-disaster funding instruments.** While access to these exists, a gap remains for expected losses, exacerbated by climate change. The Cat DDO will bridge this gap and enhance financial resilience. Tonga strengthens household resilience through social protection and adaptive measures. The National Social Protection Policy and Adaptive Social Protection Framework focus on building pre, during, and post-crisis resilience. Collaboration between relevant bodies reinforces this commitment.

27. **Health challenges persist, exacerbated by the COVID pandemic. Despite good health outcomes, capacity constraints exist.** Tonga's response framework, including the Epidemic Taskforce, demonstrated readiness in health emergencies. Vaccination efforts showed significant progress. Tonga's DRM, social protection, and health sector frameworks are aligned for the operation. Multi-hazard resilience is a priority, demonstrated through legislation, policies, and strategies. This approach fulfills international commitments for disaster risk reduction and climate adaptation. Tonga's DRM, social protection, and health frameworks align with this operation's goals. The country actively supports international commitments, responding to climate change, disasters, and health-related events with a proactive stance on risk reduction and enhanced policy frameworks.

4. PROPOSED OPERATION

4.1. LINK TO GOVERNMENT PROGRAM AND OPERATION DESCRIPTION

28. **This operation, combining a DPO with a Cat DDO, bolsters the foundation for achieving the Tonga Strategic Development Framework (TSDF) II.** Directly supporting the first six TSDF national outcomes, Pillar 1 enhances fiscal space and sustainability, imperative for recovery, improved public services, and overall development. Pillar 1 drives PFM Act reform, also a WB Sustainable Development Finance Policy (SDFP) FY23 PPA. Pillar 2 enhances disaster resilience, disaster preparedness, and post-disaster recovery. World Bank Group (WBG) investments, technical aid, and partner programs further align with the TSDF II goals.[12]

29. **Extending from previous DPO series, this operation deepens fiscal and disaster resilience reforms.** Pillar 1 emphasizes domestic revenue mobilization, fiscal and debt sustainability via revised legislation. Pillar 2 bolsters disaster resilience with proactive disaster risk management, Disaster Risk Management Policy, and National Social Protection policy. This comprehensive approach aligns with government strategy and climate policy assessment.

30. **Four key lessons underpin this operation's design.** First, DPOs in Tonga can achieve tangible results in advancing economic and fiscal reforms in the context of solid government ownership. Second, maintaining

[11] Approval of the DRM Bill by Cabinet was supported by the previous DPO/Cat DDO (Tonga Second Resilience DPO with a Cat DDO Option (P172742)). The DRM Bill was subsequently approved by Parliament in August 2021 and received Royal Assent in September 2023. It is now referred to as the DRM Act 2021.
[12] Tonga Second Resilience DPO with a Cat DDO Option (P172742).

a strong policy dialogue and close coordination with other development partners is resource intensive but critical for advancing significant reforms and achieving development outcomes. Third, the hybrid DPO/Cat DDO model reduces transaction costs of operations by coupling up-front financing with contingent financing for disaster risk management. Fourth, there are benefits including provision of access to contingent financing for public health emergencies as well as natural disasters via the Cat DDO.

31. **The GoT's record includes twelve DPOs in fourteen years, showcasing its commitment to aligned reform agendas and strong partnerships.** This sustained engagement has driven economic and fiscal progress, climate resilience, disaster management, and business environment improvement. This is Tonga's second hybrid DPO/Cat DDO, reflecting ongoing disaster and climate resilience efforts. The operation builds on the previously Cat DDO, providing strong additionality to compliment and build on reforms to strengthen disaster resilience. The previous Cat DDO (P172742) was fully deployed after the HT-HH eruption. This disaster highlighted the importance of strengthening disaster risk management and preparedness at national and sub-national levels. The earlier Cat DDO also contributed to effectively managing the COVID-19 outbreak in 2022.

32. **This operation features upfront financing of SDR 3.7 million (US$5 million equivalent) upon effectiveness and successful program completion.** Additionally, contingent Cat DDO financing of up to SDR 14.9 million (US$20 million equivalent) is available, with specific triggers, over a three-year period, extendable to six. The closing date is December 31, 2026, unaffected by Cat DDO drawdown timing.

33. **The drawdown trigger for the Cat DDO is contingent upon a "Catastrophic Event" and is satisfied when the Recipient's Prime Minister or authorized official declares a state of emergency.** No withdrawal shall be made of the Single Withdrawal Tranche unless the Association is satisfied, based on evidence satisfactory to it, that a state of emergency has been declared by the Recipient’s Prime Minister or other authorized official, in accordance with the manner prescribed in Part II Sections 8 and/or 10 of the Recipient’s Disaster Risk Management Act 2021, to respond to a Catastrophic Event.

34. **A Catastrophic Event is defined as an imminent or occurring emergency situation**, caused by: (i) a cyclone, flood, drought, storm, storm surge, tsunami, earthquake, volcanic eruption, or other similar event; or (ii) an epidemic, pandemic, or other public health emergency, that requires the Recipient to promptly mobilize its capacity and/or financial resources, but excluding an emergency situation caused by human induced hazard. The Cat DDO drawdown period spans three years, ending on December 31, 2026. Macroeconomic framework assessment occurs only at effectiveness and renewal. Renewal, once within a year before the closing date, depends on Recipient's progress and macroeconomic framework adequacy, requiring Regional Vice President approval.[13] Monitoring encompasses the program's three-year term, backed by technical assistance and joint dialogue with GoT and development partners. Program monitoring transpires over the operation's term, backed by technical support and joint dialogue. Parallel assistance activities and ongoing engagement ensure effective tracking of policy actions and reforms. Country-missions will facilitate dialogues with government agencies, reviewing progress and implementation.

[13] However, if the Bank has previously advised the Member Country that it does not meet relevant conditions for the drawdown (set out in OP 8.60, para. 22) and the Member Country has not yet returned to compliance with those conditions, the Bank conducts a full review of the overall program implementation (and, for the DDO, of the macroeconomic policy framework) as early as possible on receipt of the Member Country’s drawdown request. Once the Bank confirms that the Member Country has met the relevant drawdown conditions, the Bank proceeds with disbursement.

35. **This operation is aligned with the goals of the Paris Climate Agreement.** First, the DPO reform program is consistent with the implementation of Tonga's climate strategies, such as Tonga's revised Nationally Determined Contributions (NDCs), the Second Joint National Action Plan on Climate Change and Disaster Risk Management (JNAP2) and Tonga Climate Change Policy 2035. Second, from a mitigation perspective, for the proposed program, the prior actions are not expected to lead to an increase in GHG emissions nor are they expected to reduce carbon sinks. Third, in terms of adaptation and resilience dimensions, risks from climate hazards are unlikely to have an adverse effect on the prior action's contribution to the PDO. PA3, PA4 and PA5 actively contribute to climate adaptation goals as demonstrated in Annex 6. In sum, this operation is aligned with the goals of the Paris Climate Agreement, both on mitigation and adaptation dimensions.

4.2. PRIOR ACTIONS, RESULTS AND ANALYTICAL UNDERPINNINGS

Pillar 1: Strengthening Fiscal and Debt Sustainability

Strengthening Domestic Revenue Mobilization

Prior Action (PA) for DPO1	Indicative Trigger (IT) for DPO2
To strengthen domestic revenue mobilization, the Recipient, has published in the Gazette the Revenue Services Administration (Electronic Sales Register System) Regulations 2022, which establish an electronic sales register system to analyze and transmit fiscal data to the Ministry of Revenue and Customs.	To strengthen domestic revenue mobilization, the Recipient, through its Cabinet, has approved consumption tax reform that, among other provisions, reduces tax exemptions in the power, agriculture, and tourism sectors through revised regulations under the Consumption Tax Act.

36. **Tonga has undertaken robust fiscal reforms in recent years, amplifying its public financial management (PFM) and debt frameworks while bolstering domestic revenue mobilization**. Prior reforms, supported by the Tonga Second Resilience DPO with a Cat DDO Option (P172742), have contributed to rationalized expenditure and improved wage bill management. This was achieved through the introduction of guidelines curtailing overtime allowances and payments. Evolving from these past achievements, the current focus revolves around strengthening revenue policy and administration through its modernization and strategic targeting of augmented domestic revenue mobilization. This pillar also supports reforms directed at improving fiscal and debt policy frameworks, thus contributing to an expanded fiscal space. The principles upheld in this pillar pave the way for Tonga's adept handling of future external debt service payment hikes and safeguarding the provision of essential public goods and services.

37. **Maximizing the efficiency of consumption tax collection is crucial for Tonga's revenue framework.** Import duties, consumption taxes, and excise duties are the core of Tonga's revenue system, accounting for over 80 percent of total tax revenue. Tonga heavily relies on consumption taxes as a source of revenue, with only Samoa and Vanuatu collecting higher consumption tax as a share of GDP. Tonga, however, collects only about half of its potential consumption tax revenue due to high rates of non-compliance. Tax evasion can occur through under-reporting sales, failure to register with authorities, and misclassification of commodities. Investing in enabling technology can reduce the administrative burden on taxpayers and increase voluntary compliance. Monthly e-filing of sales tax data can enhance risk-analysis and audit-selection and strengthen revenue enforcement.

38. **The Electronic Sales Register System (ESRS) 2022 regulations introduce measures designed to improve revenue compliance and increase the efficiency of the tax system.** The regulations enhance tax compliance by requiring all businesses with revenue of over TOP 100,000 to establish an electronic sales register system to record all sales and transmit real-time information to the Ministry of Revenue and Customs (MoRC). The system allows MoRC to obtain and monitor accurate data to create a reliable database for assessing, calculating, and imposing liability for a tax. Businesses that fail to comply with the requirements are liable for a penalty of TOP 5,000 for each failure at each place of business where a breach has occurred.

39. **The ESRS regulations were gazetted in June 2022, with implementation of the Point Of Service (POS) systems beginning in August 2022.** By March 2023, 54 business across 163 outlets (particularly wholesale and retail outlets) in the two major islands (Tongatapu and Vava'u) have been registered onto the system. MoRC estimates that by the end of FY23, more than 200 businesses will have been registered. The authorities also provided awareness trainings to stakeholders via radio and TV, including by encouraging buyers to ask for receipt when purchasing items. Challenges encountered during the implementation included poor internet connectivity, especially in outer islands, and enforcing large fines on defaulters. Other challenges that may be encountered as the system is fully implemented include the use sales suppression technologies that allow firms to tamper with the registers' electronic records.[14] Moreover, some evidence suggests that increased reported sales may be partially offset by increases in expenses, thus reducing corporate taxable income.[15]

40. **The Indicative Trigger aims to reform the consumption tax legal framework by reducing high tax exemptions in sectors like power, agriculture, and tourism.** These exemptions result in significant revenue loss, estimated at around 3.8 percent of GDP in FY23, with Tonga Power Limited (TPL) being a major beneficiary. Despite their intentions to encourage investment, support low-income households, or reduce administration costs, evidence shows that these exemptions have been largely ineffective in the Pacific and globally. Reforming these exemptions can improve subsidy targeting, simplify tax administration, and enhance reporting on the government's true cost of maintaining implicit subsidies. It also promotes transparency and governance in tax expenditures, creating opportunities to increase fiscal space and encourage investment in renewable energy. Technical assistance from the Australian DFAT and the ADB supports this reform.

41. **Expected result:** The implementation of the regulations is expected to increase tax compliance and result in higher collections of consumption tax revenues. This regulation targets a total of 270 businesses subject to consumption tax. The full implementation of the regulation is expected to result in an additional revenue collection of TOP 7–10 million (equivalent to 0.6-0.8 percent of GDP) annually. Overall, consumption tax revenues as share of GDP are expected to increase from a pre-pandemic average of 13.6 percent in FY15-FY19 to 15 percent in FY25-27**.**

[14] Ainsworth. 2008. Zappers & Phantom-Ware: A Global Demand for Tax Fraud Technology.
[15] Boyer and d'Astous. 2020. Tax Compliance and Firm Response to Electronic Sales Recording.

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

Prior Action for DPO1	Indicative Trigger for DPO2
To improve the effectiveness of public debt management and achieve a sustainable fiscal policy, the Recipient, through its Cabinet, has approved for submission to Parliament the Public Financial Management Bill 2023, which among other provisions, outlines key fiscal responsibility principles and sets a numerical limit on the stock of government-guaranteed debt.	To improve the effectiveness of public debt management and to achieve a sustainable fiscal policy, the Recipient, through its Cabinet, has approved regulations to the PFM Act that set governance rules and use of the Debt Repayment Sinking Fund.

42. **Despite prudent fiscal management in recent years, Tonga continues to remain at high risk of debt distress with several weaknesses in the fiscal framework.** Before the pandemic, public debt to GDP ratio had declined from 51.2 percent in FY15 to 41.3 percent in FY19, with an uptick in recent years due to additional pandemic-related spending. Tonga, however, faces large annual external debt servicing payments in FY24–29 (over 3 percent of GDP, 16 percent of domestic revenues annually).

43. **The 2020 Public Expenditure and Financial Accountability (PEFA) Assessment highlighted several weaknesses in Tonga's fiscal framework.** The main shortcomings included: (i) Insufficient Fiscal Management Principles and Medium-Term Budgeting Framework for guiding fiscal policy to ensure a credible medium-term budgeting process; (ii) Lack of a Required Debt Management Strategy—a critical shortcoming in managing liabilities effectively; (iii) Weak Legal Framework for Internal Audit Functions, which have resulted in vulnerabilities within internal controls; and (iv) Insufficient Publication Requirements for Budget Documents—a significant transparency concern.

44. **GoT is undertaking a comprehensive review to the Public Financial Management Act 2002 through new PFM Bill 2023.** This reform will strengthen the fiscal framework through the integration of fiscal responsibility principles into legislation, along with a mandate to develop a medium-term fiscal strategy. These fiscal responsibility principles encompass: (i) Establishing a sustainable budget balance over the medium term. (ii) Attaining and sustaining a judicious level of public debt and publicly guaranteed debt. (iii) Prudently managing fiscal risks. (iv) Ensuring the efficient allocation of public funds and resources to deliver value for money. (v) Pursuing objectives of macroeconomic stability, inclusive growth, intergenerational equity, and environmental sustainability. Furthermore, as part of the debt management component, the legislation will stipulate a specific numerical limit for government guaranteed debt. To make these principles actionable, quantifiable fiscal objectives will be delineated within budget documents. Progress toward these objectives will be regularly communicated to the Legislative Assembly and the broader public, enhancing transparency and accountability in fiscal management.

45. **The indicative trigger will support implementing regulations to the PFM Act that set the governance rules of the Debt Repayment Sinking Fund.** The GoT established a Sinking Fund in late FY21 to handle loan repayment commitments. Proposed amendments to the PFM Act will provide legal protection to the fund and authorize the Minister of Finance to manage funds for loans, securities, and future liabilities. The regulations will include governance rules, fund usage guidelines, and set-aside requirements. Currently, the Debt Repayment Sinking Fund has a balance of less than TOP 20 million (less than 2 percent of GDP) saved in term deposits. This balance is insufficient to cover principal repayments, so Tonga will likely need to

refinance most of the external debt service payments. The Fund is crucial for meeting future repayment commitments. Ensuring that it is only used for debt repayment will enhance the GoT's credibility in meeting its debt service obligations.

46. **Expected result:** The implementation of this reform is expected to improve the country's fiscal and debt sustainability. Compliance with the prescribed numerical limit for government-guaranteed debt, which must not exceed 10 percent of domestic revenue, envisaged in the PFM Bill 2023, will help to ensure a prudent level of the publicly guaranteed debt. The regulation on the Debt Repayment Sinking Fund will help GoT to meet their future debt repayments and therefore reduce the stock of public debt. These efforts are expected to result in a reduction of the PPG debt as a share of GDP from 46.3 percent in FY15-19 to 42 percent in FY25-27.

Pillar 2: Enhance Resilience to Climate Change and Disasters

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

Prior Action for DPO1	Indicative Trigger for DPO2
To enhance climate and disaster resilience of disaster-affected communities, the Recipient, through its Cabinet, has approved the Disaster Risk Management Policy Framework 2023-30, which clarifies roles and responsibilities for stakeholders at the national and sub-national level.	To improve climate and disaster risk management, the Recipient, through its Cabinet, has approved the implementing regulations to the Disaster Risk Management Act.

47. **The existing legislation lays a solid foundation for emergency management, but there is a need to further enhance a proactive policy and regulatory framework for Disaster Risk Management (DRM) after the approval of the DRM Act 2021.** Accordingly, reforms under this operation will further strengthen the DRM regulatory framework, to align it with international good practice such as the Sendai Framework for Disaster Risk Reduction, 2015-30 (SFDRR).

48. **A key reform identified under the DRM Act 2021 is the creation of a National DRM Policy Framework 2023-30 (PA#3).** The development of the DRM Policy Framework 2023-30 (DRMPF) is included as a priority in the Ministry of Meteorology, Energy, Information, Disaster Management, Environment, Climate Change and Communication's (MEIDECC's) Strategic Roadmap for Emergency and Disaster Risk Management (2021-23). This reform will enable a shift from post disaster response to an ex-ante preparedness approach, with a decentralized and community level focus. The DRMPF outlines practical policy guidance for all government and non-government stakeholders on responsibilities for DRM (including for climate induced disasters such as tropical cyclones, floods, and drought). The World Bank has provided TA for the development of the DRMPF, which received Cabinet Approval on April 21, 2023.

49. **The overarching goal of the DRMPF is "to increase the resilience of Tonga's communities and assets to natural and climate related hazards through proactive disaster risk management."** The Policy is built around the following four pillars: i) DRM is the responsibility of all; ii) DRM should contribute to equity, transparency, and inclusion; iii) Development should consider future risk and be adaptable to changing conditions; and iv) Building back better physically, socially, and culturally.

50. **The indicative trigger for DPO2 is the approval of the implementing DRM Regulations to the DRM Act 2021.** This is also included as a priority in MEIDECC's Strategic Roadmap for Emergency and Disaster Risk

Management (2021-23). The DRM Regulations will be a statutory instrument which will set out the administrative detail that will operate under the DRM Act 2021. Specifically, while the DRM Act 2021 sets out broad legal and policy principles for managing disaster risk in Tonga, The DRM Regulations will provide the regulatory requirements for the operationalization of the Act Preparation of the DRM Regulations will be supported by Technical Assistance from New Zealand.

51. **Expected result:** The implementation of these reforms is a continuation of the earlier reforms supported under the previous DPO/Cat DDO (P172742). These reforms will support stronger institutional and regulatory systems for climate resilience and DRM within Tonga**,** measured via the development of new DRM Plans[16], required under the DRMPF, which cover at least 75 percent of Tonga's population. The DRM plans will include actions for the continued provision and accessibility of essential GBV support services in the aftermath of disasters, thus ensuring continued assistance for survivors and mitigating new vulnerabilities arising from disasters. The reforms will also enable Tonga to better prepare for and respond to disasters exacerbated by the impacts of climate change, such as more extreme weather and future sea level rise.

<u>Enhancing Preparedness and Response to Natural and Climate-related Hazards</u>

52. **The Government's Disaster Risk Financing Strategy (supported as PA#4 under the previous DPO/CATDDO, P172742) called for reforms to the NEF.** Accordingly, a government review of the NEF has been undertaken, under the leadership of MoF, in close coordination with MEIDECC. The NEF, established by the Government of Tonga in 2008, provides support for relief and response needs following an emergency, including natural and climate induced disasters. Under the Emergency Fund Act (2008), the NEF receives an annual appropriation up to at least TOP $5 million (approximately USD 2.1 million) and is a key source of funding for disaster response operations in Tonga. The NEF review has indicated that there remains a lack of clarity around processes and guidance for the use of the fund (including for selection and approval of funding priorities, for transparently reporting on how the fund has been used, and for use of the fund for ex ante disaster preparedness).

Prior Action for DPO1	Indicative Trigger for DPO2
To enhance disaster preparedness and response, the Recipient, through its Ministry of Finance, has issued Treasury Instructions with the Guideline for the National Emergency Fund (NEF) to govern the use of resources and implementation progress reporting of the NEF.	To enhance disaster preparedness and response, the Recipient, through its Cabinet, has approved a revised Emergency Fund Bill.

53. **A key recommendation of the Government's NEF Review is the preparation of an operational Guideline for the NEF**. The Guideline for the NEF is the first of its kind for the NEF, and it will provide operational guidance on: (i) the process to access the NEF; (ii) eligibility of entities and emergency activities for funding under the NEF; (iii) a new application and screening process to access the NEF; (iv) use of the NEF for ex ante disaster preparedness, including for climate induced disasters such as tropical cyclones, droughts and floods; (v) minimum balances to be maintained in the NEF; and (vi) requirements for additional

[16] The DRM Plans will provide improved clarity on roles and responsibilities at the national and sub-national level will strengthen preparedness for future shocks and climate-related events, especially as Tonga continues to experience an increase in extreme weather events and sea level rise due to climate change. These plans will be informed by risk assessments, stakeholder consultations and technical studies, and will inform development and agreement of integrated DRM actions for each district/village.

implementation progress reporting to increase transparency on the use of NEF funds. The Guideline for the NEF will support the effective, efficient, and accountable use of the NEF, which is also a pre-condition to mobilize additional resources for emergency management in the future. The Guideline for the NEF was approved and issued by MoF as a Treasury Instruction17 (PA#4) on March 31, 2023. Technical Assistance for development of the Guideline for the NEF has been provided by ADB, with support from the World Bank.

54. **The NEF Review also recommended further reforms of the Emergency Fund Act (2008).** The need for such reforms has also been highlighted by the joint IMF and World Bank Climate Change Policy Assessment (2020). Accordingly, IT# 4 for DPO 2 requires Cabinet approval for submission to Parliament of the revised Emergency Fund Bill (targeted for September 2024). These revisions will align the Emergency Fund Act (2008) fully with the DRM Act 2021 and will also remove legislative ambiguity around the annual appropriation and use of the NEF. Technical assistance for these revisions is being provided by the ADB.

55. **Expected result:** The implementation of these reforms is a continuation of the earlier reforms supported under the previous DPO/Cat DDO (P172742). The implementation of these reforms will support a more comprehensive, transparent, and integrated system for DRM fudding mechanisms in Tonga, particularly for ex ante preparation for climate induced disasters. As a result of the reforms the NEF use will be transparent, consistent and the appropriation process will be clear. This will strengthen the government's financial resilience to climate change and disasters by reducing the need for re-allocation of ministry budget's if NEF Balance is insufficient.

Strengthening the Social Protection System

Prior Action for DPO1	Indicative Trigger for DPO2
To strengthen the social protection system and support a timely and efficient disaster response, the Recipient, through its Cabinet, has approved a National Social Protection policy that defines guiding principles and policy priority areas to design, implement and monitor current and future social protection programs.	To improve Government's response to disasters and strengthen household resilience, the Recipient, through its Cabinet, has approved the establishment of a Social Registry to ensure timely and efficient social assistance support during emergencies.

56. **With 20.6 percent of Tonga's population living in poverty in 2021, existing vulnerability is compounded by climate vulnerabilities (e.g., frequent severe weather events and natural hazards) and by their inability to timely use their social protection system during disasters.**[18] [19] Climate-related disasters disproportionately affect poor people, who have less capacity to cope and who take longer to recover. However, despite this level of vulnerability, Tonga social assistance programs that are fragmented, with low coverage and unable to quickly respond to disasters. Tonga covers approximately 10 percent of the

[17] A Treasury Instruction is a formalized approach within the Government of Tonga, approved by the Minister of Finance and subsequently adhered to by all ministries.

[18] Monetary poverty, measured with the national cost-of-basic-needs poverty line based on the 2021 Household Income and Expenditure Survey, is published in the following report:" Assessing progress towards the reduction of multidimensional, extreme, and monetary poverty in the Kingdom of Tonga" published by the Tonga Statistics Department in 2023.

[19] Since Tropical Cyclone Isaac (1982) which was cited as a one in a 100-year event, the frequency and magnitude of climate related disasters has significantly increased, with an estimated 9 moderate to severe tropical cyclones and volcanic events impacting Tonga between 1982 and 2022.

population and spend less than 0.4 percent of GDP on social assistance programs, which is far below global (1.5 percent), regional (1.1 percent), and comparator countries (2.2 percent) averages.[20] Results from the April-May 2022 Tonga High-Frequency Surveys after the HT-HH volcanic eruption highlighted that government assistance and insurance mechanisms played only a limited role in the recent crisis.[21]

57. **To address this situation, the government has developed the National Social Protection Policy (NSPP) to efficiently target the use of resources to those that are in most need.** The NSPP takes stock of the current social protection programs, identifies gap areas, and provides five high-level policy priority areas. These areas will be the focus in the next 10 years and will initiate a set of key policy reforms. The NSPP improves social protection delivery systems by reducing fragmentation of programs, defining clear institutional roles and responsibilities, and establishing coordination mechanisms and operational tools for the implementation and monitoring of the policy (e.g., social registry, payment systems, targeting mechanisms etc.). It outlines clear strategic objectives such as efficiently increasing coverage of social assistance programs by targeting the use of resources to those that are in most need, including women.

58. **This is the first time the GoT provides a common government vision on social protection through the NSPP.** The NSPP provides a comprehensive framework and a mandate for government agencies to systematically address poverty reduction, protection of the poor and vulnerable, and disaster response. The policy is based on several consultations with the National Social Protection Taskforce and is line with the government's efforts to address climate change adaption.[22] By consolidating a set of on-going social protection programs and establishing the institutional, programmatic, and operations conditions, government will be able to quickly respond to disasters through adaptive social protection framework.[23]

59. **The indicative trigger for the next operation will be the establishment of the National Social Registry, which is central to better planning and responding to shocks and disasters.** To strengthen the SP systems, enhance coverage, and support a timely and efficient disaster response, a critical element of the NSPP is the establishment of a National Social Registry. The Social Registry is a database that allows the government to identify and track households currently or potentially eligible for social protection programs and social services. Tonga has the basic elements in place to develop a National Social Registry through the CCT registry. Establishing a registry by expanding the CCT database will support timely and efficient disaster response for the poor and vulnerable. The increased coverage of the database would also ensure better targeting and gender-responsiveness of the ongoing social programs.

60. **Expected results:** Currently, the CCT database covers about 20 percent of all households (approximately 42 percent of the poor).[24] Increasing the coverage of the database to include those who are most vulnerable to the effects of climate change and those who are not yet covered by social assistance programs, will be a key step toward the National Social Registry. The social registry will support increased coverage of poor households (target: at least 75 percent by 2027), with information about families and

[20] World Bank. 2023. *PIC-9 Public Expenditure Review*.

[21] 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.

[22] The National Social Protection Taskforce was established in 2022 and it comprises 14 members from various government agencies that have responsibilities on social protection as well as representatives from civil society.

[23] The policy makes specific reference and aligns itself with the upcoming Disaster Risk Management (DRM) framework, DRM Act 2021, and the Sendai Framework for Disaster Risk Reduction 2015-2030.

[24] Ranking based on the household Proxy-Means Testing score. It may have exclusion and inclusion errors. Validation and update of the model will be undertaken by the World Bank Technical assistance.

individuals.

61. **The analytical underpinnings for the prior actions can be found in Annex 5.**

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

62. **Addressing Key Development Challenges:** The proposed operation strategically tackles pivotal development challenges underscored in the WBG's Systematic Country Diagnostic for nine Pacific Island Countries (PIC9 SCD), including Tonga.[25] Within this context, the PIC9 SCD has spotlighted several priority areas, emphasizing the need to ensure macroeconomic, fiscal, and debt sustainability; bolster climate and disaster risk policies alongside resilient frameworks; and establish adaptive social protection systems. These focus areas find targeted solutions within the proposed operation: PA#1 and PA#2 bolster domestic revenue by enhancing consumption tax compliance and introduce fiscal and debt responsibility principles; PA#3 and PA#4 pioneer comprehensive proactive disaster risk management, via a Disaster Risk Management Policy and NEF reforms; and PA#5 pioneers an integrated social protection policy.

63. **Contribution to IDA20 Framework:** The orchestrated actions of this DPO seamlessly align with the overarching tenets of IDA20's framework, which champions "Building Back Better from the Crisis – Toward a Green, Resilient, and Inclusive Future." Encompassing the thematic scope of "Climate Change" and the cross-cutting spheres of "Crisis Preparedness," "Governance and Institutions," and "Debt," the operation resonates with actions tailored toward enhancing debt transparency, fostering crisis preparedness and response, and fortifying adaptive social protection to bolster resilience in the face of shocks.

64. **Building on Previous Support:** The proposed operation seamlessly builds upon past reforms and further harmonizes with existing investment projects and technical assistance initiatives. The strides made in enhancing revenue mobilization and debt management are fortified by prior actions from DPO1, complemented by WB and DFAT's technical assistance. Likewise, the evolution of DRM policies echoes the foundations laid in previous DPO series, closely intertwined with projects like PREP-Tonga, Safe and Resilient Schools Project, and Tonga Climate Resilient Transport Project II, substantiated by WB and New Zealand Government's support. Furthermore, the strides in education find synergy with WB Skills and Employment for Tongans Project and DFAT's Tonga Skills initiative. The trade-oriented advancements are further bolstered through WB's technical assistance.

65. **Complementing Broader Macroeconomic Policy Dialogue:** The proposed operation seamlessly supplements the Bank's wider macroeconomic policy discourse, seamlessly dovetailing with the Bank's SDFP and Tonga's two PPAs for FY23. Importantly, the provision of development policy financing stands to bridge the financing gap stemming from dual shocks, negating the need for new external borrowing, thereby affirming adherence to the PPA stipulation of zero new non-concessional external borrowing. Significantly, the second PPA's amendments to the PFM Act, which encompass fiscal responsibility principles and a numerical limit on government-guaranteed debt, enjoy endorsement through this operation's support.

4.4. CONSULTATIONS AND COLLABORATION WITH DEVELOPMENT PARTNERS

66. **Stakeholder Engagement:** The formulation of this operation has been guided by a comprehensive and high-level consultation process involving relevant authorities and stakeholders across central and sector government ministries. Furthermore, the program has been enriched through a broader Government-led

[25] PIC9 SCD: https://openknowledge.worldbank.org/handle/10986/39707

consultation encompassing non-government entities such as the private sector and community groups. To ensure a well-rounded perspective, multiple rounds of consultations were held with pertinent stakeholders, shaping the design, scope, and anticipated execution of each Priority Action (PA). For PAs receiving technical assistance support, input from development partners, including the WB, was solicited, and their feedback was actively sought. These consultations were conducted prior to cabinet submissions or ministerial-level directives. Insights garnered from these consultations were thoughtfully incorporated into the PA documentation, iterating through a collaborative process.

67. **Collaboration with Development Partners:** The proposed operation is a collaborative outcome achieved in partnership with various development stakeholders, forming a part of a coherent development policy financing framework. The WB plays a leadership role in representing development partners within the Budget Support Management Committee (BSMC), chaired by the MoF and comprising participation from both government stakeholders and development partners. The BSMC serves as a pivotal platform for cohesive dialogue to determine actions and oversee progress. Notably, the WB, ADB, Australia, New Zealand, and the European Union (EU) lend support to the same spectrum of reform measures. The WB engages in close collaboration with these pivotal development partners, facilitating analytical work and technical assistance endeavors in Tonga. This collaboration encompasses synchronized needs assessment and programming, comprehensive cross-organizational review of analytical outputs, and ongoing discussions within the BSMC framework. The collective efforts of WB, ADB, Australia, NZ, and the EU have synergistically contributed to the realization of the proposed slate of policy reforms.

5. OTHER DESIGN AND APPRAISAL ISSUES

5.1. POVERTY AND SOCIAL IMPACT

68. **Poverty Impact:** The reforms facilitated by this DPO are anticipated to yield positive poverty impacts in the medium and long term. These effects will primarily be channeled through enhanced public finance and improved resilience against climate, environmental, and health-related disasters. The influence of the first pillar's prior actions is indirect and contingent on the allocation of augmented revenues and widened fiscal capacity towards public services and social programs benefiting the impoverished. Conversely, the second pillar's prior actions are projected to yield direct and favorable outcomes for poverty reduction.

69. **First Pillar:** The initial actions under the first pillar aim to boost government revenue collection and expand fiscal capacity, which could facilitate increased resource allocation towards pro-poor investments and programs. The policy supported by PA#1 focuses on implementing the Point of Sale (POS) system among formal and larger businesses, ultimately bolstering consumption tax revenues via improved tax compliance. [26] Preliminary analysis with the Household Income and Expenditure Survey 2021 indicates that low-income

[26] In general, VAT with registration thresholds and exemptions is not necessarily regressive. For example, analyzing 31 low- and middle-income countries with household expenditure surveys that include information about the place of purchase. Bachas, Gadenne, and Jensen (2020) find that lower-income households are more likely to purchase items from smaller/informal outlets. Therefore, the informal sector makes consumption taxes progressive in those countries. Also, the recently conducted Fiji Commitment to Equity (CEQ) analysis based on the Household Income and Expenditure Survey 2019/20 finds that Fiji's VAT (9 percent, USD 45,000 registration threshold, a few exemptions) mildly progressive. Tonga's VAT has a similar registration threshold (USD 45,000) but a higher rate (15 percent). However, Tonga VAT has a wider variety of exemptions.

households are less likely to be significantly affected by this action, given their consumption patterns.[27] Although there may be some impact, effective social protection programs could help offset this effect. If properly managed, the augmented revenue could sustain or expand social programs targeting the poor and vulnerable. Similarly, enhanced public finance management backed by Prior Action #2—embedding fiscal responsibility principles and limiting government-guaranteed debt—might enable increased allocation of public funds to public services and social programs.

70. **Electricity Tax Exemptions:** The removal of tax exemptions on electricity, as stipulated in Indicative Trigger #1, might not necessarily have negative poverty implications. A comprehensive assessment is necessary to gauge the potential impact. In the near term, the planned consumption tax reform may not significantly influence consumer prices, as the reform doesn't intend to alter the financial position of electricity providers. Instead, this step aims to enhance transparency concerning tax exemptions. Subsequently, the government will determine the extent to which these exemptions should be reduced. While this could lead to increased electricity costs, the existing lifeline electricity tariff should alleviate the burden on low-income households.[28]

71. **Second Pillar:** The preceding actions under the second pillar are expected to positively impact poverty by reinforcing resilience among the poor and vulnerable against climatic, extreme weather, and health-related shocks. These groups are often more susceptible to climatic stressors due to their limited resources to cope with unexpected events. The HT-HH disaster, for instance, disproportionately affected these households, hindering their recovery even six months post-disaster. [29] These groups also encountered substantial losses in productive assets, resorting to unsustainable coping mechanisms that could compromise their human capital development.[30] The bolstered disaster risk management, facilitated by a proactive policy framework and the newly established risk reduction policy (PA #3), is designed to directly target the poor and vulnerable, enhancing their readiness for natural and climate-related hazards. PA#5, focused on the National Social Protection Policy, is projected to offer direct and positive poverty outcomes by offering a safety net to those affected by economic shocks from disasters. The improved coordination between the Adaptive Social Protection Framework and the DRMPF will enable swift responses to shocks and foster resilience among impoverished and vulnerable communities.

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[27] The poverty impact from the increase in the effective VAT rate due to improved tax compliance could be around 0.1 percentage point, though this estimate is based on various assumptions.

[28] The FY15 Tonga Second Economic Reform Support DPO (P149963) supported the lifeline tariff for electricity consumers for low-income households. According to this reform, in contrast to the households which are consuming high volumes of electricity, the households that consume less than 50 kwh electricity are eligible to a 10 percent subsidy. The project Implementation Completion Report (ICR) (Report No. ICR00004159) found that the lifeline tariff has been successfully implemented. Since the implementation of the reform, households consuming up to 100 kw electricity have been receiving a 20 percent subsidy, which provided an adequate level of welfare to the low-income households. The lifeline tariff is, however, in place if GoT decides to implement reforms that result in an increase in electricity tariffs. According to the preliminary calculations with the Household Income and Expenditure Survey 2021, poorer households are less likely to be connected to electricity. In terms of per capita expenditure for electricity, the poorest 10 percent households spend one-fourth of the expenditure by the richest 10 percent households. This is probably to some extent owning to the lifeline tariff provided to low-income households.

[29] 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.

[30] 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.

5.2. ENVIRONMENTAL, FORESTS, AND OTHER NATURAL RESOURCE ASPECTS

72. **The policy actions facilitated by the operation, including those for climate and disaster resilience, are not anticipated to negatively affect Tonga's environment, natural resources, or forests compared to the current state.** The actions in Pillar 1 primarily address fiscal sustainability and debt management, which are unlikely to yield significant environmental consequences. Meanwhile, Pillar 2 and actions related to enhancing climate change and disaster resilience are poised to yield positive environmental impacts, bolstering Tonga's climate adaptation and mitigation endeavors. These actions would potentially stimulate sustainable investments in risk reduction.

73. **Tonga's existing legal and administrative frameworks for environmental and land management, encompassing impact assessments, are poised to counteract downstream environmental repercussions, particularly concerning infrastructure projects aimed at risk reduction.** Notably, PA#3 focuses on establishing a comprehensive, proactive, and integrated disaster risk management model, which will facilitate informed decisions for development and response in high-risk zones susceptible to flooding and landslides. This informed approach minimizes asset loss and enhances the utilization of environmental resources, including building materials, while also curbing the likelihood of pollution from disaster-related waste. Furthermore, PA#5's emphasis on reinforcing the social protection system is anticipated to bolster support for the impoverished and vulnerable, potentially extending the lifespan of public assets like buildings and consequently fostering positive environmental, forest, and natural resource outcomes. These actions will also contribute to co-benefits in climate adaptation.

5.3. PFM, DISBURSEMENT AND AUDITING ASPECTS

74. **Public Financial Management (PFM):** The PEFA Assessment 2020 indicates sound budget planning and preparation processes, yet budget reliability suffers due to expenditure and revenue variances, often stemming from overestimation and underspending of budget support and development funds. Budget and fiscal reports from the treasury system are comprehensive but require estimations due to mismatches between FMIS data and bank accounts. Commitment controls, though in place, are not optimally effective. An outdated debt management strategy and lack of documented borrowing policies pose challenges. PFM reforms are ongoing, with a 2023-2028 roadmap under development to address these issues. The PFM Bill 2023 enhances transparency, requiring public availability of budget documents. The most recent budget information is the budget statement 2023/2024, and it is published on the MoF website.

75. **Foreign Exchange Control Environment:** NRBT's foreign exchange control environment is satisfactory, with annual reports and audited financial statements published. The revaluation reserve account and foreign reserves mitigate exchange rate risks. The NRBT underwent an IMF Safeguards Assessment, identifying the need to strengthen IFRS compliance for foreign exchange management.

76. **Public Procurement:** Tonga's legal framework for public procurement is ample. It is comprised of the Procurement Regulations 20215 (and amendments), which are made by the Ministry of Finance as provided within section 44 of the Public Financial Management Act of 2002. The Procurement Division within the Ministry of Finance has two units: the policy unit is responsible for policy, monitoring and oversight functions, while the central procurement unit is responsible for carrying out the procurement on behalf of all contracting entities where the estimated value exceeds TOP10,000. Progress in public procurement practices is evident, though there is room for improvement in relation to monitoring, use of competitive methods, and

publication of procurement plans.

77. **Fiduciary Risks:** Overall, the fiduciary risks associated with the proposed operation arising from Tonga PFM system, the use of budget resources and its foreign exchange environment is assessed to be Substantial. Previous reforms led to increased budget and development fund allocations, but a 2023-2028 roadmap is now being formulated to address ongoing challenges. The fiduciary risk remains substantial, prompting the inclusion of additional mitigation measures, 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. The Fiduciary risk therefore remains “Substantial”. To mitigate this risk, the WB is requiring additional measures for this operation as detailed below.

78. **Disbursement:** The proposed financing will be disbursed according to IDA disbursement procedures for development policy operations. Once the DPO grant is approved by the Board and becomes effective, and subject to: (i) satisfactory completion of the Program; and (ii) adequacy of the macroeconomic framework, the proceeds of the grant will be deposited by IDA in one tranche, at the request of the Recipient, into a Foreign Currency Dedicated Account at the NRBT, which will form part of Tonga’s foreign exchange reserves. An amount equivalent to the DPO grant proceeds will then be credited promptly to a Government of Tonga (GoT) account to finance budgeted expenditures. Grant proceeds will flow from the Foreign Currency Dedicated Account at the NRBT into an account of the government used to finance budgeted government expenditures.

79. **Reporting and Auditing:** The GoT will provide confirmation to the Bank when an amount equivalent to the grant amount has been credited promptly 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. GoT has provided this confirmation in a timely manner in the past, including for the DPO1 and DPO2/Cat-DDO. The proceeds of the operation would not be used to finance expenditures excluded under the General Conditions for IDA Financing: Development Policy Financing, dated December 14, 2018 (revised on August 1, 2020, April 1, 2021, and January 1, 2022) (General Conditions). If the proceeds of the DPO grant are used for ineligible purposes after being deposited in a government deposit account, 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 GoT to have of the Foreign Currency Dedicated Account established in the NRBT, audited by independent auditors acceptable to the Bank, in accordance with auditing standards and terms of reference agreed upon with the Bank.

80. **The Cat DDO drawdown trigger is as follows:** No withdrawal shall be made of the Single Withdrawal Tranche unless the Association is satisfied, based on evidence satisfactory to it, that a state of emergency has been declared by the Recipient’s Prime Minister or other authorized official, in accordance with the manner prescribed in Part II Sections 8 and/or 10 of the Recipient’s Disaster Risk Management Act 2021, to respond to a Catastrophic Event. A Catastrophic Event is defined as an imminent or occurring emergency situation, caused by: (i) a cyclone, flood, drought, storm, storm surge, tsunami, earthquake, volcanic eruption, or other similar event; or (ii) an epidemic, pandemic, or other public health emergency, that requires the Recipient to promptly mobilize its capacity and/or financial resources, but excluding an emergency situation caused by human induced hazard.

81. **Closing Date and Terms:** The closing date for the operation is 31 December 2026, maintaining unchanged terms, including the drawdown period and renewal aspects.

5.4. MONITORING, EVALUATION AND ACCOUNTABILITY

82. **Institutional Structure and Monitoring:** The existing aid management framework will oversee the implementation and monitoring of policy actions supported by the operation. The Ministry of Finance (MoF) will guide and coordinate the operation through the Budget Support Management Committee (BSMC), overseeing implementation, evaluation, and reporting. The MoF will lead coordination among relevant government bodies.

83. **Indicators and Monitoring:** The Bank will assess progress in policy areas through specific indicators outlined in Annex 1. Collaboration with the Government will facilitate evaluation of policy action implementation and monitoring indicators. The Bank will also coordinate with development partners for unified assessments, streamlining administrative procedures for the Government.

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

6. SUMMARY OF RISKS AND MITIGATION

85. **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 PDO. 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.

86. **Macroeconomic risk is rated as moderate, despite the GoT's strong commitment to ongoing reforms supported by this operation and ample foreign reserves.** Macroeconomic stability largely depends on external factors, including on continued development assistance from donors, commodity prices, and robust inflow of remittances. The sustainability of public finance remains heavily dependent on timely provision of development policy financing from development partners. A shortfall or substantial delay in the provision of development policy financing would undermine cash management and disrupt service delivery—putting at risk achievement of the PDO. An adverse economic shock stemming from a natural disaster or external event could cause the economy to contract, widen external imbalances, and threaten fiscal sustainability. A sharp drop in remittances inflows would put additional pressure on the balance of payments,

threatening macroeconomic stability. The risks associated with these vulnerabilities are being mitigated through i) GoT's constructive partnership with development partners (including the IMF) 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 moderate residual risk to achievement of the PDO.

87. **Fiduciary risks are substantial.** A PFM reform action plan formulated based on the PEFA assessment 2020. The GoT has made some progress to lower fiduciary risks by developing a new PFM roadmap 2023-28, which focused on improving the existing legislative and regulatory framework, revising government chart of account, developing an integrated financial management information system (IFMIS), improving decentralization, program-output budgeting, PFM governance and strengthening government staff capacity.

88. **Institutional Capacity for Implementation and Sustainability is moderate, after accounting for selectivity in the number of reform actions and the provision of dedicated technical assistance**. Weak public service capacity means that program implementation and sustainability can be directly affected by the performance or departure of a few key officials, and the occurrence of additional shocks which divert attention from the reform agenda to immediate priorities. 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. Dedicated technical assistance has been provided to support the achievement of all 5 PAs. In the absence of another external shock, these measures are judged to be sufficient to mitigate the risks to the operation to a large degree. However, if Tonga experiences another significant disaster over the medium-term significant parts of the bureaucracy may be forced to shift their attention to disaster recovery efforts. This risk is mitigated by reforms under the previous Cat DDO and PA# 3, PA# 4, and PA# 5, which have already introduced mechanisms to strengthen the preparedness and response capacity of Government at the national and sub-national level if a disaster strikes during the implementation period of this operation.

89. **Other risks, including potential COVID-19 resurgence are rated as moderate.** A local outbreak of new variants of COVID-19 could have severe social impacts and would require the diversion of administrative capacity to contain the virus. GoT is mitigating the risk of a local outbreak through widespread vaccination (supported by PA#5 from the Previous DPO/Cat DDO, P172742) and investment in public health facilities. However, there remains a residual risk to the operation that new variants of the virus could enter the country as borders have re-opened. Lockdown measures would directly interrupt the implementation of the reform program and result in delays in the results timelines.

Table 7: Summary Risk Ratings

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

ANNEX 1: POLICY AND RESULTS MATRIX

Prior actions and Triggers		Results		
Prior Actions under DPO 1	**Triggers for DPO 2**	**Indicator Name**	**Baseline**	**Target**
Pillar 1 --- Strengthening fiscal and debt sustainability				
Prior Action #1. To strengthen domestic revenue mobilization, the Recipient, has published in the Gazette the Revenue Services Administration (Electronic Sales Register System) Regulations 2022, which establish an electronic sales register system to analyze and transmit fiscal data to the Ministry of Revenue and Customs.	**Indicative Trigger #1.** To strengthen domestic revenue mobilization, the Recipient, through its Cabinet, has approved consumption tax reform that, among other provisions, reduces tax exemptions [within the power, agriculture, and tourism sectors] through revised regulations under the Consumption Tax Act.	**Results Indicator #1:** Consumption tax revenue as share of GDP	13.6 percent of GDP (Average FY15-19)	15 percent of GDP (FY25-27)
Prior Action #2. To improve the effectiveness of public debt management and achieve a sustainable fiscal policy, the Recipient, through its Cabinet, has approved for submission to Parliament the Public Financial Management Bill 2023, which among other provisions, outlines key fiscal responsibility principles and sets a numerical limit on the stock of government-guaranteed debt.	**Indicative Trigger #2.** To improve the effectiveness of public debt management and to achieve a sustainable fiscal policy, the Recipient, through its Cabinet, has approved regulations to the PFM Act that set governance rules and use of the Debt Repayment Sinking Fund.	**Results Indicator #2:** Public and Publicly Guaranteed (PPG) debt as share of GDP	46.3 percent of GDP (Average FY15-19)	42 percent of GDP (Average FY25-27)

Prior actions and Triggers		**Results**		
Pillar 2 --- Enhance resilience to climate change and disasters				
Prior Action #3. To enhance climate and disaster resilience of disaster-affected communities, the Recipient, through its Cabinet, has approved the Disaster Risk Management Policy Framework 2023-2030, which clarifies roles and responsibilities for stakeholders at the national and sub-national level.	**Indicative Trigger #3.** To improve disaster risk management, the Recipient, through its Cabinet, has approved implementing regulations to the Disaster Risk Management Act.	**Results Indicator #3:** Share of population covered by DRM Plans which include planning for climate induced disasters and essential GBV support services	0 (FY23)	75 percent (FY27)
Prior Action #4. To enhance disaster preparedness and response, the Recipient, through its Ministry of Finance, has issued Treasury Instructions with the Guideline for the National Emergency Fund (NEF) to govern the use of resources and implementation progress reporting of	**Indicative Trigger #4.** To enhance disaster preparedness and response, the Recipient, through its Cabinet, has approved a revised Emergency Fund Bill.	**Results Indicator #4:** Budget allocations to National Emergency Fund (up to 0.5 percent of GDP) and implementation progress reporting are consistent with revised legal framework	No (FY23)	Yes (FY27)
Prior Action #5. To strengthen the social protection system and support a timely and efficient disaster response, the Recipient, through its Cabinet, has approved a National Social Protection policy that defines guiding principles and policy priority areas to design, implement and monitor current and future social protection programs.	**Indicative Trigger #5.** To improve Government's response to disasters and strengthen household resilience, the Recipient, through the Ministry of Internal Affairs, has established a Social Registry to ensure timely and efficient social assistance support during emergencies.	**Results Indicator #5:** Share of poor and vulnerable households registered in the CCT database disaggregated by sex and vulnerability status	42 percent (FY23)	At least 75 percent (FY27)

ANNEX 2: FUND RELATIONS ANNEX

Tonga—Assessment Letter for the Asian Development Bank and the World Bank
September 29, 2023

This note provides the IMF staff's assessment of Tonga's macroeconomic conditions, prospects, and policies, based on the available data and information as of end-August 2023. The assessment has been requested by the Asian Development Bank for processing of the Policy-Based Grant and by the World Bank for the Development Policy Operation (DPO) and Catastrophic Deferred Draw Down Option for Tonga.

Recent Developments, Outlook, and Risks

1. **The Tongan economy is rebounding strongly from a major double shock in early 2022.** After an estimated contraction of 2 percent in FY2022, real GDP is estimated to have expanded by 2.6 percent in FY2023 (July 2022-June 2023). The bold policy support measures deployed in response to the Hunga Tonga–Hunga Ha'apai (HTHH) volcanic eruption-tsunami and the local COVID-19 outbreak in January-February 2022, together with aid from the international community, were instrumental in mitigating the socioeconomic fallouts. The post-HTHH recovery in FY2023 has been driven by strong domestic demand and a pickup in tourist arrivals following the border reopening in August 2022.

2. **The recovery, however, has been accompanied by emerging supply-side bottlenecks and inflation pressures.** Tonga is experiencing significant labor shortages resulting from increased demand from seasonal worker programs in Australia and New Zealand. Combined with slow progress in rebuilding damaged tourism facilities (e.g., hotels and resorts) and buoyant domestic demand supported by remittances, underlying inflationary pressures remain elevated, with core inflation standing at 10.1 percent in July—well above the central bank's reference rate of 5 percent. Headline inflation peaked at 14.1 percent in September 2022 and has since moderated to 4.8 percent in July 2023, driven by the decline in global energy prices and monetary policy tightening in trading partner economies.

3. **Economic recovery is expected to continue in the short term, but long-term growth prospects remain weak**. Growth in FY2024 is projected at 2.5 percent, underpinned by public investment. Although tourism-related services are recovering, tourism receipts as a share of GDP are anticipated to remain below pre-pandemic levels until FY2026 due to slow reconstruction of damaged facilities. The recovery in agricultural production is expected to proceed slowly, reflecting labor shortages and bad weather due to El Niño. Tonga's long-term growth is projected at 1.2 percent, reflecting its exposure to increasingly frequent natural disasters, persistent loss of workers to emigration, and limited economies of scale due to geographical barriers.

4. **Risks to the outlook are tilted to the downside.** Tonga's limited productive capacity and strong foreign demand for Tongan workers have significantly increased inflation risks. An acceleration in outward worker migration could slow down the pace of reconstruction and the economic rebound. A sharp increase in global commodity prices could further intensify inflation pressures, deteriorating households' real purchasing power and the current account deficit (CAD). A

major natural disaster could derail the current economic recovery, place additional demands on scarce public resources, and increase asset quality risks in the banking sector. A further loss of correspondent banking relationships (CBRs) in the region, including due to AML/CFT-related weaknesses, could disrupt transfers and remittance flows. On the upside, tourism could recover faster due to stronger-than-expected pent-up demand.

5. **The external position for FY2023 is assessed to be broadly in line with the level implied by medium-term fundamentals and desirable policies.** Tonga continued to receive sizable remittances and budget support from donors in FY2023 and saw a rebound in tourist arrivals. However, imports have simultaneously increased, driven by higher demand for reconstruction-related capital goods. While the CAD is estimated to have widened from 6.3 percent of GDP in FY2022 to 7.9 percent in FY2023, foreign exchange (FX) reserves have increased further in FY2023 and import cover strengthened to about 11 months, supported by official capital transfers and the IMF's Rapid Credit Facility (RCF) disbursement in July 2022.

6. **Tonga is assessed as being at high risk of debt distress.**[1] Without additional grant commitments to IMF staff's baseline projection, the present value (PV) of the external and public debt-to-GDP ratios are projected to keep rising and reach above the 55 percent threshold and the 70 percent benchmark, respectively, starting in FY2033. This mainly reflects significant development spending needs over the long term to achieve its climate resilience and Sustainable Development Goals (SDGs). Debt obligations are largely external, with over half of the total external debt to China Exim Bank. Debt repayments are expected to surge in FY2024, mainly to China Exim Bank, and stay elevated at over 3 percent of GDP until FY2027.

Fiscal Policy

7. **The expanded budget envelope for FY2024 is appropriate, given the need to support reconstruction and strengthen social protection.** The primary fiscal balance is expected to have shifted to a surplus of 1.0 percent in FY2023, as a pickup in HTHH-related external grants more than offset increased reconstruction-related expenditures. Based on both the authorities' FY2024 budget and IMF staff's forecasts, the primary balance is expected to revert to a deficit of 6.3 percent of GDP as HTHH-related external grants unwind and implementation of public reconstruction projects gathers momentum. Concurrently, the authorities have phased out most pandemic- and HTHH-related tax exemptions and plan to gradually normalize current spending, including by limiting the public sector wage bill. The government should also prioritize on the execution of budgets related to reconstruction and social protection.

8. **Beyond the near term, a combination of domestic fiscal measures and additional donor support is required to meet Tonga's development spending needs while minimizing the risk of debt distress.** The primary fiscal deficit is projected to widen further in the long term under the baseline, primarily reflecting a decline in committed grants and sizable spending needed to achieve

[1] The Debt Sustainability Analysis (DSA) for Tonga will be published as part of the forthcoming 2023 IMF Article IV policy consultation staff report. The latest published DSA can be found in IMF Country Report No. 2022/282.

Tonga's SDGs and climate resilience goals. The fiscal adjustments to address the accompanying deterioration in debt dynamics should include gradual increases in tax revenues and further reductions in the public wage bill and other current expenditures. Steadfast implementation of reforms aimed at enhancing revenue administration, spending efficiency, and fiscal transparency, such as the ongoing deployment of the Electronic Sales Register System and public financial management (PFM) reform, would facilitate these fiscal adjustments. Funding capital investment projects will be challenging if new grants underperform the historical trends. The government's plan to refrain from new non-concessional borrowing would further help reduce Tonga's risk of debt distress.

Monetary and Exchange Rate Policies

9. **The National Reserve Bank of Tonga (NRBT) has recently taken measures to tighten its monetary policy stance, but further actions are needed to contain underlying inflation pressures.** The NRBT increased the statutory reserve deposit (SRD) ratio from 10 to 15 percent and established a deposit facility for retirement funds in February 2023. Under staff's baseline projection predicated on current monetary policy settings, inflation would remain above the reference rate until end-FY2024 due to persistent domestic inflation pressures. To prevent high inflation expectations from becoming entrenched, a further tightening of the monetary policy stance is warranted. This could be achieved by increasing the policy rate, possibly combined with a further hike in the SRD ratio to mop up more liquidity. Resuming issuance of NRBT notes can promote financial market development and improve Tonga's monetary policy framework.

10. **The current currency-basket regime has served Tonga well, helping preserve exchange rate stability.** The nominal effective exchange rate appreciated by 1.7 percent (y/y) in June 2023, helping partially offset the impact of higher import prices denominated in trading-partner currencies on domestic inflation. Meanwhile, the appreciation of the real effective exchange rate over the same period appears to have had relatively limited impacts on Tonga's exports due to the HTHH-induced disruption to crop production and border closures.

Financial Sector Policies

11. **The authorities should consider more proactive measures to tackle NPLs and asset quality risks.** Systemic risks appear modest overall, with the banking sector remaining well capitalized and liquid. Risks to asset quality have increased, however, reflecting the impacts of HTHH and COVID-19. The banking system's non-performing loan (NPL) ratio increased from 3.6 percent at end-2021 to 7.4 percent in 2023Q1. While the current level of banks' NPLs appears manageable given the existing financial buffers, the capacity to sustain another severe shock to the economy in the near term without disrupting bank credit has likely weakened. Measures to tackle NPLs could include: (1) conducting more intrusive oversight for banks with relatively higher NPLs; (2) requiring banks to adopt a more conservative approach to provisioning, including for secured loans and overdue non-NPL loans; and (3) requesting banks to prepare and submit their plans to address NPLs, which could include concrete operational targets. The NRBT should continue to conduct regular stress tests to ensure that banks maintain sufficient capital to absorb any potential losses.

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Strengthening prudential standards and regulations (e.g., for credit unions and those related to provisioning), avoiding frequent staff turnovers, and enhancing relevant data collection by expanding the scope and increasing the frequency—with support from the ongoing IMF TA in these areas—will help enhance Tonga's capacity to conduct risk-based supervision and further mitigate asset quality risks in the financial sector. The NRBT's regulatory and supervisory remit should be broadened to cover non-bank financial institutions (NBFIs).

12. **Reforms aimed at promoting financial deepening, stability, and inclusion should continue.** The NRBT's initiative to set up a local credit registry is welcome, which should eventually be expanded to include NBFIs to capture all loans extended to individual borrowers. Moreover, the NRBT should implement its plan to expand the Domestic Electronic Payment System to include the government and NBFIs. The authorities could also strengthen their efforts to tackle low financial literacy to enhance individuals' use of financial products and services, including through financial education in schools and engagement with local communities. These efforts, together with the government's ongoing digital ID initiative, could help foster financial inclusion.

13. **The authorities are taking measures to strengthen the AML/CFT frameworks.** Like other Pacific Island countries (PICs), Tonga is facing elevated risks of losing CBRs, including due to gaps in the AML/CFT framework and low profitability on the part of overseas correspondent banks. Building on the recent progress, including the adoption of an IT system to strengthen the analytical capacity of the Financial Intelligence Unit, the NRBT is seeking to amend the AML/CFT law to address the gaps identified by the Asia Pacific Group on Money Laundering (APG) in the Mutual Evaluation Report, with ongoing IMF TA in this area.

Structural Reforms

14. **Enhancing resilience to natural disasters and climate change is a top reform priority.** The Disaster Risk Management Act of 2023 marks an important step forward in this regard. It aims to pivot the focus of Tonga's disaster management frameworks from ex-post responses to proactive ex-ante risk mitigation and preparedness, including by improving coordination across relevant ministries and management of scarce resources (IMF-World Bank 2021 Climate Change Policy Assessment Report). Expanding the classification of climate change-related spending and strengthening the social protection system are other priorities. The ongoing PFM reform, as well as the initiative to establish a national database of households eligible for social protection benefits, are important in this regard. Stricter enforcement of the Building Code, especially for residential properties, and facilitating relocation to safer grounds would significantly contribute to enhancing disaster resilience, which should be supported by allocation of adequate fiscal resources.

15. **Developing the private sector is critical to boost Tonga's growth potential.** Tonga is confronting important challenges to long-term growth posed by sustained worker outflows and increasingly frequent natural disasters. In this context, digitalization can be an effective way to enhance economy-wide efficiency and overcome geographical limitations. Other important reform priorities include: (1) increasing government spending on education and training to reduce the skill

mismatch; (2) reducing gender inequality in the labor markets; (3) cutting red tape hindering private sector investment, especially by improving the efficiency of land leasehold administration.

Capacity Development

16. **Tonga is a major recipient of IMF technical assistance (TA) in the region.** The authorities have shown strong ownership and the capacity to absorb IMF TA. Recent IMF TA focused on climate change, PFM, tax policy, revenue administration, macroeconomic frameworks, and AML/CFT and financial stability frameworks. Addressing data shortcomings is a high priority in Tonga, especially for external, fiscal, and national accounts statistics, and IMF TA has played a critical role in mitigating the authorities' capacity constraints in these areas.

IMF Relations

17. **The 2022 Article IV consultation was concluded on July 15, 2022**, along with the IMF Executive Board's approval of the disbursement of US$9.03 million in emergency financing under the IMF's Rapid Credit Facility to Tonga to help meet its urgent fiscal and balance of payments needs due to the HTHH disaster and the local outbreak of COVID-19. Tonga is on a standard 12-month Article IV consultation cycle with the IMF.

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Table 1. Tonga: Selected Economic Indicators[1]

(Forecasts based on the IMF October 2023 World Economic Outlook)

Population (2021): 100 thousands
Major exports: root crops, vanilla, squash, fish

	FY2021	FY2022	Est. FY2023	Projections FY2024	Projections FY2025
Output and prices			(Annual percent change)		
Real GDP[2]	-2.7	-2.0	2.6	2.5	2.2
Consumer prices (period average)[3]	1.4	8.5	10.2	5.8	4.1
Consumer prices (end of period)[3]	6.9	11.3	7.4	6.2	3.2
Central government finance			(In percent of GDP)		
Revenue	48.3	45.2	47.7	41.6	37.6
of which: Grants	22.4	19.0	24.4	17.0	12.9
Expenditure	49.3	45.9	47.4	48.3	46.1
Expense	41.8	40.1	40.1	37.3	35.1
Net acquisition of nonfinancial assets	7.5	5.9	7.2	11.0	11.0
Primary balance	-0.6	-0.2	1.0	-6.3	-8.0
Overall balance	-1.0	-0.7	0.4	-6.8	-8.5
Overall balance (excl. grants)	-23.4	-19.7	-24.0	-23.8	-21.4
Money and credit			(Annual percent change)		
Broad money (M2)	25.0	13.4	-0.1	4.5	3.4
Domestic credit	-8.2	-3.3	3.9	16.1	8.8
Of which: Private sector credit	1.0	-1.0	6.4	5.9	4.3
Balance of payments			(In millions of U.S. dollars)		
Current account balance	-24.7	-31.5	-43.0	-41.0	-45.0
(In percent of GDP)	-5.2	-6.3	-7.9	-7.1	-7.4
Exports of goods, f.o.b.	16.2	15.1	16.3	18.4	19.6
Imports of goods, f.o.b.	214.5	214.9	295.7	285.7	295.4
Tourism receipts	9.1	9.6	35.6	50.9	58.5
Total remittances	217.4	215.9	239.2	227.9	224.8
(In percent of GDP)	46.2	43.4	43.7	39.2	37.0
Compensation of overseas workers	37.8	35.3	44.2	48.9	53.8
Personal remittances	179.6	180.6	195.0	179.0	171.0
Official grants	10.5	26.4	85.4	75.1	78.4
Capital account balance	69.1	84.6	53.1	29.0	5.4
Financial account balance	1.1	23.7	-6.7	25.3	47.4
Gross official foreign reserves					
In millions of U.S. dollars	317.9	375.5	388.1	401.4	409.2
(In months of next year's total imports)	11.7	10.3	10.9	10.9	10.8
Debt			(In percent of GDP)		
Public debt (external and domestic)	47.8	45.4	41.2	45.4	51.6
Of which: External debt	41.2	39.4	37.2	38.0	43.9
External debt service ratio	0.7	1.5	2.1	3.8	3.5
Exchange rates					
Exchange rate (National currency per US dollar)	2.3	2.3	2.3	...	...
Real effective exchange rate (2010=100; +=appreciation)	107.1	115.7	125.0	...	...
Memorandum items:					
Nominal GDP (millions of US$)	470.5	497.6	547.2	581.1	607.4

Sources: Tonga authorities; and IMF staff estimates and projections.

[1]Fiscal year beginning July 1.
[2] Real GDP data for FY2022 are estimated by staff.
[3]CPI basket and methodology changed in September 2018.

ANNEX 3: LETTER OF DEVELOPMENT POLICY

MINISTER FOR FINANCE

MINISITĀ PA'ANGA

7 November 2023

REF: MF.178/35/103

Mr. Ajay Banga
President
The World Bank
Washington, DC, 20433
USA

Letter of Development Policy

Dear President Banga,

The Government of Tonga continues to focus on reforms to achieve inclusive and sustainable growth and development, despite multiple challenges in recent years, including the COVID-19 crisis and the Hunga-Tonga-Hunga-Ha'apai (HT-HH) volcanic eruption and tsunami. In this, we are guided by the *Tonga Strategic Development Framework (TSDF II), 2015–2025: A more progressive Tonga: Enhancing our Inheritance*, which provides an overarching strategic framework to support a better quality of life for all.

Over the last decade, the Kingdom of Tonga has embarked on an ambitious reform program. The reforms implemented to date have strengthened our public financial management systems, increased tax collections, and enhanced resilience to climate change and disasters. Our debt position stabilized, our allocation of public resources is more strategic, and their use is more efficient. Efforts to enhance climate change and disaster resilience have enhanced the government's capacity for disaster preparedness and response, and reduced disaster risk. Consistent implementation of reforms has resulted in substantial achievements despite limited administrative capacity in our small country.

We are very much appreciating the ongoing support of the World Bank and other development partners. Since 2011, the Government and development partners have been working together through the Joint Policy Reform Matrix (JPRM) process to prioritize, support implementation, and monitor reforms that are critical for Tonga's sustainable, resilient, and inclusive development. The current year's Development Policy Operation (DPO) with a Catastrophe-Deferred Drawdown Option (Cat DDO) provides fiscal resources to support the economic recovery following dual shock and enhance fiscal and disaster resilience. The Cat DDO is providing contingent financing to help us respond to future catastrophic events. This DPO with a Cat DDO has been complemented with technical assistance to guide the formulation of sound policies and reforms and support their implementation that help us to achieve our goals. To this end, we very much support the efforts made to align the policy reforms in this DPO with Cat DDO with government priorities, including those outlined in the TSDF II.

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This is the first of a programmatic series of two operations and builds on reforms supported by the Second Resilience DPO with a Cat- DDO (P172742). The operation is designed around two Program Development Objectives (PDO) and Pillars. Pillar 1 aims at building fiscal resilience through strengthening fiscal and debt sustainability. Pillar 2 supports enhancing resilience to climate change and disasters. To build fiscal resilience, we are committed to expanding our fiscal space by strengthening domestic revenue mobilization. In July 2022, we approved a regulation on the electronic sales register system (ESRS) which introduces measures to improve consumption tax compliance. The ESRS is mandatory for all businesses with revenue of over TOP 100,000 and will help us obtain and monitor accurate information for assessing, calculating, and imposing liability for a tax. We are also committed to improving public debt management's effectiveness and achieving a sustainable fiscal policy. This year, we have approved a Public Financial Management (PFM) Bill for submission to Parliament. This Bill includes provisions on key fiscal responsibility principles and sets a numerical limit on the stock of government-guaranteed debt. The government is also committed improve budget transparency by making the full budget publicly available on a regular basis.

Natural hazards regularly impact Tonga, with the Hunga Tonga–Hunga Ha'apai volcanic eruption and tsunami being the most recent example. Strengthening our resilience to climate change and disasters requires support for adaptation, preparedness, and response capabilities. We have approved a National Disaster Risk Management (DRM) Policy Framework 2023-2030, which includes practical guidance for all stakeholders on responsibilities for proactive DRM, including risk reduction, preparedness, and response. We are also undertaking reforms to the existing National Emergency Fund (NEF) and have prepared a NEF Guideline for utilizing the NEF, which focuses on strengthening the application and screening process for accessing the fund, including for ex-ante disaster preparedness. Further, disasters have substantial costs, especially to vulnerable groups, when families lose their income and livelihood. We have approved a National Social Protection Policy which strengthens the social protection system's ability to provide timely and efficient response for economic and climate-related shocks.

Furthermore, we are committed to prudently managing the fiscal risks that stem from the scheduled repayment of two large loans over the next six years. The dual shocks have created large financing needs and we required substantial costs of funding reconstruction of past disasters and strengthening our resilience to future natural disasters. We remains committed to implementing responsible fiscal policies to ensure that we can meet our debt servicing needs and avoid a severe fiscal adjustment in the future, including through improving expenditure efficiency and avoiding any new non-concessional external borrowing. To this end, we are working with development partners, including the World Bank, to prepare reforms that can help to secure our long-term fiscal sustainability.

Looking ahead, we are committed to reinforcing these priority reform areas as part of the ongoing Joint Policy Reform Matrix (JPRM) with the World Bank and other development partners. The Government is firmly committed to implementing the reforms supported by this Development Policy Operation with a Cat DDO, which will be instrumental in achieving the country's ambitious development goals. We look forward to the continued active engagement of its major development partners, including the World Bank in Tonga's reform and development efforts.

Yours Sincerely,

MINISTER FOR FINANCE
TONGA

Hon Tiofilusi Tiueti
Minister for Finance

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ANNEX 4: ENVIRONMENT AND POVERTY/SOCIAL ANALYSIS TABLE

Prior Actions	Significant positive or negative environment effects	Significant positive or negative poverty, social or distributional effects
Operation Pillar 1: Strengthening fiscal and debt sustainability		
Prior Action #1. To strengthen domestic revenue mobilization, the Recipient, has published in the Gazette the Revenue Services Administration (Electronic Sales Register System) Regulations 2022, which establish an electronic sales register system to analyze and transmit fiscal data to the Ministry of Revenue and Customs.	No	Potentially negative, but insignificant poverty effect of an estimated 0.1 percentage point increase in poverty rate
Prior Action #2. To improve the effectiveness of public debt management and achieve a sustainable fiscal policy, the Recipient, through its Cabinet, has approved for submission to Parliament the Public Financial Management Bill 2023 that, among other provisions, outlines key fiscal responsibility principles and sets a numerical limit on the stock of government-guaranteed debt.	No	Potentially positive distributional effects
Operation Pillar 2: Enhance resilience to climate change and disasters		
Prior Action #3. To enhance climate and disaster resilience of disaster-affected communities, the Recipient, through its Cabinet, has approved the Disaster Risk Management Policy Framework 2023-30, which clarifies roles and responsibilities for stakeholders at the national and sub-national level.	Positive. Proposed for climate adaptation co-benefits.	Significant positive poverty effect
Prior Action #4. To enhance disaster preparedness and response, the Recipient, through its Ministry of Finance, has issued Treasury	Positive. Proposed for climate adaptation co-benefits.	Significant positive poverty effect

Instructions with the Guideline for the National Emergency Fund (NEF) to govern the use of resources and implementation progress reporting of the NEF.		
Prior Action #5. To strengthen the social protection system and support a timely and efficient disaster response, the Recipient, through its Cabinet, has approved a National Social Protection policy that defines guiding principles and policy priority areas to design, implement and monitor current and future social protection programs.	Positive. Proposed for climate adaptation co-benefits.	Significant positive poverty effects

ANNEX 5: DPF PRIOR ACTIONS AND ANALYTICAL UNDERPINNINGS

Prior Actions	Analytical Underpinnings
Pillar 1: Strengthening fiscal and debt sustainability	
Prior Action #1. To strengthen domestic revenue mobilization, the Recipient, has published in the Gazette the Revenue Services Administration (Electronic Sales Register System) Regulations 2022, which establish an electronic sales register system to analyze and transmit fiscal data to the Ministry of Revenue and Customs.	The 2022 PIC-9 Public Expenditure Review (PER) found that non-compliance practices account for the largest share of the gap between collection and potential consumption tax revenue. The practices, among others, include under-reporting sales and failing to register. This finding is consistent with the Tax Administration Diagnostic Assessment Tool (TADAT) Performance Assessment Report in 2021. The report mentioned adoption of electronic systems and actions to detect inaccurate reporting as two of the areas where Tonga performs poorly. Tax systems rely heavily on taxpayer's reporting in tax declarations; therefore, administrations need to monitor tax losses from inaccurate reporting. In Tonga's case, most of the data received to support verification of the tax declaration are in manual format, preventing automated cross-checking. Enabling technology, such as the electronic sales register system, will lower the administrative burden on businesses and increase compliance. The proposed system records, analyses, stores, and transmits the transaction data to the Ministry's system, which will help GoT assess and accurately calculate tax liability.
Prior Action #2. To improve the effectiveness of public debt management and achieve a sustainable fiscal policy, the Recipient, through its Cabinet, has approved for submission to Parliament the Public Financial Management Bill 2023 that, among other provisions, outlines key fiscal responsibility principles and sets a numerical limit on the stock of government-guaranteed debt.	The 2020 Public Expenditure and Financial Accountability (PEFA) Assessment highlighted several weaknesses in Tonga's fiscal framework. These included lack of fiscal responsibility principles and a framework to guide fiscal policy to support credible medium-term budgeting and managing liabilities. In response, GoT is undertaking a reform to the Public Financial Management Act 2002. The criticality of this reform is also highlighted by the Tonga's PFM Action Plan 2020, IMF 2020 Article IV Consultation Staff Report and IMF 2022 Article IV Consultation Staff Report. As suggested by the IMF 2022 Staff Report, this reform will improve medium-term budget process that will lead to improved spending efficiency.
Pillar 2: Enhance resilience to climate change and disasters	
Prior Action #3. To enhance climate and disaster resilience of disaster-affected communities, the Recipient, through its Cabinet, has approved the Disaster Risk Management Policy Framework 2023-30, which clarifies roles and responsibilities for stakeholders at the national and sub-national level.	Tonga faces significant disaster risk. For example, analysis undertaken under the Pacific Catastrophe Risk Assessment and Financing Initiative indicates that in any given year Tonga faces is expected to incur, on average, US$15.5 million in losses due to earthquakes and tropical cyclones. In the next 50 years, Tonga has a 50 percent chance of experiencing a loss exceeding US$175 million and casualties higher than 440 people, and a 10 percent chance of experiencing a loss exceeding US$430 million and casualties higher than 1,700 people. To implement policy reforms to address this risk in a manner consistent with global good practice, the World Bank is supporting the preparation of a DRMPF through technical assistance funded by GFDRR, delivered under the programmatic ASA Resilience in the Pacific: Strengthening Adaptive Urbanization and Disaster Risk Management (P180119).
Prior Action #4. To enhance disaster preparedness and response, the Recipient, through its Ministry of Finance, has issued Treasury Instructions with the Guideline for the National Emergency Fund (NEF) to govern the use of resources and implementation	The Government of Tonga's Disaster Risk Financing Strategy, prepared with Technical Assistance from the World Bank, and the International Monetary Fund's (IMF) Climate Change Policy Assessment (CCPA) published in 2020 in collaboration with the World Bank and ADB, recommends a series of NEF reforms. Recommendations from this work has been investigated and strengthened through a government-led review of the NEF to further identify and elaborate reform needs,

progress reporting of the NEF.	with technical assistance from the ADB and the World Bank. The DRF Strategy, CCPA and Government NEF review have identified a suite of reform needs including to: (i) review the Emergency Fund Act and implementing framework to ensure the funding is made available effectively and efficiently to meet needs for disaster preparedness and immediate response; (ii) clarify mechanisms for accessing the NEF ex ante for disaster preparedness, in cases were a disaster such as a tropical cyclone is imminent, but not yet declared; and (iii) provide clear guidance through an operations manual for the use of the NEF, including for ex ante measures.
Prior Action #5. To strengthen the social protection system and support a timely and efficient disaster response, the Recipient, through its Cabinet, has approved a National Social Protection Policy that defines guiding principles and policy priority areas to design, implement and monitor current and future social protection programs.	This prior action and trigger are supported through the ongoing technical assistance work provided under the Supporting Adaptive and Gender Inclusive Social Protection in Pacific Island Countries (P178476), funded by *RSR-ADSP R19 Building Gender-Smart Adaptive Social Protection in Tonga for Green, Resilient and Inclusive Recovery* and the Financial Sector Support in the Pacific Island Countries (P174933).

ANNEX 6: PARIS ALIGNMENT ASSESSSMENT

Program Development Objectives: Strengthen fiscal and debt sustainability and enhance resilience to climate change and disasters	
Step 1. Is this operation consistent with the country climate commitments, including for instance, the NDC, NAP, LTS, and other relevant strategies?	The DPO reform program is consistent with the implementation of Tonga's climate strategies, such as Tonga's revised Nationally Determined Contributions (NDCs), the Second Joint National Action Plan on Climate Change and Disaster Risk Management (JNAP2) and Tonga Climate Change Policy: A Resilient Tonga by 2035. On mitigation, the Program does not hinder the achievement of Tonga's climate goals. On adaptation, the Program supports Tonga's efforts to build resilience to the impacts of climate change. In particular, PA3 and PA4 direct support objectives to build resilience response capacity through establishment of an umbrella framework and mainstreaming climate change and disaster risk management approaches into government legislation, policies and plans at all levels.
Mitigation goals: assessing and reducing the risks	
Pillar objective: Strengthening fiscal and debt sustainability	
Prior Action #1. To strengthen domestic revenue mobilization, the Recipient, has published in the Gazette the Revenue Services Administration (Electronic Sales Register System) Regulations 2022, which establish an electronic sales register system to analyze and transmit fiscal data to the Ministry of Revenue and Customs. **Prior Action #2.** To improve the effectiveness of public debt management and achieve a sustainable fiscal policy, the Recipient, through its Cabinet, has approved for submission to Parliament the Public Financial Management Bill 2023 that, among other provisions, outlines key fiscal responsibility principles and sets a numerical limit on the stock of government-guaranteed debt.	
Step M2.1: Is the prior action likely to cause a significant increase in GHG emissions?	**Answer:** No **Explanation:** PA1 establishes an electronic sales register system to analyze and transmit fiscal data. It is not expected to lead to a significant increase in GHG emissions. **Explanation:** PA2 supports a PFM Bill that aims to improve the effectiveness of public debt management and achieve a sustainable fiscal policy. It is not expected to lead to a significant increase in GHG emissions.
Step M2.2: Is the prior action likely to introduce or reinforce significant and persistent barriers to transition to the country's low-GHG emissions development	**Answer:** N/A

pathways?	
Step M3: Is the risk of the prior action introducing or reinforcing significant and persistent barriers being reduced to low after mitigation measures have been implemented?	**Answer:** N/A
Conclusion for PA1 and PA2: ALIGNED	
Pillar objective: Enhance resilience to climate change and disasters	
Prior Action #3. To enhance climate and disaster resilience of disaster-affected communities, the Recipient, through its Cabinet, has approved the Disaster Risk Management Policy Framework 2023-2030, which clarifies roles and responsibilities for stakeholders at the national and sub-national level. **Prior Action #4.** To enhance disaster preparedness and response, the Recipient, through its Ministry of Finance, has issued Treasury Instructions with the Guideline for the National Emergency Fund (NEF) to govern the use of resources and implementation progress reporting of the NEF. **Prior Action #5.** To strengthen the social protection system and support a timely and efficient disaster response, the Recipient, through its Cabinet, has approved a National Social Protection Policy that defines guiding principles and policy priority areas to design, implement and monitor current and future social protection programs.	
Step M2.1: Is the prior action likely to cause a significant increase in GHG emissions?	**Answer:** No **Explanation:** PA3 supports a Disaster Risk Management Policy Framework 2023-2030, which clarifies roles and responsibilities for stakeholders at the national and sub-national level. It is not expected to lead to a significant increase in GHG emissions. **Explanation:** PA4 supports Treasury Instructions with the Guideline for the National Emergency Fund (NEF) to govern the use of resources and implementation progress reporting of the NEF. It is not expected to lead to a significant increase in GHG emissions. **Explanation:** PA5 supports a National Social Protection Policy that defines guiding principles and policy priority areas to design, implement and monitor current and future social protection programs. It is not expected to lead to a significant increase in GHG emissions.
Step M2.2: Is the prior action likely to introduce or reinforce significant and persistent barriers to transition to the country's low-GHG emissions development pathways?	**Answer:** N/A
Step M3: Is the risk of the prior action	**Answer:** N/A

<table>
<tr><td>introducing or reinforcing significant and persistent barriers being reduced to low after mitigation measures have been implemented?</td><td></td></tr>
<tr><td colspan="2">Conclusion for PA 3, PA 4 and PA 5: ALIGNED</td></tr>
<tr><td colspan="2">Mitigation goals: All prior actions of the proposed DP) program are aligned with the mitigation goals of the Paris Agreement.</td></tr>
<tr><td colspan="2">Adaptation criteria: assessment of physical climate risks</td></tr>
<tr><td colspan="2">Pillar objective: Strengthening fiscal and debt sustainability</td></tr>
<tr><td colspan="2">Prior Action #1. To strengthen domestic revenue mobilization, the Recipient, has published in the Gazette the Revenue Services Administration (Electronic Sales Register System) Regulations 2022, which establish an electronic sales register system to analyze and transmit fiscal data to the Ministry of Revenue and Customs.
Prior Action #2. To improve the effectiveness of public debt management and achieve a sustainable fiscal policy, the Recipient, through its Cabinet, has approved for submission to Parliament the Public Financial Management Bill 2023 that, among other provisions, outlines key fiscal responsibility principles and sets a numerical limit on the stock of government-guaranteed debt.</td></tr>
<tr><td>Step A2: Are risks from climate hazards likely to have an adverse effect on the prior action’s contribution to the Development Objective(s)?</td><td>Answer: No
Explanation: PA1 focuses on establishing an electronic sales register system to analyze and transmit fiscal data. Risks from climate hazards may disrupt internet connectivity, especially in outer islands. However, this will not have a material impact on the PA’s contribution to strengthen fiscal and debt sustainability considering Tonga’s efforts to build resilience through implementation of climate adaptation good practices applicable to the country context.
Explanation: PA2 - Implementation of reforms under this PA are not expected to be affected by climate hazards.</td></tr>
<tr><td>Step A3: Does the design of the prior action reduce the risk from climate hazards to an acceptable level, considering climate adaptation good practices applicable to the country context?</td><td>Answer: N/A</td></tr>
<tr><td colspan="2">Conclusion for PA1 and PA2: ALIGNED</td></tr>
<tr><td colspan="2">Pillar objective: Enhance resilience to climate change and disasters</td></tr>
<tr><td colspan="2">Prior Action #3. To enhance climate and disaster resilience of disaster-affected communities, the Recipient, through its Cabinet, has approved the Disaster Risk Management Policy Framework 2023-2030, which clarifies roles and responsibilities for stakeholders at the national and sub-national level.</td></tr>
</table>

Prior Action #4. To enhance disaster preparedness and response, the Recipient, through its Ministry of Finance, has issued Treasury Instructions with the Guideline for the National Emergency Fund (NEF) to govern the use of resources and implementation progress reporting of the NEF. **Prior Action #5.** To strengthen the social protection system and support a timely and efficient disaster response, the Recipient, through its Cabinet, has approved a National Social Protection Policy that defines guiding principles and policy priority areas to design, implement and monitor current and future social protection programs.	
Step A2: Are risks from climate hazards likely to have an adverse effect on the prior action's contribution to the Development Objective(s)?	**Answer:** No **Explanation:** PA3 focuses on clarifying roles and responsibilities for stakeholders at the national and sub-national level to enhance climate and disaster resilience of disaster-affected communities. Risks from climate hazards are not likely to have an adverse effect on this PA's contribution to enhance resilience to climate change and disasters. On the other hand, PA3 contributes to further strengthening Tonga's resilience to risks from climate hazards. **Explanation:** PA4 aims to enhance disaster preparedness and response through issuing Treasury Instructions with Guidelines to govern the use of resources. Risks from climate hazards are not likely to have an adverse effect on PA's contribution to enhance resilience to climate change and disasters. On the other hand, PA4 contributes to further strengthening and building Tonga's resilience to risks from climate hazards. **Explanation:** PA5 focuses to strengthen the social protection system through the approval of the National Social Protection Policy. Risks from climate hazards are not likely to have an adverse effect on PA's contribution to enhance resilience to climate change and disasters.
Step A3: Does the design of the prior action reduce the risk from climate hazards to an acceptable level, considering climate adaptation good practices applicable to the country context?	**Answer:** N/A
Conclusion for PA 3, PA 4, and PA 5: ALIGNED	
Adaptation and resilience: All prior actions of the proposed DPO program are aligned with the adaptation and resilience goals of the Paris Agreement.	
OVERALL CONCLUSION OF PARIS ALIGNMENT ASSESSMENT: This operation is aligned with the goals of the Paris Agreement.	