

Chapter 5

Rationalizing Commercial Laws and Regulations

Constraint: *A deficient legal framework for business increases the costs and risks of investment and contracting.*

Commercial laws and regulations determine the ways in which commerce takes place, the way companies are created and closed down, and the manner in which enforceable agreements (contracts) are structured. They affect investment, lending, how debts are collected, whether consumers are protected, the extent of competition, how property is held and sold, and the rights of women in commerce. In short, commercial law influences all aspects of business.

Countries and regions where the legal system functions effectively have an advantage in encouraging both local and foreign investment over those where the law is outdated, opaque, slow, and costly. In many countries, lawmakers do not fully appreciate just how important for business it is to have a sound and modern legal system. At present, many commercial laws and associated processes in Tonga are outdated, placing its businesses at a competitive disadvantage.

Doing business in Tonga means contending with complex regulations and entering contractual arrangements within a commercial legal framework in which many laws are missing. While in some areas regulations are light (e.g., in the labor market), in many others they are heavy handed and hard to understand. This gives rise to varying interpretations of the requirements of business law by local legal practitioners, business advisors, investors, and other people.

In Tonga, some laws and regulations are helpful, but others do not encourage the establishment of businesses. And with the

many gaps in the law, contracting becomes much more uncertain and risky than it would be if there were a modern legal framework. This chapter identifies how the system of business laws and regulations constrains the private sector and what must be done if economic growth is to increase.

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A. Missing Laws and Regulations

As international trade and commerce expands, it is becoming increasingly common for business dealings in Tonga, as in other Pacific Island countries, to take place between strangers over long distances. In such circumstances, it is important to be able to make agreements with confidence. This requires reliable institutions for contracting and dispute resolution. Apart from a successful mediation framework, Tonga does not yet have such systems. The laws affecting contracts are in many cases outdated and add to the uncertainty associated with business agreements and the settling of disputes. Other elements are also missing in the legal foundation of commercial transactions in Tonga. Until recently, whenever Tongan law did not provide guidance, it was possible to use English statutes and case law. However, a 2003 amendment to the Civil Law Act (1966) removed the possibility of using the English statutes, so gaps in the commercial legal framework are more serious than they used to be.

Enforceable Agreements

A contract is an enforceable agreement by one or more persons to exchange legal obligations with one or more other persons. They are a foundation of business. But Tonga does not have a contract law, even for the sale or exchange of goods (in which one person exchanges an obligation to provide a good for someone else's obligation to give him or her a certain amount of money or a different good). Most contractual disputes used to be solved by using English statutes and English common law and equity as a base—that is the precedents arising from individual court cases over many years. Using English statutes is no longer possible and the range of common law precedent is so vast that it complicates both contracting and dispute resolution. A codification of contract law would create greater certainty, lower transactions costs, and improve accessibility to the rules of contract law for everyone engaged in commerce. This would quickly give Tonga a commercial law foundation that is recognized as among the best in the world.

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Dispute Resolution

Business disputes can be resolved through the court system rendering enforceable decisions or through alternative dispute resolution—either arbitration or mediation. In Tonga, delays in court cases being heard have declined dramatically since the introduction in 2006 of a computerized system that tracks cases as they travel through the court system. When a case is moving too slowly, the chief justice is able to use this new management system to persuade lawyers either to proceed without delay or to drop

the case. The average period for resolving commercial lawsuits declined from 550 days to less than a year.

The chief justice has also introduced a much greater use of mediation, which has been extremely successful in resolving conflicts that would otherwise have taken up valuable court time. Mediation involves a go-between helping the parties approach a mutually acceptable resolution. But mediation is an entirely voluntary process that is not binding on the parties and is best suited for lower-value, local disputes.

Arbitration also avoids the courts by the parties agreeing to have their dispute decided by a neutral arbitrator, who is often an expert in the subject of the dispute. In a modern alternative dispute resolution system, arbitration awards can only be appealed to the courts under the most exceptional circumstances, and the arbitrator's decision is legally enforceable. Arbitration is widely used in other countries by larger businesses and international investors. However, Tonga does not have any legal framework for arbitration.²² Since inter-country investment agreements invariably have binding arbitration clauses, the lack of a basis for enforcing the outcomes in Tonga raises the risks for foreign investors. So Tonga needs an Arbitration Act, which would give legislative support to the arbitration process and awards.

Laws that are Missing but Needed

Tonga has many gaps in its commercial legal framework. There are no statutes for:

- **Bankruptcy.** The absence of a law for this is a serious deficiency in Tonga's laws governing commerce. People who have gone bankrupt have no way of discharging their debts and start again with a clean slate. While the current Companies Act allows for liquidation, there is no Receiverships Act. The common law provides the rules for

²² Except for limited arbitration under the Foreign Investment Act which uses the Arbitration Act (1996 UK).

receiverships, and this creates difficulties and ambiguities for practitioners who are appointed receivers. A good Receiverships Act would provide clarification by stating the rules in a simple, straightforward manner. This is an approach that New Zealand has adopted and is being followed in other Pacific countries.

- **Sale of goods.** There is no act providing a legal framework for the exchange of goods. When the exchange of goods and services involves a written contract, a lengthy legal document is needed for every transaction unless there is a law that provides a framework for contract standardization. Standardization allows both parties to contract more effectively, at lower cost, and with more certainty. It is especially important when dealing with foreign suppliers or customers.
- **Consumer credit.** There is also no act that comprehensively sets out the conditions under which credit of different types can be granted, the conditions and terms of loans, and the rights and obligations of the parties that enter into loan agreements (Chapter 6).
- **Electronic transactions.** An act is needed to simplify contracting over large distances.
- **Collateral.** The framework and rules supporting the pledging of collateral needs strengthening by introducing a new Personal Property Securities Act that allows the pledging of movable property as collateral for lending (Chapter 6).
- **Land leasing.** The land law framework needs to be simplified and modernized so that those who wish to lease their land can easily do so and investors who wish to lease land can get better information on what is available (Chapter 7).

B. The Application of Regulations not Based on Law

Some officials in government departments impose on local businesses requirements and procedures that have no basis in existing laws or regulations. When these are protested,

officials state “that is the way we have always done things here.” In many cases, regulations that have been repealed or amended are still enforced by government departments. Often procedures are not documented, making compliance with current practices complicated and costly. Such unwritten rules, which can depend on the whim of an official, are often more burdensome than the written rules because their application is inconsistent and their requirements are unknown. This is especially a problem for foreigners, and there is anecdotal evidence that a number of potential investors were so frustrated that they left Tonga for more investment-friendly countries.

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C. Outdated or Overly Complicated Laws and Regulations

Legislation

Companies Act (1995). This act is based on the New Zealand Companies Act of 1993. While it is suitable for many aspects of the operation of companies in Tonga, in other ways it is too complicated for most business activities. Local lawyers report that the act contains many provisions that are necessary in a larger country, but are unnecessary and burdensome for doing business in a small country.

It is difficult for a business, particularly if the shareholder is a foreigner, to establish a company in Tonga without the benefit of a lawyer or accountant. This makes setting up a business costly. One lawyer interviewed observed, “If companies followed all the provisions of the Tonga Companies Act, there would be no companies in the country.” Some of those provisions have no economic or other rational basis. All they do is raise the

costs of registration and operation, especially when considered in conjunction with the Foreign Investment Act of 2002. For example, the Companies Act requires that “adequate” liquidity be maintained and that foreign companies file audited accounts. Neither of these requirements have any economic justification. This has had a negative effect on the perception of Tonga as a place to invest.

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There are aspects of the act that, although sensible in New Zealand, in Tonga place unnecessary burdens on companies. For example, the New Zealand Act abolished the distinction between private and public companies.²³ To protect shareholders, the New Zealand Act contains extensive governance standards that go well beyond what the approximately 1,200 small companies in Tonga should be required to meet, e.g., that companies must have a company secretary who is a lawyer, an accountant, or other approved person. While this provision is not enforced, it adds to the uncertainty and risk. This requirement has since been abolished in New Zealand when its Companies Act was updated and is not needed in Tonga.

Nevertheless, a major advantage of Tonga’s Companies Act’s being closely modeled on that of New Zealand is that it provides a strong foundation of case law that is continually being updated, and is a source of guidance for updating and modifying Tongan legislation. The Companies Act needs to be modified to make it more relevant to the circumstances

of Tonga. It needs to be simplified, updated, and brought in line with the latest New Zealand legislation where this is relevant to Tonga.

At the same time, a new electronic companies registry needs to be introduced to replace the paper-based registry that was destroyed 2 years ago.

Business Licences Act (2002); Business Licences Regulations (2007). One of the most costly aspects of doing business in Tonga is meeting the licensing requirements. Every business must obtain and renew multiple licenses because licenses are issued on an activity rather than on a business basis. Since the regulations identify 100 different activities, the process is tortuous and costly. Most business activities require the approval of several officials. The process imposes large costs because of the delays and lack of clarity. And this ordeal must be repeated either annually or biannually. This is another example of the pervasive and dampening effect that government has on the private sector in Tonga. Nevertheless, some progress has been made; for example, work permits for foreigners can now to be issued for 10-year periods.

Price and Wage Control Act, Cap 113. This act provides for a “competent authority appointed by the King to determine prices and wages in all sectors of the economy.” Experience throughout the world has shown that such controls are harmful. They distort resource allocation and damage the economy by interfering with market mechanisms. Their effect is usually the opposite of what was intended. When prices are high, it is usually because there is a shortage of supply. Forcing the prices to be lower than market levels reduces the incentive for producers to increase the supply. In cases where prices are high because of monopoly power, the best solution is to increase competition or, if that is not possible, regulate. The Price and Wage Control Act should be abolished.

²³ Generally defined as companies that have large numbers of shareholders and which are listed on a stock exchange.

Stamp Act, Cap 70. A Stamp Act authorizes a government to collect money when legal documents, such as deeds and contracts, are transferred. A stamped or printed paper (the “stamp”) is affixed to the document as evidence that the tax has been paid. Tonga’s Stamp Act is a disincentive to leasing land, trading, and entering into contracts where the value of the contract or the assets is specified. When land, a lease, or sublease is sold, there is a 10% stamp duty. Since a 15% sales tax is also levied, the total charge on selling or transferring property is 25%, excluding any sales commissions that might be paid. So if someone places a piece of property on the market for \$100,000, a buyer will be required to pay at least \$125,000, and with sales commission included, substantially more. This greatly reduces the number of possible buyers.

Financial Institutions Act (2004). This act contains a privacy provision that prevents financial institutions from providing information about customers, except with their explicit permission. This provision inhibits the establishment of a credit bureau, which is an important part of a modern financial system.

Foreign Investment Act (2002); Foreign Investment Regulations (2006). While local lawyers describe the introduction of this act and its accompanying regulations as a major step in reducing red tape that foreign investors must face, the practical measures for obtaining all the approvals required for foreign investment are still difficult and costly.²⁴

Bureaucratic Processes

Obtaining Approvals

The processes required to obtain a Foreign Investment Registration Certificate and to incorporate under the Companies Act are onerous. Foreign-owned corporations encounter

complex and time-consuming bureaucratic processes in obtaining the approvals they need to operate. All foreign-owned businesses must get a Foreign Investment Registration Certificate from the Secretary for Labour, Commerce and Industries. Although the law requires certificates to be issued within 7 days, they are not issued anywhere nearly that quickly. Lawyers and investors describe a process fraught with frustration and delay. Similarly, bureaucratic steps for getting business visas are daunting. The permit process is lengthy, with only the largest or most determined of investors persevering to completion.

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Restricted and Reserved Activities

The Foreign Investment Act stipulates that certain activities are restricted exclusively to Tongan investors and that for some other reserved activities Tongans are given preference. The latter may only be undertaken by foreign-owned businesses if they can satisfy conditions specified in the regulations. While it is understandable that Tonga may want to put citizenship restrictions on some activities, in practice such restrictions do not work very well. It is common for front businesses to be formed with a Tongan as the nominal majority shareholder, but with a foreign investor the actual owner. In such cases, the Tongan acting as the front is outside the protection of the law. The front could end up owing lenders the debts of the actual owner, or could have

²⁴ There are concerns that if the process of allowing in foreign investors is too easy, Tonga will become a haven for business people of doubtful repute and practices, and that this will negatively affect the image of the country. Some fairly simple procedures could alleviate such concerns. For example, requiring a credit report from all the countries in which the investor had lived would ensure that he or she had managed their businesses responsibly. This could be done during the immigration process. Simplifying company registration and the processes surrounding the obtaining of licenses, together with making the land leasing framework more effective, would greatly reduce the cost of investing in Tonga.

unpaid tax liabilities or even be subject to criminal charges if the business has undertaken illegal activities. Experiences in other countries show the problems with restricting activities. For example, Palau, which has a more extensive set of restrictions than Tonga, has a large number of front businesses. Instances are common of the real owners fleeing the country, leaving the nominal owners with unpaid tax bills and other liabilities. Interviews in Tonga revealed that the practice of front businesses is becoming more common. The country is better off not restricting activities.

Opaque and Undocumented Procedures

In addition to the burdensome requirements of the Foreign Investment Act, foreign investors face the problem of hard-to-understand and undocumented procedures that government departments require them to follow.

One example recounted by foreign investors in Tonga is the Department of Immigration's requirement that potential investors have at least \$50,000 in a Tongan bank account, even though no law requires this.

The process required of foreigners for setting up business in Tonga discourages investment by raising the costs of doing business. Foreign investment regulations are so frustrating, some lawyers report, that investors have given up and invested in countries that are more welcoming, thereby depriving Tonga of much-needed financial capital, technology, and know-how. This is one reason for the very low rate of foreign direct investment. While the new law for foreign investors is a major improvement, processes need to be radically streamlined.

The Starting a Business Working Group was established in 2006 to examine the regulatory regime in Tonga. It reports to the Task Force on Regulatory Reform and has identified many processes that need revising. The Working Group has documented the ways in which business regulations make it harder for Tonga

to compete for investment. Unfortunately, the task force to which it reports has not met for a long time.

D. Reform has Started

Legal and regulatory reform has started in several areas. The Companies Act is being amended and legislation necessary for a modern collateral framework is being drafted. Regulations and practices that raise the costs of doing business are all being reviewed to identify those that are unnecessary. As new laws are passed and regulations become simpler, Tonga will become an easier place in which to invest and expand business.

E. Summary of Recommendations

- Create new statutes for the areas that lack them: arbitration, bankruptcy, personal property securities, and electronic transactions.
- Review the contracting framework with a view to introducing some codification.
- Modify the Companies Act so that transactions costs are lower and it is more relevant to the circumstances of Tonga.
- Introduce a new electronic companies registry to replace the paper-based registry that was destroyed.
- Abolish the Price and Wage Control Act.
- Streamline the processes associated with the Foreign Investment Act.
- Continue regulatory reform, especially in the areas of business licensing and foreign investment.
- Have licensing done by company rather than by activity.
- Use the Task Force on Regulatory Reform as a place from which to forward suggestions to the National Economic Development Council.