

Promoting Prosperity in Tonga: Removing Constraints on the Private Sector

The Tongan Economy is Not Achieving its Potential

The Tongan economy has been underperforming for more than a decade. The productivity of both labor and capital has been low, resulting in poor returns on investment. Few new businesses have started and existing ones have been slow to expand. Job creation

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has been insufficient to employ the growing number of school leavers looking for work, and, after adjusting for inflation, wages and salaries have not risen. This has led many Tongans to seek opportunity overseas. There are now more Tongans living in other countries than in Tonga. Since many emigrants are highly skilled, this is a serious loss to a country of only 100,000 people.

In all dynamic, growing economies, growth comes from the private sector. But the

growth of Tonga's private sector has been hampered by a number of constraints, which has resulted in the low productivity of investment. Removing them would make Tonga an attractive, low-cost place to do business. Businesses would start or expand and employment would increase. There would be new or higher profits for owners, new or better wages for employees, and new or higher returns to investors. And if Tonga were more prosperous, government could afford to supply better health and education services. The impetus to seek employment overseas would abate as more Tongans would be able to find good jobs at home. Those who had been educated abroad would have new incentives to bring their skills back to Tonga.

There are certain policy changes that would raise productivity and increase the profitability of investments. Generally, they involve making Tonga an attractive, low-cost place to do business. Some changes would need to be made right away, but others could be made over a number of years. If the changes are made, the economy should grow much faster than it has been. Fortunately, the government has made a strong commitment to implementing reform, and has embarked on a number of new initiatives. A summary of the major constraints on the private sector and what to do about them follows. Greater detail can be found in the main report.

Recovering from Two Shocks to the Economy

Constraint: *The destroyed commercial district of the capital city discourages investment by creating the perception of political instability and of inability of the economy to recover.*

Background: One of the reasons investment has been low over the past few years is the perception that Tonga is a risky place to do business. First, a civil-service strike in 2005 closed down government for several weeks. Then the following year, civil disturbances resulted in the destruction of many buildings in the central business district of Nuku'alofa. The two events created the perception, particularly among foreigners, that Tonga is unstable. And so expected returns on investment have had to be higher than normal before they would invest.

The rebuilding of the commercial district will serve as an indicator that political stability has returned and that the government is determined to press ahead with the transformation of the economy. Some progress has already been made in the rebuilding, but the bulk of the work has yet to be done. Although the financing required is beyond the capacity of the local financial markets, there are a number of options available, including grant financing from Australia and New Zealand and an in-kind loan from the People's Republic of China. The need to rebuild provides an opportunity to increase employment and augment the skills of the workforce. And if the task of rebuilding is handled in the right way, investor confidence in Tonga will rise.

What to do:

- Rebuild Nuku'alofa as soon as possible, making sure that whatever combination of financing alternatives is used, it increases local employment and skills.
- Have independent building experts certify that all construction work is of good quality.

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Reducing the Presence of the State in the Economy

Constraint: *An oversized public sector lowers overall productivity both directly and by crowding out private sector.*

Background: An effective government is necessary for economic prosperity, but if the public sector gets too big, it constrains the private sector. Governments have far-reaching powers to help—and harm—the private sector, both by what they do and what they do not do. Some examples of what governments can do to help are maintain law and order, set and enforce the rules of commerce, enforce property rights, and provide any infrastructure that the private sector is not best suited to provide (e.g., roads). There are also things

governments should not do. For example, they should not employ more people than absolutely necessary. Governments should not own or operate businesses—experience around the world shows that they are almost always poor operators of businesses. Also, if the public sector (the part of the economy in which goods and services are delivered by or on behalf of the government) is too

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large, it “crowds out” the private sector (the part of the economy in which goods and services are delivered by private enterprise) by taking skilled workers and private investment opportunities away from it. In Tonga, more people work in the public sector than in private businesses and the government controls a substantial proportion of the economy’s capital stock. As a result, the growth of the economy has been held back by the low or negative rates of return on businesses owned by the state and the low productivity of public sector workers.

What to do:

- Make sure enterprises owned by the state operate on business principles: that they adhere to legal rules established for all companies and that they make sufficient profit to compensate for the commercial risks they take.

- Continue to enhance effective stewardship of the state-owned enterprises by freeing ministers from the requirement to serve as directors and by expanding the pool of skilled directors with targeted training.
- Later, privatize these enterprises or outsource their operations in a transparent manner through public-private partnerships.
- Continue with the civil-service downsizing that had begun after the strike of 2005.
- The government’s commitment to reform is indicated by the fact that it has already started this work. But more is necessary to reduce the size of the Tongan public sector so that it supports dynamic private sector development.

Improving the Infrastructure

Constraint: *Gaps in the infrastructure cripple business.*

Background: An essential function of government is to ensure that good quality infrastructure is widely available and provided in the most effective way. Some infrastructure is a public good—that is to say, it is something that benefits society as a whole, but provides insufficient incentives for private enterprises to supply on their own. As it is a key function of government to provide public goods, governments must see to it that those parts of the infrastructure are built and maintained. However, private companies are capable of profitably and efficiently building or operating other parts of infrastructure and providing still other parts efficiently, even though government pays for it.

In the case of Tonga, some areas of infrastructure are being taken care of adequately, but the low quality, limited

nature, or absence of other areas is a constraint on private sector activity. Widely available and affordable telecom and Internet services facilitate the communication required for commerce in a globalized world. Transportation and communication are especially important for a small and remote island economy. In Tonga, improved land, water, and air transportation services would allow faster movement of goods and people. And if Tonga had reliable electricity, it would be possible for offices, hotels, and shops to avoid the expense of installing backup generators. As well as being unreliable, Tonga's electricity supply is the most costly in the Pacific.

The government purchase of the monopoly power provider (Shoreline) was completed in July 2008.

What to do:

- Investigate introducing competition in electricity generation and then restructure the power company and sell it to a private provider or outsource its management to a private company.
- Explore the possibility of improving the cost and availability of Internet and other telecommunications services by bringing fiber optic cable to Tonga or by acquiring additional satellite capacity.
- Push ahead with the contracting out of road maintenance.
- Ensure that in any investment in critical elements of infrastructure (e.g., domestic and international sea and land ports) private sector involvement is considered, say through private-public partnerships, and that adequate provision is made for maintenance.

Rationalizing Commercial Laws and Regulations

Constraint: *A deficient legal framework and overly complex regulations make doing business difficult.*

Background: Commercial law determines the way businesses are created and closed down and the manner in which enforceable agreements (contracts) are structured. Of Tongan laws that apply to business, some are helpful, some make life difficult, some are out-of-date, and some do not exist. Generally, Tonga's commercial law framework makes doing business unnecessarily costly and risky and discourages investment. The law

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that limits prices and wages distorts resource allocation and damages the economy.

The absence of an effective framework for drawing up contracts or for arbitration adds to the costs and uncertainty associated with business agreements and the settling of disputes over them. An effective arbitration law would allow disputants to reduce delays and costs by avoiding court. Normally,

international contracts have binding arbitration clauses. However, overseas arbitration awards cannot be enforced in Tonga, thereby raising risks for foreign investors. The reform of the Companies Act and the Companies Registry has already started and the government

shifted their investment plans to countries that are more welcoming, thereby depriving Tonga of much-needed financial capital, technology, and know-how. And the current practice of licensing businesses by activity rather than company is time-consuming and expensive.

What to do:

- Amend the Companies Act.
- Complete the recreation in electronic form of the Companies Registry.
- Introduce a Personal Property Securities Act.
- Have licensing done by company rather than by activity.
- Commence work on introducing legislation to fill in the gaps in the commercial law framework.
- Repeal price and wage controls.
- Continue regulatory reform, especially for business licensing and foreign investment.
- Eliminate procedures not specified in written law or regulation.
- Use the Taskforce on Regulatory Reform as a place from which to forward suggestions for urgent consideration and implementation to the National Economic Development Council.

Increasing Access to Finance

Constraint: *Insufficient access to finance will arise when the economy expands in response to widespread reform.*

Background: Apart from the rebuilding of Nuku'alofa, which under any circumstances would require funding from overseas, the financing available in Tonga is adequate for the current level of business activity. But if

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has shown commitment to further reform by requests to commence work on several other laws governing commercial transactions.

Doing business in Tonga also means contending with complex regulations. While in some areas (e.g., the labor market) regulations are light, in most they are heavy handed and hard to understand. And in addition to the written regulations, there are rules and procedures required by some government departments that have no basis in law, but which are imposed by officials who maintain that “that is the way we have always done things here.” These unwritten rules are often more burdensome than the written rules (especially for foreigners) because their application is inconsistent and their requirements unknown. Regulations for foreign investment are so burdensome, local lawyers report that some investors have given up and

the constraints on the private sector identified in this report are removed, returns to capital will increase and many more investment and business opportunities will arise. Then there will be a need for greater access to finance. Without improved financial markets, many investors and entrepreneurs will not be able to find financing, and opportunities will go to waste. Since many financial market reforms involve measures that take time to implement, action should begin right away.

Collateral: Because the existing collateral framework is weak, pledging business assets as collateral is expensive and uncertain. This makes lending risky, especially to smaller businesses. Banks therefore lend mainly to larger companies or to those who own real estate.

Credit information: There is no information available on the creditworthiness of loan applicants. Banks are therefore unable to assess the likelihood of being repaid.

Microloans: The availability of microloans in Tonga is limited. Success in other countries, such as Vanuatu, shows them to be a good way to assist farmers, microbusinesses, and women's groups.

Remittances: Migrants send home the equivalent of 40% of Tonga's gross domestic product as remittances. This buttresses domestic living standards and finances agricultural enterprises and small businesses. But the cost of transferring funds is high—more than 10% of the average amount transferred. This benefits the financial institutions making the transfers, but not Tonga. Freeing up more of this money would promote savings and increase access to finance.

What to do:

- Pass a new law that reforms the personal property securities framework. Work on this has commenced.
- Establish an electronic registry that records what collateral has been pledged, by whom, and to which lenders.
- Establish a credit information system that is linked to the credit bureaus in Australia and New Zealand.

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- Investigate the feasibility of introducing a microfinance pilot scheme.
- Lower remittance fees by promoting competition between institutions transferring funds and by using modern technologies, such as smart cards and mobile phones.

Land and Private Sector Development

Constraint: *Incomplete and often inaccurate land records.*

Background: No country has become prosperous without clearly identified and well-protected property rights and a centralized, unambiguous record of who has the right to use a particular piece of land and what the exact boundaries of that land are. Land records in Tonga are incomplete and often inaccurate.

The private sector is constrained by the land framework. And even Tongan farmers wanting to expand their farms have trouble negotiating leases that give them long-term security over the area they would like to farm.

By law male subjects are entitled to receive allotments of land with a permanent right of use that amounts to ownership. This land can be leased to investors but the process is slow and costly for investors, both local and foreign. There appears to be insufficient awareness that at least in principle leases can have a life of 99 years. As a result, the private sector is constrained by the land framework. And even

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In addition, the mortgage framework has a number of practical problems. The Land Act requires the Minister of Lands to approve and register all mortgages, which increases the amount of time to finalize deals on land that is being leased. Furthermore, the granting of mortgages is restricted to banks, which removes the possibility of credit unions financing leases.

What to do:

- Streamline and modernize the leasehold system and its administration.
- Make the land-leasing process less complex and more transparent by creating a register of landowners who would like to lease their land for cultivation or business.
- Remove the restrictions on other financial institutions to financing mortgages.
- Have a national debate on how best to achieve these goals in a way that takes traditional land ownership structures into account.

Making Agriculture a Growth Sector

Constraint: *Confusing standards and lack of good advice hamper farmers.*

Background: Output from agriculture has been in decline for a number of years. But it is still the largest sector of the Tongan economy. Together with fishing, it makes up 25% of total output. Agriculture has the potential to perform

much better than it has recently. Tonga has a good growing climate and is well placed geographically to serve winter markets in both the southern and northern hemispheres. An improvement in agriculture would increase income in rural areas. One of the reasons for weak performance has been poor advice and assistance from the Department of Agriculture's extension service. Another reason is that Australia and New Zealand's regulations governing agricultural importation are hard to understand and comply with.

What to do:

- Contract out agricultural extension (training) and the phytosanitary (plant quarantine) processing for exports.
- Develop capacities to deal and comply with Australia and New Zealand standards for importing agricultural products.

Implementing Reform

While a number of the foundations of private sector dynamism are missing in Tonga, there is also a strong sense that things need to change and that reforms are achievable. In fact, progress has already been made. With a forcefulness that is rare in a Pacific Island nation, the government has expressed a willingness to undertake far-reaching reforms that would encourage private sector development, and it has already undertaken a number of measures that will contribute to growth.

Nevertheless, to implement many of the changes recommended in this report, it will be necessary to develop a consensus among government ministers, senior government

officials, and business leaders that is strong enough to overcome the obstacles that could arise. One possibility would be to use the National Economic Development Council as a forum for discussions between the government and the private sector about the problems of running a business in Tonga and to develop a joint vision for change and growth that can then be translated into policy actions.

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