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 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.

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 own or operate businesses—experience around the world shows that they are almost always poor operators of businesses.

Governments should not own or operate businesses—experience around the world shows that they are almost always poor operators of businesses. 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 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 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,

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.
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

Regulations for foreign investment are so burdensome, local lawyers report that some investors have given up and shifted their investment plans to countries that are more welcoming.

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
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.

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.

- 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 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.

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.

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.
Transforming Tonga: A Private Sector Assessment—Summary

The current momentum and appetite for change bring the opportunity for Tonga to become one of the more advanced reformers among Pacific Island countries. This private sector assessment provides a framework for private sector–oriented reform that will help improve the Tongan business environment, making it a more attractive and profitable place to invest in, and allowing it to create jobs and bring prosperity throughout the nation.

About the Asian Development Bank

ADB’s vision is an Asia and Pacific region free of poverty. Its mission is to help its developing member countries substantially reduce poverty and improve the quality of life of their people. Despite the region’s many successes, it remains home to two thirds of the world’s poor. Nearly 1.7 billion people in the region live on $2 or less a day. ADB is committed to reducing poverty through inclusive economic growth, environmentally sustainable growth, and regional integration.

Based in Manila, ADB is owned by 67 members, including 48 from the region. Its main instruments for helping its developing member countries are policy dialogue, loans, equity investments, guarantees, grants, and technical assistance. In 2007, it approved $10.1 billion of loans, $673 million of grant projects, and technical assistance amounting to $243 million.
Transforming Tonga
a private sector assessment

Asian Development Bank
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Abbreviations

ADB  Asian Development Bank
CSO  community service obligation
DSL  digital subscriber line
GDP  gross domestic product
GSM  Global System for Mobile Communications
SCP  Shipping Corporation of Polynesia
SOE  state-owned enterprise
TAL  Tonga Airport Ltd.
TCC  Tonga Communications Corporation
TEU  twenty-foot equivalent unit
TWB  Tonga Water Board
Chapter 1
The Tongan Economy is Not Achieving its Potential

In this report we aim to show how Tonga’s economy would be able to bring about greater prosperity if certain constraints on the private sector were removed. We believe that Tonga has an opportunity to increase its rate of economic growth, but that to do so some far-reaching reforms need to occur. Promisingly, the government has already started to implement some courageous and far-reaching policies that will reduce the cost of doing business and increase the profitability of investing in Tonga.

This chapter presents an overview of the reasons for the underperformance of the Tongan economy and outlines suggested reforms. Subsequent chapters discuss the issues in more detail.

A. Tonga’s Economy is Underperforming

Official statistics, which are known to be incomplete, show that the real growth rate of Tonga’s gross domestic product (GDP) over the past decade averaged 2.5% per year. Some indicators, such as construction and the demand for electricity, suggest the number should be a bit higher; but even so the growth rate is disappointing. As a result, the economy is not generating sufficient opportunities to provide employment to those who wish to work. By some estimates, only a quarter of the 2,000 high school graduates entering the job market at the end of 2007 will be able to find jobs in Tonga.

Because of this, many educated and skilled Tongans have taken high-paying jobs outside the country. More generally, there are now as many Tongans living abroad as there are at home,1 which represents a major loss of human

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1 About 44% of the expatriate Tongan population lives in New Zealand, 32% in USA, and 19% in Australia.
resources for the country. Migration has some benefits—it does bring benefits in the form of remittances, which account for the equivalent of 40% of GDP. These inflows partially finance the large trade deficit as well as sustain and smooth consumption for family members who remain in Tonga. However, the effect of remittances on the competitiveness of the economy is uncertain, as is the extent to which remittances add to investment rather than sustain consumption.

Because emigration has kept the population stable (at about 100,000), per capita GDP has grown at the same rate as overall GDP. So there has been a steady increase in prosperity: per capita GDP in 2006 was 50% higher than it was in 1990. In absolute terms, it is now US$2000. Although this works out to only about US$5 per person per day, with Tonga’s benign living conditions, fertile land, and abundant sea, it means that there is almost no extreme poverty in Tonga.

But many Pacific Island countries at the same level of development as Tonga have had higher growth rates. Samoa, for example, grew at 4% per year over the same period. If Tonga had grown at that rate, per capita GDP would be 30% higher than it is now. And Samoa’s growth rate over the past 6 years has actually been below the average for developing countries. Current growth estimates for 2008/2009 are for growth of 3% of real GDP. So it appears that Tonga’s economy has been performing well below its potential.

The quality of available statistics prevents precise identification of developments in the various sectors of the economy. Rough estimates show that the most rapidly growing sectors of the Tongan economy have been construction, the output of which

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Table 1: The Structure of Tonga’s Economy

<table>
<thead>
<tr>
<th>Industry/Sector</th>
<th>2006 (% of Total)</th>
<th>Annual Change (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Agriculture, Forestry, and Fisheries</td>
<td>25</td>
<td>(1.72)</td>
</tr>
<tr>
<td>Mining and Quarrying</td>
<td>0.46</td>
<td>4.55</td>
</tr>
<tr>
<td>Manufacturing</td>
<td>5.06</td>
<td>0.78</td>
</tr>
<tr>
<td>Electricity and Water</td>
<td>2.36</td>
<td>6.48</td>
</tr>
<tr>
<td>Construction</td>
<td>9.66</td>
<td>6.82</td>
</tr>
<tr>
<td>Commerce, Restaurants, and Hotels</td>
<td>16.92</td>
<td>3.81</td>
</tr>
<tr>
<td>Transport and Communications</td>
<td>8.69</td>
<td>2.57</td>
</tr>
<tr>
<td>Finance and Real Estate</td>
<td>11.98</td>
<td>4.39</td>
</tr>
<tr>
<td>Government Services</td>
<td>13.45</td>
<td>0.73</td>
</tr>
<tr>
<td>Entertainment and Private Services</td>
<td>5.91</td>
<td>2.04</td>
</tr>
<tr>
<td>Ownership of Dwellings</td>
<td>4.17</td>
<td>1.43</td>
</tr>
<tr>
<td>Less: Imputed Bank Service Charge</td>
<td>(3.67)</td>
<td>3.37</td>
</tr>
</tbody>
</table>


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2 This is the second highest in the world. According to the International Monetary Fund (Tonga: 2007 Article IV Consultation–Staff Report; Staff Supplement; Public Information Notice on the Executive Board Discussion), remittances declined from the equivalent of 45% of GDP to close to 40% in 2006, although substantial uncertainty surrounds the actual remittance flow because of the possibility of unrecorded transfers. The World Bank (Pacific Islands at Home & Away: Expanding Job Opportunities for Pacific Islanders Through Labor Mobility, 2006) estimates that remittances amounted to 41.8% of GDP in 2004.

3 For GDP per person to stay the same, GDP must grow at the same rate as the population. If population growth is zero, GDP per person will grow at the same rate as GDP.

4 In 2005, the world average per capita GDP was around $9,100. The poorest country, Myanmar had a per capita GDP of $97. Australia’s was $34,714. (The Economist. Guide to Economic Indicators, 6th ed. 2007. New York: Bloomberg Press, 2007, pp. 45–46.).
by nearly 7% over the past 2 years, and electricity and water, which has also risen significantly. Unfortunately, GDP statistics do not disaggregate tourism as a separate sector, but indirect evidence from the sectors that encompass tourism activity—commerce, restaurants and hotels, transportation and communications, and entertainment and private services—reveals that they have all registered steady growth. Tourism arrivals by air rose 20% in the first 9 months of 2007 and cruise ship visitors by 50%. The largest sector of the Tongan economy is still agriculture and fishing (Table 1), which make up for 25% of total output. Although agriculture has been declining for a number of years, it has the potential for revival.

B. Causes of Underperformance: Low Returns on Investment

Why is growth slow, and what can be done about it? A major reason for the slow growth has been the low profitability of investment, which results from the low productivity of both labor and capital.

Rates of return on investment. Economies grow as a result of productive investment. The long-term prosperity of a country depends on its investment ratio (investment divided by GDP). In fast-growing economies such as the People’s Republic of China, this ratio regularly exceeds 40%. Even in mature, high-income economies that are expanding, the investment ratio is typically well over 20%. The average investment ratio in the Pacific Island economies, by contrast, has consistently been below 20%. Rule-of-thumb estimates are that to achieve a real growth rate of 5% per year, the investment ratio needs to be at least 25%. Estimates place investment in Tonga at about 20% of GDP over the past 10 years, although the unavailability of accurate statistics means that this is subject to larger-than-usual error.

Low productivity. The more productive the economy is, the more profitable investment is—and the more people are going to want to invest. Foreign investment is often especially beneficial to a country because it brings with it capital and much-needed knowledge and business experience. For Tonga, foreign direct investment averaged slightly over 2% of GDP between 1996 and 2006. Unless both the investment rate and the amount of foreign direct investment can be raised, Tonga’s growth rate will continue to be low. The productivity of labor, which has declined over the last 10 years, will remain low. Productivity is disappointing despite Tonga’s having the best-educated population of the Pacific Island economies. When Tongans emigrate, they immediately earn much higher wages and salaries than they do in Tonga. This suggests that the cause of low productivity lies not in the workforce, but in factors that limit its ability to produce. These factors constitute constraints on growth and are the focus of this report. Constraints take a number of forms, some of which are under the control of policy makers and some of which are not. But even in the case of geographical constraints that cannot be removed (e.g., small size and remote location), sound policy can reduce their negative effects.

Figure 2: Average Gross Capital Formation 1995–2004 (% of GDP)
C. Causes of Underperformance: Constraints on Investment and Growth

Constraints on private sector development raise the costs of doing business, reduce rates of return on investment, and harm economic growth. Removing them will improve the performance of the Tongan economy.

Constraints of Size and Distance

Some constraints on growth in Tonga are such that little can be done about them. Tonga is a small island. This leads to fixed costs being high. For example, the cost of government must be spread over a small population. Like other small countries, Tonga has a limited institutional capacity because there are no economies of scale for public services, policy formation, regulatory activities, the administration of justice, and foreign affairs. Thus, the per capita cost of a governmental apparatus is higher for the economies of small islands. So taxes must consume a higher proportion of income than in countries where economies of scale are achieved. In addition, there are only a small number of potential customers to sell to, which reduces opportunities for firms to take advantage of economies of scale in production and distribution. Most private sector firms in Tonga cannot afford to spend money on market intelligence; and because of high costs, they are less likely to invest in new skills and technologies. Because of Tonga’s size, the private sector could find it difficult to generate innovative projects.

Since Tonga is also remote, imports, exports, and tourists all need to be transported over vast distances, which increases the costs of living in and visiting the country. But the experiences of small and remote countries around the world (e.g., Mauritius and Iceland) show that with appropriate policies prosperity is possible. So although some facts cannot be altered, steps can be taken to reduce the seriousness of the problems they create. However, in many Pacific Island economies, the opposite is often done. Policies that magnify the problem are adopted.5

So Tonga should implement policies that minimize the negative economic effects of its geography. Tonga can greatly benefit from focusing its trade on the nearest high-GDP countries, Australia and New Zealand.6 More

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6 This is known as the “gravity model” of international trade. Tonga, like other Pacific Island economies, depends heavily on international trade for its prosperity.
generally, Tonga should take every opportunity to integrate with world markets. It can do this by establishing low trade barriers, ensuring a low-cost business environment, promoting low-cost communications and transportation, and developing a commercial law framework that promotes reliable contracting with distant business partners. The specific example of opening air travel to competition is already bringing substantially lower airfares. It is an excellent example of the benefits of competition.

Constraints Arising from the Perception of Risk

Besides expected returns on investment, there is another factor in investment decision making: apparent risk. When potential investors are deciding where to invest their capital, they must consider the risks that could negatively affect their investment. This is especially the case for foreign investors. Factors such as macroeconomic imbalances and political stability have a powerful influence on investment decisions. Poor macroeconomic policy can lead to exchange rate depreciation and thus a loss of capital. An unstable political environment raises fears of violence and property loss. Frequent policy changes increase the cost of doing business and reduce rates of return.\(^7\) In the face of macroeconomic or political instability, investors require higher rates of return or shorter periods over which they recoup their investments before they are willing to invest. This means that the higher the risk is, the higher the potential profits must be to make an investment attractive. Two recent shocks to the economy in 2005 and 2006 have contributed to the impression among potential foreign investors that Tonga is unstable and therefore a risky place to invest in. Fortunately, the monarch and the government are acting vigorously to reduce these perceptions, as the country progresses toward full democracy. Before his coronation in August 2008, the King of Tonga announced that he is surrendering many of his powers, saying that the monarchy must be an instrument of change. The King also indicated that he would cede some Privy Council functions to the cabinet before the elections of 2010.

Frequent policy changes increase the cost of doing business and reduce rates of return.

The rebuilding of Nuku'alofa's commercial district will add greatly to the perception that stability has returned to Tonga. Matters relating to the perception of instability are discussed in Chapter 2: Recovering from Two Shocks to the Economy.

Constraints that Limit Productivity

The dominant role of the state. In Tonga the state continues to play a prominent, even dominant, role in the economy. It is the largest employer and the government wage bill accounts for over 13% of GDP, a figure that is set to rise to over 14% before it begins to decline with the reduction in public employment. The government also owns a large portion of the assets of the economy. A large public sector crowds out the private sector since small size makes reaping economies of scale and specialization impossible. However, research on the effect of market proximity shows that commerce declines rapidly as distance increases. In technical terms, commerce between two countries is proportional to the product of their GDPs divided by the distance between them raised to the power of 0.9. Edward Leamer (2007) illustrates the effect of distance by a dramatic example: “The distance between Los Angeles and Tijuana (Mexico) is 150 miles. If Tijuana were on the other side of the Pacific . . . and if this distance were increased to 10,000 miles, the amount of trade between them would drop by a factor of 44. Other things being held constant, expect the amount of trade between Shanghai and Los Angeles to be only about 2% of the commerce between Los Angeles and Tijuana.”\(^8\)

\(^7\) Many surveys of the business environment in countries around the world found that political and policy instability were among the most negative factors influencing investment decisions.
sector. This is discussed in Chapter 3: Reducing the Role of the State in the Economy.

**Inadequate infrastructure.** Infrastructure is crucial for growth and prosperity, poverty reduction, and private sector development. In the case of Tonga, in some areas infrastructure is adequate, but in other areas it is of low quality, limited, or absent altogether. This is a constraint on private sector activity. The subject is covered in Chapter 4: Improving Infrastructure.

**Identifying the constraints to growth is only a first step.**

**Weak commercial law and opaque regulation of business.** Commercial law determines how businesses are created, the ways contractual arrangements are structured, and how businesses are closed down. Doing business in Tonga means contending with complex regulations and entering contractual arrangements within a commercial legal framework that lacks many standard laws. The ways the economy is being constrained by missing or out-of-date laws and regulations are discussed in Chapter 5: Rationalizing Commercial Laws and Regulations.

**Access to finance.** By several measures, Tonga has the best-developed financial market in the Pacific region, and over the past few years there has been a rapid expansion of credit to households. But if the barriers to private sector development identified in this report are removed, returns to capital will increase, and investment and business opportunities will arise. Without improved financial markets, many investors and entrepreneurs will not be able to find financing, and opportunities will go to waste. Since financial market reforms frequently involve changes in the law and in institutions such as registries, planning horizons are normally long. So to ensure that access to financing does not become a problem, change should be initiated soon. These questions are discussed in Chapter 6: Increasing Access to Finance.

**Land.** No country has become prosperous without well-protected property rights. The private sector in Tonga is constrained by a land framework that makes it difficult for investors, especially small ones, to identify land available for leasing. And once they have identified it, they have a hard time getting the rights to use it. Changes are needed, but in a way that is sensitive to customary land traditions in Tonga. These issues are discussed in the short Chapter 7: Making Land Work.

**Agriculture.** Although agriculture has been declining for a number of years, together with fishing, it accounts for 25% of the total output of the Tongan economy and 30% of total employment. But agriculture has the potential to expand and provide jobs and higher incomes to large numbers of rural Tongans. To solve agriculture’s problems requires treating them as problems of private sector development. Although the constraints discussed in the previous chapters apply to all sectors of the economy, because of agriculture’s importance to the economy and to rural development, a chapter is devoted to it: Chapter 8: Making Agriculture a Growth Sector.

**D. Implementing Reform**

Identifying the constraints to growth is only a first step. Doing something about them usually requires building a consensus for change and establishing a process for implementation, a process that often extends over several years. It is not an easy process. Implementation issues are covered briefly in the concluding Chapter 9: Implementing Reform in Tonga.
Chapter 2

Recovering from Two Shocks to the Economy

**Constraint:** The 2005 civil service strike and the 2006 destruction of part of the commercial district of Nuku’alofa have created a perception of risk, thereby discouraging investment.

As mentioned in Chapter 1, recently two sets of events have contributed to the impression of heightened country risk among domestic and foreign investors. This impression has reduced investment and output. These events prompted questions about Tonga’s economic and political stability. And until investors are convinced that long-term stability has returned, for investment to occur, expected returns will have to be higher than they would otherwise have needed to be.

A. Two Shocks to the Tongan Economy

1. The first shock was the combination of the 2005 civil servants’ strike and the subsequent large wage increase for public sector employees. These events raised concerns about the future stability of the economy and about what macroeconomic policy was going to be. There were fears that a budget deficit would rise to a level where inflationary forces would be uncontrollable. But the government handled the budgetary pressures skillfully. The upward pressure on spending was used as a catalyst for downsizing the civil service. There has been a 20% decline in public sector employment, with more to come. This reduction and plans for future cuts demonstrate the government’s commitment to ensuring that public sector wage inflation does not jeopardize macroeconomic stability. They have had a reassuring effect. While fiscal concerns remain, the prompt response does indicate a degree of macroeconomic management that is evident in other Pacific islands.

Further downsizing will also reduce negative perceptions and serve the need to reduce the role of the state and the economy (Chapter 3).

2. Just when the country was recovering from the first shock, a greater one came. In November 2006 violent civil unrest broke out during which much of the central business district of the capital, Nuku’alofa, was destroyed. The destruction imposed a deadweight loss on the economy. The Tongan business community has indicated that 10 major businesses need to be rebuilt and 150 smaller ones were burned or looted, some of which also wish to rebuild. While the loss of output was mitigated by the flexibility that some businesses displayed in transferring to alternative premises, the owners of many smaller businesses had most of their inventory destroyed and had no alternative premises to move to. They cannot resume business until the rebuilding has taken place.

B. The Benefits from Reconstructing Nuku’alofa

The economy will not recover fully from the civil disturbances until the central part of Nuku’alofa is reconstructed. Doing so can serve to indicate the return of political stability and the government’s determination to press ahead with the transformation of the economy. The impact of the willingness of the government to reform is already being seen; a large international group of hotels has announced a substantial investment in the island of Vava’u, the first such investment in Tonga. Three new hotels are under construction in Nuku’alofa and at least one of them is planned for completion in the second half of 2008.
The manner of rebuilding can improve the perception of stability and bring other benefits as well. If local people are hired for the rebuilding, employment will increase, and it will assist in the development of the domestic workforce, enabling local workers and firms to acquire badly needed skills. In particular, local people will become more qualified to fulfill the contracting out (outsourcing) needs of government ministries, such as the Ministry of Works. The rebuilding has the potential to greatly expand employment in the country. It will also strengthen the private sector and allow a well-planned development that minimizes disruption and adverse economic consequences, such as overheating the domestic economy.

C. Financing Reconstruction

The Tongan authorities have estimated the cost of reconstruction at US$30 million–US$50 million. The amount of capital needed to finance the rebuilding is beyond the capacity of the domestic financial market. Some financing will come from insurance payouts. Although the insurance companies initially contested the validity of the claims of those whose businesses were destroyed on the grounds that the damage was politically motivated, some have subsequently honored many of the claims. But much of the remaining funding will have to come from outside. Recently, agreements to provide long-term financing of the reconstruction were signed with several funding agencies, including:

- Australia and New Zealand, which have given grant funding amounting to A$15 million. These grants have been fully allocated to businesses wishing to reconstruct, but only a small amount has been actually drawn down. Both countries have signaled a willingness to consider additional grant funding, but only after the initial amounts have been fully used.

- The People’s Republic of China, which recently signed a concessionary loan of CNY440 million (US$60 million). Although the terms involve Chinese contractors supplying much of the materials and staffing, the loan also provides for commitments by builders to employ and train local labor. However, negotiations continue on how to ensure that the work performed will be of high quality and provide value for the amount spent.

Progress has been made formulating plans for rebuilding, with reports that the center of town will be expanded. Some headway with the actual rebuilding has already been made, but the bulk of the work has yet to be done. However, appropriate checks and balances regarding the quality of the new construction need to be in place. By carrying out the whole process with transparency, a positive perception of politics in Tonga will be created and the greatest return on funds invested in rebuilding will be generated. As with the aftermath of the great Chicago fire in the United States, the rebuilding of Nuku’alofa could turn a tragedy into a transformation. A combination of reform and reconstruction could jump-start the economy.

D. Summary of Recommendations

- Rebuild Nuku’alofa as soon as possible.
- Use various methods and sources of financing: in-kind loans, donor grants, commercial banks, and development banks.
- Make sure that whatever combination of financing alternatives is used, it increases local employment and skills.
- Have the rebuilding program be fully transparent and competitive: Have the tendering process for the rebuilding contracts, including those involving foreign companies, be open. Have independent building experts certify that all construction work meets local construction codes and is of good quality.

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8 In the aftermath of the civil disturbances, Australia and New Zealand gave A$5 million as a Business Recovery Facility to assist with business cash flow and restocking of businesses damaged or destroyed.
Chapter 3
Reducing the Presence of the State in the Economy

Constraint: An oversized public sector lowers overall productivity directly and crowds out the private sector.

A. Tonga has a Large Public Sector
When the public sector, through ownership and employment, controls too much of an economy's assets or workforce, it lowers the long-term growth rate. This happens because of two main reasons:

• First, since economic growth stems from the productive use of capital, if the assets owned by government are not used productively, the growth of the economy as a whole will be reduced. In Tonga, one major constraint on faster growth is the low yield of many government-owned assets.

• Second, a large public sector (the part of the economy in which the goods and services are delivered by and on behalf of the government) crowds out the private sector (the part of the economy in which goods and services are delivered by private enterprise). Some skilled workers and investment opportunities, which would otherwise be available to the private sector, are diverted to the public sector, which typically uses them less efficiently.

This means that the more assets that are under government control, the higher the rates of return must be to the private sector's investments to affect the underperformance of the government's assets. So a large, underperforming public sector holds back the growth of the economy both directly and indirectly.

In Tonga, the state plays a prominent, even dominant, role in the economy. It employs a large proportion of the working population. Estimates put government employment at about 13% of the labor force. The number of government employees has declined since the downsizing began in 2006, but it is still higher than any other Pacific Island nation. Government wages in 2008 are forecast to be some 14% of GDP, over 30% higher than the average for Pacific Island economies.

B. Tonga has 17 State-Owned Enterprises
The government is a major provider of goods and services within the domestic economy, both directly and through the enterprises it owns. Through its ownership interest in state-owned enterprises (SOEs), the government is a large investor in the commercial sector within the kingdom. In many cases, the Tongan Government provides services at a loss or below the level of an economic-risk-adjusted return on the assets employed. This is because the government in effect provides free or heavily subsidized capital to the entities it owns and controls.

An SOE, called a public enterprise in Tonga, is a company created and owned by a government for the purpose of undertaking commercial business activities.\(^9\) The state has T$111.5 million (T$37 million in loans, T$74.5

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\(^9\) Public enterprises are established under the Public Enterprise Act 2002. Throughout the Pacific these entities are referred to as either state-owned-enterprises or public enterprises. As the term state-owned-enterprises is more generally used around the world, that term has been used in this report.
million in equity) invested in the 17 SOEs listed in the Public Enterprise Act. This is equivalent to 45% of the GDP forecast for 2007/2008. The most recent financial statements of these entities show that their combined profits are equivalent to only 4.8% of the total assets owned by the state. Only 4 of the 17 SOEs earned profits. Over a longer time period, the financial results of SOEs have been even less impressive. In the 8 years from 1999 to 2006, cumulative net profits were T$15.9 million, or T$2 million per year, which means a rate of return that is barely positive. Remembering that SOE assets add up to 45% of GDP, the poor profitability represents foregone revenues that could have been used to improve health and education services. A recent analysis of the profitability of SOEs in Tonga by the Asian Development Bank (ADB) found that the economic value destroyed by SOEs between 2002 and 2006 was T$34 million, almost exactly 50% spending on education over the same period.

The SOE portfolio is imbalanced. In addition, there are wide swings in year-by-year profitability because the only companies that earn profits are Leiala Duty Free (now privatized), Tongan Communications Corporation, and the Tongan Development Bank. The ratio of equity to total assets for the SOE portfolio is 65%, indicating a low level of debt for most SOEs, which is fortunate given their poor profit performance. It has the additional benefit that if SOEs are slated for privatization (see page 12), there will not be a lot of preexisting debt that has to be dealt with before sale, which implies a better selling price for the government.

Because the SOEs crowd out competition from the private sector, underperforming SOEs also perpetuate low productivity, which is a chronic problem in Tonga. Crowding out occurs because the private sector is not likely to want to engage in activities where SOEs are receiving subsidized capital. A recent example is the investigation by the Tonga Water Board (TWB) of the possibility of setting up a water-bottling operation. Currently TWB is operating at a loss. The private sector will certainly be crowded out of that market if the government allows TWB to invest in water bottling. Keep in mind that its existing operations are losing money and TWB is not required to achieve a return that fully compensates for the risks it is taking on existing and new investments.

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<tr>
<th>Table 2: State-Owned Enterprise Portfolio (T$ Million)</th>
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<td>Assets</td>
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<td>Government Equity</td>
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<td>Net Profits Less Dividends</td>
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<td>Losses</td>
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<td>Loans to Public Enterprises</td>
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<td>Total Government Investments</td>
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<td>Government Public Debt</td>
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<td>Loans to Public Enterprises (% of Total Public Debt)</td>
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<th>Table 3: Financial Results of Tongan State-Owned Enterprises (T$ Million)</th>
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C. Solutions

The main ways to reduce the size of the public sector are by downsizing, outsourcing (contracting out), and privatizing. When reducing the size of government, the standard for doing so should be informed by a clear idea of the essential functions of government, which in the economic sphere include protecting property rights, providing an effective commercial law framework, ensuring that workers are educated, providing or paying for infrastructure, and making sure that the rules governing the financial system promote access to finance.

Downsizing

With the increase in public sector wages and salaries in 2005,10 the country could no longer afford to pay so many civil servants. So as well as reducing the crowding-out effect of the high level of government employment and salaries on the ability of the private sector to attract good employees, there is an added macroeconomic reason for reducing the number of people working for the government. The only way to ensure that government revenue is still sufficient to pay for the essential functions of government is to reduce the number of state employees while at the same time improving the efficiency of the remainder. Progress has been made in reducing government employment. In 2006, the number of people employed in the Tongan public sector was reduced by 25%, through voluntary resignation, because of the generous severance packages offered by the government. Although this downsizing was not enough to offset the large wage increases awarded, further employment cuts are planned.

Improving the Quality of the Civil Service

The country’s brain drain of skilled workers seeking better opportunities abroad undermines the quality of civil servants (and indeed of the whole working population). With the recent downsizing and the public service hiring freeze, the technical and professional skills in the civil service have been hollowed out: 85% of permanent and casual salaried staff is in the junior administrative classes. There has been a drain of well-qualified middle and upper-middle level managers in the civil service as a result of them taking severance packages. In the second level of management and in many ministries at levels immediately below the chief executives or permanent secretaries is a shortage of personnel. In many ministries there are not enough staff members with the knowledge and skills for the work that needs to be done. This limits the government’s ability to develop and implement a reform agenda (not to mention fulfill the core functions of government). We encourage a continuation of prudent downsizing, but it needs to be combined with training the staff that remains.

Because the SOEs crowd out competition from the private sector, underperforming SOEs also perpetuate low productivity.

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10 This occurred following the 2005 civil service strike. Wages and salaries were raised above those of comparable workers in the private sector, using a formula known as 60/70/80, which represents the percentage increases in salaries for government employees at various grade levels. A biannual survey of the business community conducted by a local management consulting firm found that while the public and private sector pay rates were similar in 2002 and 2004, in 2006 public sector pay was 40% higher for 80% of the positions surveyed. This risks crowding out private businesses and increasing the public sector deficit.
Outsourcing, or Contracting Out

Other reductions in expenses and improvements in returns on money spent can be achieved through outsourcing (contracting out) and privatization. In fact, contracting out more activities to the private sector is one solution to the shortage of well-qualified public officials. Currently contracting out by the public sector to private sector providers is limited. Tonga Airports Ltd. contracts out baggage handling, and the Port Authority, which operates as a landlord port, successfully contracted out stevedoring until 2005, when it then took back stevedoring into its own operations. The Ministry of Works already contracts with the private sector and is considering outsourcing much of its road maintenance operations. Senior government officials have said in recent statements and interviews that they are determined to do a lot more contracting out to private providers.\textsuperscript{11} We encourage the outsourcing of as many services and functions as is feasible.

Privatization

Enterprises owned by the state are candidates for privatization as a way to improve their efficiency and allow more money to be spent on other government-provided services, such as health and education. Tonga’s Public Enterprise Act of 2002 sets the legal framework for the government’s stewardship of SOEs. It is modeled after similar legislation in Australia, New Zealand, and other countries in the Pacific. However, the Public Enterprise Act has an omission that constitutes a major departure from international best practice. The act fails to stipulate that SOEs must operate as successful businesses, usually defined to mean profitable in a way that is comparable to businesses in the private sector. We recommend that the government add such a provision to the Public Enterprise Act. While it may not be possible to find successful businesses in Tonga to compare with, SOEs in other Pacific islands or even just other small economies could be used.

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\textbf{Box 1: Procedures for Contracting Out} \\
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- Establish a clear expectation, through statements of corporate intent, which state-owned enterprises (SOEs) will contract out the delivery of functions and services for which they are responsible or provide justification for not doing so. For example, if the Ministry of Works were to retain responsibility for maintaining roads, it would have to show how it could do so more cheaply and/or with better service than a private business. \\
- Develop a clear policy statement on community service obligations. \\
- Look for opportunities to make the provision of community service obligations contestable through tendering (making a bid) for minimum subsidies. \\
- Develop a public–private partnership policy that sets out general guidelines and expectations for contracting with the private sector by ministries and SOEs. \\
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\end{tabular}

\textsuperscript{11} Samoa’s experience with contracting out is an excellent example of what can be achieved. Since it contracted out road maintenance and construction to private companies, productivity has increased four-fold and 90\% of roads are now paved.
In some cases, governments are reluctant to privatize SOEs that are considered dominant in the local market or are involved in “strategic” activities (ones important to national identity or security). SOEs that provide telecommunications, broadcasting, or airline services are seen as strategic in a number of Pacific Island economies, although this view is changing rapidly. While each government must determine its own policies for SOE divestment, many concerns about loss of control can be dealt with through competition, regulation, and innovative ownership structures. This was done with Polynesian Air (renamed Polyblue), the Samoan airline that was partially privatized through a sale of 49% of equity to Virgin and 2% to a private Samoan investor. The government retained a minority stake of 49%, but effective control remained in Samoa.

An immediate candidate for privatization is the Tonga Communications Corporation (TCC), whose establishing legislation stipulates that at least 10% of the equity must be sold. That company and the recently formed Ministry of Public Enterprises (whose job it is to coordinate the stewardship of SOE assets) are looking at options for achieving this. TCC is in a strong financial position and is generating enough cash to meet most of its identified future investment requirements. It is therefore a good enterprise to privatize, either in whole or in part. There are strong reasons for considering an outside investor that could bring much-needed capital and expertise to Tonga. The experiences elsewhere in the Pacific and in the Caribbean demonstrate that when an experienced foreign operator enters the market, prices decline, the number of subscribers increases, and the service area expands.12

Tonga would be well served by the government’s freeing up underperforming capital and then using it for new public services, such as health and education. Selling these low-yielding assets to private operators would not only raise revenue for investment in infrastructure, but also increase the growth rate. Newly privatized enterprises would probably treat existing customers better—to retain them before seeking to expand. They would be under pressure to obtain a commercial return on their investment.

The government is looking for ways to allow the public to participate in the benefits of privatization, possibly through share distribution. However, unless there is a market to list and trade the privatized shares on, it is difficult to see how the public could gain financially. Establishing a stock exchange in Tonga would be prohibitively costly. One possibility would be to list a company on the Fiji Islands stock exchange, although its rules, lack of liquidity, and cost would make this difficult. Even in the Fiji Islands, it is not unusual for only a single company’s shares to be traded on any given day. Nevertheless, it is not impossible.

12 In Samoa, the entry of a new operator, Digicel, has resulted in a 50% decline in call rates and a tripling of the number of subscribers within the space of a year.
In any case, as suggested earlier, the benefits of privatization go well beyond creating broader public ownership. But one should bear in mind that privatization, contracting out, and related solutions, such as public–private partnerships, are not panaceas. Still, they can greatly improve the efficiency of low-performing assets and functions now under government control.

...the benefits of privatization go well beyond creating broader public ownership.

D. The Government is Already on the Move

Although details of how this should be done have yet to be formulated, the government has announced its intention to reduce the presence of the state in the economy through downsizing, contracting out, and SOE privatization. Ministers have indicated a desire to see the government get back to its core functions and responsibilities and look for opportunities to outsource or privatize.

The government is exploring ways to contract out the functions of the Ministry of Works and the Ministry of Transport. It has already sold its shares in Westpac Bank for US$10.45 million, and in July 2008 it completed the sale of its 75% interest in Leiola Duty Free Stores.

Reforming the Public Service

The Public Service Commission is in charge of public sector reform. Its work plan is to modernize the civil service and its administration by the following means:13

- Restructuring departments
- Redeploying staff from peripheral to core functions
- Reviewing business processes for efficiency
- Going over the code of conduct with staff members (as a way of promoting ethical behavior)
- Reviewing job levels, salaries, and conditions of service with a view to entering into union-mediated agreements that would avoid the boom-and-bust cycle of salary increases in Tonga
- Building a workplace culture that monitors performance and rewards excellence by having workers and organizations agree to performance targets

The position of the chairman of the Public Services Commission has been part-time in the past, but in view of the restructuring task ahead, a full-time chairman has been appointed.

Restructuring Ministries

Tonga’s 18 government ministries have been restructured on paper, and new chief executive officers are being appointed. However, the 26 departments within the portfolios have not been restructured yet. The deep cuts in the public sector have resulted in staff and skills shortages and have increased the responsibilities of those remaining. As a result, the current staff are finding it difficult to devote enough time to fulfilling their primary functions. And they are having trouble setting up a structure and staff to manage outsourcing or cost-recovery models that will pay for themselves.14

Several ministries complained that they do not have enough funds to undertake basic operations. Concern has also been expressed about the lack of long-term funding plans. The managers of infrastructure assets, such as roads and ports, are dependent on the annual budget cycle to determine spending priorities, while their projects typically last for a number of years.

14 As is typical of numerous instances of downsizing, many of the best people take “packages” because they are the ones with the most alternatives.
SOE Policy Initiatives

Some recent government initiatives are designed to improve SOE performance, including through greater private sector involvement. These initiatives place Tonga at the forefront of SOE reform in the Pacific, and as they are implemented productivity should increase and the drain on the budget should decrease. The establishment of the Ministry of Public Enterprises will help in the development of a centralized, coordinated approach to the stewardship of SOE assets. The ministry is reviewing how much SOE directors and chief executives are paid. Early indications are of a determination to achieve a higher return on assets, a better use of capital, stronger financial oversight (even to the extent of calling up loans in default), improved management, better monitoring, and stronger governance structures. This should lead to a more focused and commercially oriented monitoring regime.

SOE performance is being improved through:

• Strengthening their corporate governance
• Enforcing the government’s requirement of a 10% hurdle rate for all investments
• Privatizing some of them—the Ministry of Public Enterprises completed the sale of the government’s 75% shares in the now-named Leiola Group Ltd. in July 2008
• Developing policies on pricing, funding, monitoring, and contracting community service obligations (CSOs)
• Continuing the corporatization of government-controlled entities along the lines of Tonga Airports Ltd. (which was corporatized earlier in 2007), Tonga Post, and Tonga Power
• Establishing clear and commercially based policies and procedures for government loans to them

• The phasing out of the practice of appointing government ministers as their directors. A large pool of directors will be developed to allow for competition in choosing the best-qualified directors, and encourage training and development

Human Resource Constraints in the Ministry of Public Enterprises

Within the Ministry of Public Enterprises, the human resource base that can support the measures listed above is thin. The ministry is new and the staff in general is new to the SOE monitoring role. In fact, some deepening and expanding of the skills base in this ministry is needed. ADB is providing on-the-ground assistance through a current technical advisory team. The chief executive officer has only recently started in his new role, and the minister has recently been given the added responsibility of being the minister of finance too. The ministry should quickly determine priorities. It should be given the resources it needs to achieve them.

The deep cuts in the public sector have resulted in staff and skills shortages.

Government is currently undertaking serious efforts, with ADB support, to rationalize Tonga’s public enterprise portfolio. This includes restructuring some SOEs, such as the International Dateline Hotel and the Shipping Corporation of Polynesia, and selling either shares in or assets of other SOEs, such as Tonga Machinery Pool and Tonga Timber.
E. Summary of Recommendations

• Quickly determine the priorities of the Ministry of Public Enterprises and give it the resources necessary to achieve such priorities.

Make sure SOEs do, in fact, operate on business principles.

• Make sure SOEs do, in fact, operate on business principles—that they adhere to legal rules established for all companies and that they make enough profit to compensate for the commercial risks they take. Give this a legal basis by adding a provision to the Public Enterprise Act that stipulates that SOEs must operate as successful businesses, comparable to businesses in the private sector.

• Reduce the role of the state in the economy by continued action on privatizing SOEs, contracting out, and engaging in transparent public–private partnerships. Continue downsizing the civil service.

• Formally adopt the already drafted guidelines on CSOs and look for opportunities to make their provision contestable through tendering (making bids) for minimum subsidies.

• Develop a public–private partnership policy that sets out general guidelines and expectations for contracting with the private sector by ministries and SOEs.

• Restructure civil service departments, redeploying staff from peripheral to core functions, reviewing business processes for efficiency, and going over the code of conduct with staff members (as a way of promoting ethical behavior).

• Review civil-service job levels, salaries, and conditions of service, including performance targets.
Chapter 4
Improving the Infrastructure

Constraint: Poor-quality and missing infrastructure add to business costs and harm rural development.

Many studies have shown good-quality infrastructure to be essential to an economy that encourages investment, entrepreneurship, and growth. It is also crucial for poverty alleviation. A reliable and low-cost supply of electricity keeps costs down and removes the need for both businesses and individuals to have backup generators, thereby allowing capital to be put to more productive uses. A safe and efficient water supply keeps the population healthy and reduces work absences due to illness. Widespread availability of Internet and telephone services brings remote island countries closer to the rest of the world and the remote parts within those countries closer to the rest of the country. It promotes trade, commerce, and entrepreneurship. In the Pacific, roads and interisland shipping connect rural producers with urban or foreign customers, stimulating agricultural development and rural development. In the case of Tonga, some areas of the infrastructure are adequate, but other areas are of low quality, limited, or altogether absent. These deficiencies constrain private sector activity.

This raises the fundamental question of how to improve infrastructure in Tonga and what the role of the state should be in financing and supplying infrastructure. In all countries in the world, both the state and the private sector supply infrastructure. Often state funding is crucial because without it infrastructure would not exist. It is almost impossible, for example, for a private company to invest in building city streets because there is no way to charge for their use. The state therefore has to see to the building of roads. However, this does not mean that it has to actually build them. Invariably, a private company can construct roads more efficiently than a government department or a state-owned construction company. The same principle of state funding of private provision applies in many other areas. Even if the government is funding infrastructure, it can usually be built, maintained, or have service supplied more cheaply by the private sector. If there are efficiency gains, taxpayers get more for the taxes they pay.

Invariably, a private company can construct roads more efficiently than a ... state-owned construction company.

A. Transportation
Roads
Tonga’s transportation infrastructure is fairly well developed. Road density is high by regional standards, although only 30% of roads are paved (compared with 90% for Samoa).16 Roads within and around Nuku’alofa appear well maintained and are comparable to, if not better than, those found in other South Pacific capitals. However, beyond the major routes, it is evident that road maintenance has been allowed to slip in recent years.

The Ministry of Works is not corporatized, but operates as a regular government department. Recent government reforms

have seen a number of functions moved out of the Ministry of Works, including those of the Civil Aviation Authority and the Maritime Authority. This has left it primarily responsible for building and maintaining roads, issuing building permits, managing national disasters, and testing vehicles for safety.

A ministry of transport has recently been formed and will be responsible for the management of Tonga’s roads. It will also be responsible for the civil aviation and maritime authorities. This will effectively create a purchaser/provider split. However, the most significant short-term problem is the lack of a 5-year or 10-year plan for road construction, maintenance, and funding because these activities typically have a life of many years. Planning and budgeting is hindered by the fact that road maintenance and construction has tended to be planned and funded on the basis of an annual budget.

While planned expenditure on roads is among the highest in the Pacific (Figure 5), without longer-term planning and funding, it is difficult to see how the purchaser/provider split will benefit road construction and maintenance. Tonga has the fewest automobiles per kilometer of road in the Pacific (Figure 6). A cost-benefit analysis is needed of where road investment funds should be spent, particularly in light of the apparent underinvestment in road maintenance in the feeder road system, which exists side-by-side with very high spending on road building.

Greater use of the private sector, increased contracting out, and a long-term funding plan would improve road infrastructure in Tonga with little or no increase in cost. The private sector is active in only limited aspects of road construction and maintenance. It owns most quarries and trucks used by the Ministry of Works. At the request of the government, ADB has commenced a review of road maintenance and construction. It is trying to determine how the private sector can play a more significant part. The minister of transport has said that he sees the future role of the

![Figure 5. Planned Annual Investment in Roads per Capita US$ for 2005–2015](image)

Source: Castalia Research.

![Figure 6. Vehicles per Kilometer of Road](image)

Sources: Kiribati Ministry for Works and Energy and World Bank.
ministry as that of a regulator, with operations ideally contracted out to the private sector. This would have beneficial implications for all activities the ministry will be responsible for—maritime, civil aviation, roads, and ports.

The bus service in the capital is privately owned and operated, as are the numerous taxis. The buses appear to be efficiently run, and the quality of rolling stock is generally higher than that of comparable Pacific Island economies.

**Shipping**

The government puts no restrictions on the nationality or registration origin of shipping lines that serve Tonga. Ships that have a license from the Ministry of Marine and Ports and conform to the safety and other requirements of the Shipping Act many enter Tonga. International shipping is open to competition. Freight rates from Australia to Tonga are comparable to those of other Pacific Island countries, except the Fiji Islands.

Two shipping companies operate on the main interisland routes. The government-owned Shipping Corporation of Polynesia (SCP) operates a ferry with a capacity of 350 that makes a weekly tour of the main island groups, including the Niues. A private company, Uata Shipping Ltd., operates a 40-meter ferry with a passenger capacity of 200 that also makes a weekly trip around the islands. Two motorized barges go from island to island. A third company operate a 25-meter ferry to ‘Eua. Both ferries are old and uncomfortable. While they meet requirements for interisland service in fair weather, they do not meet international safety standards for ocean-going vessels. They do not sail when bad weather is forecast and are not suited for carrying tourists.

The SCP ferry was acquired in 1979–1980 under a concessional loan from the Government of Germany. Frequent breakdowns have been disrupting service, with the result that passenger traffic has declined precipitously. For example, there were 6,507 passengers to Ha’apai in 2001, but only 2,973 in 2004, mainly because one of the vessels was laid up for repairs. SCP is supposed to acquire a new vessel using grant funds from the Government of Japan. However, the new boat is not expected to be available until 2010. There is a possibility that the People’s Republic of China will replace a barge taken out of service after maintenance defects were identified. The ability of the SPC to obtain vessels through grant funding and government-guaranteed loan financing gives it an advantage over private-sector operators and could lead to the crowding out of private shipping operators. This possibility would be eliminated if the government charged SCP a price for its capital, including the grant funding. The government is also investigating whether the operation of the new interisland vessel could be contracted out to a private operator, which would be another way of increasing competition within the domestic shipping market.

The SCP has been corporatized for over 5 years, and it has been profitable on an operating-cost basis. However, profitability has suffered recently because of the high maintenance costs of its aging interisland vessel.17 SCP currently does its own maintenance, but has problems retaining skilled workers, who frequently leave for overseas once they have been fully trained.

<table>
<thead>
<tr>
<th>Table 4: Pacific Freight Rates per 20 Foot Container</th>
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<tr>
<td>Fiji Islands</td>
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<td>Kiribati</td>
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<td>Samoa</td>
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<td>Tonga</td>
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17 This implies that insufficient allowances are being made for depreciation. Including the cost of capital, the SCP is probably unprofitable.
Port Authority

The Port Authority is a public enterprise (SOE) under the Public Enterprise Act. It operates as a landlord port at Nuku’alofa, which handles 99% of all cargo coming into or going out of Tonga. The Port Authority successfully contracted out stevedoring work until 2005, when it incorporated stevedoring into its own operations. We view this as a step backward and urge that stevedoring be contracted out again. The Port Authority also operates pilot vessels, as do two private companies. Its internal target for return on investment is 4% (which is well below the government’s 10% target). The Port Authority traditionally pays a dividend of 50% of after-tax profits. However, actual rates of return are unacceptably low—2.3% in 2005. For the comparable period in 2006, it was 4.6%. Given the Port Authority’s purely commercial orientation, this low return on investment requires that the Port Authority be restructured so that the rate of return increases to at least the 10% government benchmark.

The Maritime Authority administers the ports on Vava'u and the smaller islands. The intention is for the Port Authority to ultimately take responsibility for all ports in Tonga. The smaller ports (except the port on Vava'u) are operating at a loss. The authority is concerned that should it become responsible for those ports, they will drag down its financial performance. Performance will in any case be reduced when it undertakes the urgently needed deferred maintenance in the smaller ports and in marine navigation signals and lights throughout the islands—if this is not funded through CSOs. An additional problem is the cost of meeting the post-9/11 US security requirements. They will be very high if the smaller ports are also required to upgrade.

The throughput of the main port in Nuku’alofa (as measured in tons per capita) is well above that of most ports in the region (Figure 7). The Port Authority has developed a US$40 million expansion plan for the Nuku’alofa port that includes upgrades for both the domestic and international wharfs. The authority is seeking funding to develop a feasibility review and a business case for the expansion. The planned expansion should not proceed unless it can be demonstrated that it is commercially justified. The Port Authority should be encouraged to leverage private capital and expertise for the port expansion through public–private partnerships rather than relying on soft or government funding.

Airports

Tonga Airport Ltd. (TAL) has only recently been corporatized. It is responsible for the main airport on Tongatapu (Fua'amotu International Airport) and for five others. The airports on Vava'u and Ha'apai are big enough for medium-sized planes to land, but the others can only take small planes. The smaller airports are financed by cross-subsidies from the profits of the Fua'amotu Airport. The two airports on the Niuas Islands were reopened in the first half of 2008.

Recently the Tongatapu airport has been handling an average of 60,000 international arrivals per year, but expects 70,000 this year. There are an average of three international and six domestic landings a day. Although TAL is required to cover costs, a profit target has yet to be set. The company acts simply as a
landlord, with all operational activities (such as baggage handling, ground staff, and fuel servicing) undertaken by private operators. However, TAL does manage airport security. The TAL operational staff appear to possess a high level of technical skill. The company is exploring ways to increase its revenue, and to this end it has recently introduced car-parking fees at the Fua’a’amatu Airport. TAL expects revenue to grow as a result of increased use of the airport infrastructure.

If Tonga had better land, water, and air transportation services, the movement of people and goods would be more frequent and cheaper. Improving services in areas where service is limited or nonexistent would raise the incomes of remote communities by providing them with more opportunities to engage in commerce. In turn, this could reduce the incentives of the rural population to move into urban areas.

B. Telecommunications

Two companies that are regulated by the Department of Communications under the Communications Act provide telecommunications services in Tonga. The TCC, which is wholly owned by the government, provides fixed-line and mobile-telephone services, international-calling facilities, and Internet service. Digicel, which until recently traded as TonFon, provides mobile-phone service, cable television, international calling, and Internet service.\(^{18}\) Competition between the two companies has increased the range of available products and reduced prices for the public. In terms of telecommunications charges, Tonga now ranks as a low-price country.

\(^{18}\) The Shoreline Group, previously the owner of Tonfon, sold its interest to Digicel in December 2007.

Figure 8: Cost of Peak Mobile Phone Calls

FSM = Federated States of Micronesia, ST = Solomon Telekom Company Ltd., TCC = Tonga Communications Corporation.

Note: Prices and exchange rates effective September 2007. In some cases operators offer per minute, per 2-minute or per 30-second rates. Some have introduced per second billing. Where more than one rate provided by a company (for example, mobile-to-mobile and mobile-to-land line) a simple average was taken.

At the end of 2002 there were an estimated 11,500 landlines. The main growth in recent years has been in mobile-phone use. Digicel has more than 15,000 users. Major investment has been made in infrastructure, including phone towers. Mobile-phone communications are evolving rapidly, which adds to the potential viability of businesses in the outer islands. More than 35% of the population now has access to a GSM mobile phone.  

While DSL Internet service is available, in many cases connection speeds are slow. This is because satellite capacity is limiting bandwidth. We recommend exploring options for increasing satellite capacity. For the longer term, the feasibility of a fiber-optic cable link should be investigated.

C. Utilities

Electricity

If Tonga had reliable electricity, it would be possible for offices, hotels, and shops to avoid the expense of installing backup generators. Until recently, the Shoreline Group supplied nearly all electricity in Tonga (Box 2). The Shoreline Group is a privately owned conglomerate that took over the government-owned power generation and distribution facilities in 1997, when they were on the verge of collapse. Shoreline was given a monopoly on the provision of power on the main islands. The group undertook major investment in generation and distribution, and there are now 12.5 megawatts of capacity, which allows for a 20% reserve at peak demand. Unusually for the region, there are no CSOs.

Over 80% of the population of Tonga has electricity, which compares favorably with other countries in the region, especially in light of Tonga’s geography. The demand for electricity has been growing rapidly. Over the past 3 years, growth has exceeded 6% annually. The cost of power in Tonga is the highest in the Pacific region by a large margin (Figure 9), even though the power supplier receives government subsidies. There is no apparent justification for the high power prices.

In July 2008, the government acquired the entire generation and distribution infrastructure of Shoreline. However, the purchase of the Shoreline power assets by the government is not consistent with the goals for SOE reform. Since regulation of the power sector is undertaken by the Tonga Electric Power Board, not only would government ownership of the operator create a conflict

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Box 2: The Shoreline Group

The privately owned Shoreline Group operated the electric power infrastructure in the Kingdom of Tonga. It took over responsibility for the generation of power in Tongatapu from the Tonga Electric Power Board (TEPB) in 1998. In 2000, it commenced generation and distribution of electric power in the Vava’u group of islands. In 2002, the company acquired distribution and transmission in Tongatapu from the TEPB under a 10-year lease agreement. At the same time, it also took over the generation, distribution, and transmission of electricity in Ha’apai and ‘Eua. The Shoreline Group monopolizes generation and distribution in the geographical areas in which it operates. The agreement through which the Shoreline Group took over the operation of the power system provided for a return of the operation to public ownership on commercial terms. In 2005, the Shoreline Group indicated a desire to exercise this provision, but rather than return the operation to the government, a private buyer was sought. Northpower (a New Zealand based power utility) came close to purchasing Shoreline’s power assets, but agreement could not be reached. Finally, in July 2008, the government purchased the power generation and distribution network from Shoreline.
of interest, but it would also seem to expose
the government to operation risk in a sector
that is technically complex. Nevertheless,
as a way of ultimately privatizing electricity
generation, temporary ownership could be the
only feasible course of action and provides an
opportunity to introduce some competition
into the electricity market, which would
bring downward pressure on the very high
electricity prices. We recommend that before
returning the operation to private hands, the
government restructure the power sector in
a way that brings competition to generation,
transmission, and distribution.

Currently, the Tonga Electric Power Board
regulates electricity prices. Interviews with the
board revealed that regulation is based on a
modified RPI-X system, the main departure
from which is determined by a fuel cost
and efficiency adjustment. However, ad hoc
elements are involved in price setting as well.
In general, the aim is to allow for a return
equivalent to a 10% weighted cost of capital.
We recommend that once the government
acquires the assets, it sell its interests in the
company to a private group. If the government
can quickly divest itself of this in a manner
that actually increases the opportunities for
competition in the power sector, there could be
long-lasting economic benefits.

Box 3 describes a new regulatory regime
for electricity that came into effect in July
2008. Rather than have a body that regulates
this sector exclusively, it would be better
to establish an independent regulatory
commission that has authority to (i) investigate
anti-competitive practices in all sectors, and
(ii) enforce general consumer protection.
Competition would eliminate any need for
price controls, which are a damaging and
distortionary aspect of the Tonga business
environment. The Independent Consumer
and Competition Commission in Papua New
Guinea is a good model for such a body.

**Box 3: A New Electricity Regulatory Regime**

The government is in the process of establishing a
new electricity commission (modeled on the New
Zealand Electricity Commission) that would take
over the regulatory functions of the TEPB. While the
legislation has been drafted, it has not yet come into
force. Contemporaneously with the establishment
of the commission, the TEPB will cease to exist,
but licenses, regulations, and by-laws approved
by the TEPB will remain in force through transition
provisions. The functions of the new commission are
to enforce the new Electricity Commission Act of 2007;
to enter into and enforce concession contracts with
third parties (including the state) for the generation,
distribution, and supply of electricity; to license
electricians; to regulate electrical safety standards;
and to recommend regulations for concessionaires
supplying electricity.

**Figure 9: Average Residential and Commercial Tariffs (US Cents per Kilowatt Hour)**

![Figure 9: Average Residential and Commercial Tariffs (US Cents per Kilowatt Hour)](image_url)

Sources: Castalia Research and Pacific Islands Applied Geoscience Commission.
**Water**

The Tonga Water Board (TWB) is a public enterprise under the Public Enterprise Act. All water in Tongatapu comes from either bore or rain water. The water is not treated. The TWB is usually only responsible for the provision and reticulation of water in the capital cities of the islands. Rural areas have their own water supplies. As Tonga develops, the costs of not treating the water are increasing.

The TWB owns the pipe infrastructure and undertakes its own pipe laying. The majority of retail and business water connections on Tongatapu are metered. Meters are read and water charges are invoiced monthly. Since there is no postal delivery service in Tonga, invoices are hand delivered to customers, also monthly.

The government does not subsidize the price of water, and the TWB’s price covers the full cost of production, including a 10% margin to cover asset replacement, although their actual rate of depreciation is higher than 10%. The TWB has generated net losses for the last 5 years, mainly due to the depreciation charge. To improve profitability, the TWB introduced a 26% increase in the price of water that came into effect on 1 January 2008.

The TWB recognizes that several opportunities for public–private partnerships in the provision of services lie within the TWB ambit of operation, including maintenance, infrastructure development, meter reading, invoicing, and billing. However, because of the importance of water, the TWB has expressed reservations about contracting out maintenance to the private sector. But controlling private contractors through robust contracting and monitoring could allay these concerns.

The TWB is investigating the feasibility of developing its own water-bottling operation. The TWB estimates that it would cost T$2.5–3.0 million to establish a bottling operation. However, there are already three private producers of bottled water, and there is no reason to believe that the TWB has a comparative advantage in water bottling. As we have already observed, a move by the TWB into bottled water would likely crowd out the private sector and negatively affect the economy.

**D. Summary of Recommendations**

- Before returning the operation of the monopoly power provider to private ownership, restructure the power sector in a way that brings competition to generation, transmission, and distribution.
- Investigate 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.
- Improve road infrastructure with increased use of the private sector, and develop a long-term funding plan.
- Ensure that any investment in critical elements of infrastructure (e.g., domestic and international sea and land ports) includes adequate provision for maintenance.
- For port expansion by the Port Authority, leverage private capital and expertise through public–private partnerships (rather than relying on soft or government funding).
- Establish an independent regulatory commission that would have authority to investigate anti-competitive practices in all sectors and to enforce general consumer protection.

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21 Note: this is the same process for electricity and fixed-line telephone customers. They all use different groups to read meters (water and electricity) and deliver invoices.
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.

### 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.

In Tonga, delays in court cases being heard have declined dramatically.

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. 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

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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.

In many cases, regulations that have been repealed or amended are still enforced by government departments.

**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.

“If companies followed all the provisions of the Tonga Companies Act, there would be no companies in the country.”

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.

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.
Chapter 6
Increasing Access to Finance

**Constraint:** After reforms are implemented, a lack of access to finance will lead to some investment opportunities being lost.

A. Financial Markets

By several measures, Tonga has the best-developed financial market in the Pacific region. Over the past few years, there has been a rapid expansion of credit to households, much of it to finance construction. While the banks themselves complain of tight liquidity, the Reserve Bank of Tonga believes the tightness in the system is appropriate, given current macroeconomic circumstances. Existing limits are probably appropriate—there is currently enough liquidity to sustain business activity. So apart from the capital required for rebuilding Nuku’alofa, which needs to come from outside the country, increases in credit would probably not result in increased real growth over the short term. Under present circumstances, access to finance is probably not a problem for business growth.

But if the barriers to private sector development identified in this report are removed, returns to capital will increase, and many more investment and business opportunities will arise. At that point, economic growth could be increased by a greater availability of finance. Without improved financial markets, many investors and entrepreneurs will not be able to find financing, and opportunities will go to waste. Since financial market reforms frequently involve changes in the law, planning horizons are normally long. To ensure that access to finance does not become a constraint, actions to initiate change should start soon.

Tonga has four licensed financial institutions: two foreign-owned commercial banks (ANZ and Westpac), a locally incorporated

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Figure 10: Domestic Credit to the Private Sector (% of GDP)

Source: World Development Indicators.

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25 The World Bank Doing Business indicators currently rank Tonga as having the least-developed financial market in the Pacific. This ranking is not consistent with our findings presented in this chapter.

26 The government owned 40% of Westpac until recently, when this share was sold to the Westpac group.
commercial bank, and the government-owned Development Bank of Tonga. All four are profitable, but profit rates are lower than those of banks in other Pacific Island economies.

To deepen the financial system, the way in which assets are pledged as collateral for loans needs to be strengthened.

B. The Collateral System

To deepen the financial system, the way in which assets are pledged as collateral for loans needs to be strengthened. Such a change would probably increase the demand for money and improve the potential for growth, especially if combined with the introduction of a credit information bureau (see the next section). This suggests that credit could expand more rapidly without causing inflation.

The collateral framework in Tonga (also known as the secured transactions framework or the personal property securities framework) is complicated, costly, and does not provide lenders with confidence that they can repossess and sell pledged assets in the event of default. This makes lending risky, especially to smaller businesses. While it is possible for banks to take security interests over leases and company assets, if the borrower fails to repay the loan, the process of repossession is costly and lengthy, and the final outcome is uncertain.

Because of the uncertainty and expense, banks insist on businesses providing collateral equivalent to several times the value of the loan, thereby raising the risk of borrowing as well.\(^{27}\) The mechanism for businesses to pledge collateral is the company charge,\(^{28}\) which is costly because it requires hiring a lawyer to draw up the documents. The creation of charges over assets occurs through provisions of the Companies Act in the case of corporations, but since the Companies Registry was destroyed in the civil disturbances, there is no reliable and comprehensive record of existing charges. Determining whether assets have already been pledged to another lender is also difficult. For example, banks reported having to call other financial institutions to ensure that automobiles are unencumbered as collateral. There is little or no lending to sole proprietors unless they have real estate leases to pledge as security.

One good thing about the legal system in Tonga is that lawyers can serve notices related to civil procedures, obviating any need to wait for bailiffs to do so. This speeds up the process. However, it can take a long time to get a court order to repossess pledged assets. Bankers did indicate that there is a good repayment culture, and they have found that announcing defaulting debtors’ names on the radio is often enough to prompt repayment. However, shaming debtors into repayment is a poor solution to the problem of overdue loans. While the repayment culture probably accounts for the willingness of financial institutions to lend, all the people interviewed who deal with financial markets in Tonga strongly supported an initiative to reform the secured transactions framework.

A further hindrance to financial market development arises from the Land Act’s prohibition of the mortgaging of crops (Chapter 7). In countries with flourishing agricultural sectors, crop mortgages are a major source of financing for farmers. Since agriculture is a large part of the economy and has great

\(^{27}\) If the business fails, the borrower risks losing much more than the value of the loan because lenders typically cannot sell the repossessed assets for their full value.

\(^{28}\) A company charge is a collateral interest in company property created in favor of a creditor to secure the amount owed to the lender. In Tonga, the Registrar of Companies registers most charges.
potential to expand, this prohibition adds to the difficulties of obtaining financing for the development of the sector (Chapter 8).

**C. Credit Information**

Currently no records on the credit worthiness of loan applicants in Tonga are available. Banks are therefore unable to assess the likelihood of being repaid. In addition, some people move to other countries in the hope of not having to repay the loans they already have. Tongans move with ease between Tonga and New Zealand, as well as between Tonga and the United States and Australia. Banks, therefore, generally turn down most loan applications that are not secured by collateral. As a result, those remaining in Tonga who would be a good credit risk are excluded because of the behavior of a small number of defaulters. The lack of credit information raises the risks of lending.

As pointed out in the chapter on laws and regulations, the Financial Institutions Act (2004) requires financial institutions to get the permission of customers before providing information on them. This clause inhibits the establishment of a credit bureau, which is an important part of a modern financial system.

A credit bureau should be established in Tonga, and it should be connected to the ones in New Zealand and Australia so credit information can be shared. This would reduce the risk of default because leaving the country would not be as easy a way to avoid debt. The result would be that interest rates on borrowing in Tonga would decline for those who are creditworthy. This would expand access to finance for Tongans, particularly for microbusinesses and small businesses. The provision in the Financial Institutions Act (2004) would have to be abolished for this to work.

**D. Microloans**

The success of small-scale lending initiatives in countries such as Vanuatu and Papua New Guinea shows microloans to be a good way to assist farmers, microbusinesses, and women’s groups. While some microfinance is available in Tonga, the practice is still in its infancy. We strongly recommend investigating the feasibility of introducing a pilot scheme in Tonga that is similar to the initiatives in Vanuatu. If such a scheme were combined with new technologies, such as smart cards and mobile phone payments systems, there would be added benefits, including the ability to transfer remittances at much lower cost than is now possible. But a legal foundation for the electronic transfer of funds (whether for microfinancing or remittance transfers) would have to be created by modifying the exchange control regulations and passing an electronic transactions act.

**E. Remittances**

Migrants send home the equivalent of 40% of Tonga’s GDP as remittances. They are not only an essential buttress to living standards, but also a source of finance for small businesses and agricultural enterprises. The extent to which remittances are invested rather than consumed depends directly on rates of return that can be realized from investing in Tonga. There is anecdotal evidence that a large amount of the building that has been taking place in Nuku’alofa has been financed by remittances. (This risks remittances being used to bid up prices for land and buildings, resulting in a housing bubble that could be damaging in the long run.)

The Chamber of Commerce has targeted the Tongan diaspora as a source of outside investment and know-how. It is too soon to know how successful this initiative will be,
but other countries with large diasporas have been able to harness the energy and knowledge of its citizens living overseas. Ireland and India are notable examples. However, such successes usually only occur when the originating country is growing rapidly enough to provide expatriates with opportunities. The initiative could have a positive effect if reform is successful because it would provide places to invest other than real estate.

...reform and heightened competition have lowered the costs of remittance transfer.

Currently, the cost of transferring remittance 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 make more finances available. In other parts of the world, reform and heightened competition have lowered the costs of remittance transfer. The recent experience of a number of Latin American countries in bringing down the costs of transfer is illuminating. The important lessons from the Latin American experience are:

- Technology can make a big difference. Mobile phone penetration in Tonga is high and will probably expand now that Digicel has started operations in the country. This provides an opportunity to use cellular-based payment systems, such as those that have arisen in the Philippines and South Africa, where using mobile phones as devices to receive remittances has brought down the cost of transfer dramatically.
- The use of credit unions in both the sending and the receiving countries can inject much-needed competition. In several Latin American countries, central bank involvement was instrumental in modifying regulations and in assisting with clearing facilities that allowed credit unions to enter this sector. Similar measures could be considered in Tonga.
- Funding agencies can play a major role in highlighting the problem at conferences on financial markets and microfinance.

To use new technology for remittances and microfinance, it is necessary to reform the exchange control regulations and pass an electronic transactions act.

F. Other Sources of Finance

The National Economic Development Council, a committee chaired by the Prime Minister, has established a T$15 million fund to assist in the financing of businesses that will be lent through commercial banks. In other countries such initiatives have been no more than marginally successful. The long-term solutions to lack of access to finance are rather
- a well-functioning collateral framework
- an effective credit information system
- a commercially based microcredit industry

G. Summary of Recommendations

- Pass a new law that reforms the personal property securities framework.
- 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 credit bureaus in Australia and New Zealand.
- Investigate the feasibility of introducing a microfinance pilot scheme.
- Promote competition between institutions transferring remittance funds and use modern technologies, such as smart cards and mobile phones, as ways to lower remittance fees.
- Reform exchange control regulations.
Constraint: Uncertainty about what land is available for lease and what the requirements for securing a lease are once land is identified makes it difficult for investors to secure leases within a reasonable period of time.

A. The Importance of Land for Growth

No country has become prosperous without 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. The private sector in Tonga is constrained by the existing land framework because it makes it very difficult for investors, especially small ones, to identify land available for leasing. And once it has been identified, it is difficult to get the rights to use it. Even Tongan farmers wanting to expand their farms have trouble negotiating leases that give them long-term security over the new area they would like to farm.

B. Quasi-Owning and Quasi-Leasing

In Tonga, all land is the property of the Crown and there is no formal concept of freehold ownership. However, by law male subjects are entitled to receive allotments of land with a permanent right of use that amounts to ownership. Although the Land Act (1988) prohibits the buying and selling of these rights of use, there is an active market in informal land transactions, because land rights can be “gifted”—the person with the right to use the land can give this right away. While there is not supposed to be a sale, in practice an exchange of rights is brought about through a “gift exchange,” in which the right to use a piece of land is exchanged for a “gift” equivalent to the value of the quasi-lease. This is even taxed at a rate based on the imputed value of the land and the number of years of the right to use it.

There is also a leasehold market, in which leases are bought and sold. To some extent, the lease market overlaps with the “gift exchange” market. The potential for 99-year leases exists (in fact, a large international hotel chain announced recently that it had secured one on Vava'u and will be investing up to US$100 million in a new resort), but there appears to be insufficient awareness among smaller investors of the possibility of obtaining longer leases. And many investors report that the process of securing long-term leases is arduous. Leases of 50 years or longer require the approval of the Privy Council. Shorter leases require cabinet approval.

C. Mortgages

The mortgage framework has a number of practical problems. First, it is time consuming. The Land Act requires the Minister of Lands to approve and register all mortgages, which
increases the amount of time needed to obtain land for leasing. Second, using land leases as collateral involves significant risk to those who are pledging the leases. Lawyers report that some banks repossess mortgages even when the debtor owes only a small amount. The bank then holds onto the lease rather than auctioning it off and using the proceeds to refund to the debtor the difference between the amount owed and the value of the lease.

Women can and do enter into lease agreements. However, they have limited formal use rights. Only when a woman’s husband dies is such a right created—the widow has the use right while she is alive, but she cannot pass it onto her heirs. As restrictions on the use of assets tend to lower their productivity, security of tenure for both sexes would probably make land use more productive.31

E. Summary of Recommendations

• 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.
• Have a national debate on how best to achieve these goals in a way that takes traditional inheritance structures into account.
• Consider extending women’s land rights.

D. Land Rights

In Tonga, rights in land need to be strengthened if the country’s development potential is to be realized.29 Although land transactions are taking place, there is an urgent need to centralize them in a formal way so investors can know what is available and what the terms and various costs are. Formalizing the process would greatly reduce search costs that arise from lack of information and uncertainty.30

29 The considerations presented in this chapter apply only to land. Under Tongan law, dwellings and other buildings are treated as personal property and so fall under movable property law.
30 When people are uncertain of their rights to a piece of property, they are reluctant to make the investments necessary to protect and improve it, the expected returns being low.” (Partha Dasgupta, Human Well-Being and the Environment (Oxford: Oxford University Press, 2001), p., 113.
Chapter 8
Making Agriculture a Growth Sector

**Constraint:** Confusing standards and lack of good advice suppress agricultural output and lower the prosperity of rural areas.

**A. Recent Agricultural Performance Has Been Poor**

Although output and exports from agriculture and fisheries have been in decline for a number of years, they account for 25% of the total output of the Tongan economy and 30% of total employment. The single largest agricultural market is in exports of Tongan squash to Japan. However, competition has eroded the ability of most Tongan farmers to obtain a viable income from selling this product to Japan. There has been market diversification in the form of baby squash exports to Korea and butternut squash exports to the United Kingdom, both of which show promise. More traditional Pacific Island produce (e.g., coconut and root crops) is exported to Australia and New Zealand, where the Tongan expatriate community prizes it.

As a result of low productivity Tonga’s agriculture sector is not realizing its potential. Agriculture has the potential to expand exports and to provide jobs and higher incomes to large numbers of rural Tongans. Tonga has a good growing climate and is well placed geographically to serve winter markets in both the southern and northern hemispheres. High world prices for food will add to revenues from these activities and stimulate more agricultural production in Tonga.

All the problems of doing business more generally, as discussed in previous chapters of this report, are present in the agricultural sector, including access to finance, problems with property rights, inadequate infrastructure, and the role of the government. If it is to be productive, agriculture too requires a good business environment. In this regard, the recent tax reforms, especially the lowering of import duties, should help agriculture by making it cheaper to buy imported inputs.

Agriculture has the potential to expand exports and to provide jobs and higher incomes.

**B. Problems Unique to Agriculture**

But agriculture also has unique problems that merit special attention. The most important of these are:

**Opaque Quarantine Regulations in Export Markets**

Quarantine regulations in Australia and New Zealand present a major barrier to Tongan exporters: Their phytosanitary (plant disease quarantine) regulations governing agricultural imports are hard to understand and comply with. There are also reports that they are applied inconsistently. One solution would be for funding agencies to be asked for assistance in dealing with phytosanitary standards in Australia and New Zealand. If inspectors from these countries could spend time in Tonga providing hands-on training about compliance, much of the problem could be solved.

**Poor Agricultural Extension Services**

The advice and assistance provided by the Ministry of Agriculture’s extension services have been inadequate. Often, agricultural extension officers employed by the Ministry
of Agriculture are not commercially oriented, nor do they have knowledge of the commercial requirements of farming. Often their advice is supply driven. It tends to favor crops the extension service thinks should be grown, whether or not there is a market for it.\textsuperscript{32} One solution would be to make agricultural extension market oriented. It could be contracted out, with farmers deciding whether to pay for the services, perhaps on a matching grant basis with the government. This raises a more general problem. There are only a small number of full-time commercial farmers in Tonga. This shows that commercial agriculture is still in its infancy. Subsistence farming is an important food source and provides a safety net, but future expansion of agriculture depends critically on commercialization. To expand agriculture through commercialization, the guiding principle for agricultural policy formation must be that agriculture is the archetypical small enterprise sector. It should not be viewed as something unique because it involves cultivation. Farming as a business requires a well-functioning business environment.

Limited Access to Finance

Agriculture is disadvantaged by a lack of access to finance. Crops cannot be pledged as collateral for loans. Reform of the collateral framework will help improve financing for agriculture by allowing equipment and crops to be pledged as security for loans.

Poor Postharvest Facilities

There is a treatment facility at the airport, but it is not functioning adequately. One solution would be to privatize postharvest facilities, perhaps initially by asking for minimum subsidy bids for providing equipment and services, subject to specific standards being met by operators of the facility.

Government Provision of Farm Supplies

Government provision of farm supplies is crowding out private sector involvement, while not adequately meeting the needs of farmers. The solution is to privatize the provision of agricultural supplies.

C. Summary of Recommendations

- Contract out agricultural extension and the phytosanitary (plant disease control) processing for exports. At the same time, ask funding agencies for assistance in dealing with Australia and New Zealand’s phytosanitary standards and related capacity building.
- Make the guiding principle of agricultural policy formation the idea that agriculture is the archetypical small-enterprise sector. Do not view it as a sort of special case because it involves cultivation. Improve the business environment for agriculture.
- Reform the collateral framework so that it allows equipment to be financed and crops to be pledged as security for loans.
- Privatize the provision of agricultural supplies.
- Privatize postharvest facilities to the extent possible.

...commercial agriculture is still in its infancy...future expansion of agriculture depends critically on commercialization.

\textsuperscript{32} This is typical of agricultural extension services elsewhere. See ADB. 2007b. Samoa: Consolidating Reform for Faster Growth. Manila.
Chapter 9
Implementing Reform in Tonga

In the preceding chapters we identified various problems that constrain the development of the private sector in Tonga. In each chapter we recommended measures that, if implemented, would increase the prosperity of Tonga’s citizens, generate jobs for its school leavers, and make Tonga more attractive for its diaspora to return to.

In any country, implementing change depends on the appetite and the opportunities for reform. In this regard, Tonga is fortunate. While a number of important elements for private sector dynamism are missing, there is also a strong sense that things need to change and a strong belief that reforms are achievable. With a forcefulness that is rare in a Pacific Island nation, the government has expressed a willingness to undertake far-reaching changes in an effort to encourage private sector development. And in a number of areas, important and courageous measures have already been taken.

Experiences in many countries show that for a reform program to be sustained, several things must be taken into account. In addition to identifying the problems, reform requires building a long-lasting consensus on the need for change, arriving at a joint vision for the priorities, dealing with vested interests, and implementing reform effectively. A policy implementation framework for reform is necessary to ensure agreement on priorities.

To make the sorts of changes recommended in this report, it will be necessary to ensure the existing consensus among government ministers, senior government officials, and business leaders is strong enough to overcome obstacles and is sufficiently long-lived to implement complex reform measures, such as changing laws that affect business. The program described in this document will take several years, so it is vital that a process that transcends particular individuals be established. Political leaders change, public servants move to different jobs, and private sector leaders must balance public advocacy with the needs of their businesses. The process of reform needs to be resilient enough to accommodate such developments.

A public–private forum in which the factors that hinder private sector development are discussed and in which understanding between government and the private sector is increased is vital for obtaining momentum and support for reform. The problems of running a business in Tonga could be discussed and a joint vision for change and growth could be developed and then translated into policy proposals. One possible forum for such purposes is the National Economic Development Council, which is chaired by the Prime Minister. It might also be the best institution to oversee the reform program and ensure the execution of the sorts of measures recommended in this document.

While the initiative and appetite for improving the business environment must exist inside Tonga, support and resources, both financial and of expertise, appear to be available from funding agencies. A problem in many countries is that funding agency support is uncoordinated. This is not a problem in Tonga. Development partners, including ADB, have committed themselves to close cooperation. And currently there is strong cooperation among financial agencies, especially in the area of private sector development. They have the potential to bring the resources and expertise that would allow Tonga to unleash the full potential of its economy and people.

Tonga has both the desire and the opportunity for private sector–related reform to an extent that is rare among Pacific Island economies. The outlook for the future is more promising than it has been in years.
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Transforming Tonga: A Private Sector Assessment

The current momentum and appetite for change bring the opportunity for Tonga to become one of the more advanced reformers among Pacific Island countries. This private sector assessment provides a framework for private sector–oriented reform that will help improve the Tongan business environment, making it a more attractive and profitable place to invest in, and allowing it to create jobs and bring prosperity throughout the nation.

About the Asian Development Bank

ADB’s vision is an Asia and Pacific region free of poverty. Its mission is to help its developing member countries substantially reduce poverty and improve the quality of life of their people. Despite the region’s many successes, it remains home to two thirds of the world’s poor. Nearly 1.7 billion people in the region live on $2 or less a day. ADB is committed to reducing poverty through inclusive economic growth, environmentally sustainable growth, and regional integration.

Based in Manila, ADB is owned by 67 members, including 48 from the region. Its main instruments for helping its developing member countries are policy dialogue, loans, equity investments, guarantees, grants, and technical assistance. In 2007, it approved $10.1 billion of loans, $673 million of grant projects, and technical assistance amounting to $243 million.