Continuing Reform To Promote Growth
Update of the Private Sector Assessment for Tonga

This analysis is a follow-up to Transforming Tonga: A Private Sector Assessment. It assesses progress made until early 2012 in reducing transaction costs and other barriers to growth identified in the 2008 private sector assessment. It concludes that Tonga has been one of the leading reformers in the Pacific in improving its business environment, although it has been impacted by the adverse macroeconomic shocks arising from the global economic crisis.

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CONTINUING REFORM TO PROMOTE GROWTH
Update of the Private Sector Assessment for TONGA

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Continuing reform to promote growth: update of the private sector assessment for Tonga


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Every effort has been made to ensure the accuracy of the data used in this publication.
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In 2008, the Asian Development Bank (ADB) published Transforming Tonga: A Private Sector Assessment (PSA), which found that Tonga had registered negative productivity growth for an extended period. Following discussions between ADB and the government on the PSA recommendations, Tonga embarked on a far-reaching private sector-oriented reform program. It aimed at improving the Tongan business environment to encouraging private sector investment and entrepreneurship. In the area of business law reform, a comprehensive amendment to the Companies Act was passed in 2009, and an electronic registry is being installed, which will reduce the cost of starting businesses. In 2010, a Personal Property Securities Act was passed, and a supporting electronic registry was established, which will increase access to credit. The government also embarked on a program to improve the efficiency of Tonga’s state-owned enterprises. Although the reform agenda is incomplete, particularly in the area of business licensing, the reforms that were implemented should bring significant long-term benefits to the Tongan economy. ADB has supported the implementation of many of these measures.

Although the global economic crisis hit the Tongan economy particularly hard, revised statistical data show that the economy expanded over the past 3 years. Worker remittances, which were the equivalent of 31% of gross domestic product in 2008, dropped to 20% in 2009. Since remittances generate a significant proportion of income used for consumption in Tonga, the decline had a negative impact on domestic demand and government revenue.

While the government states that private sector-led growth is a key component of its economic strategy, a number of its policies have negatively impacted businesses in Tonga. In particular, government efforts to raise revenue and improve cash flow by increasing license fees and delaying business tax reimbursements at a time when business conditions were deteriorating have had a severe negative impact on investment and domestic demand more generally. However, discussion with government on an earlier draft of this report resulted in a far-reaching review of the licensing system with the assistance of the ADB.

This PSA update, prepared in close consultation with representatives of the Tongan government and private sector, is part of the regular update of analytical work under the Pacific Private Sector Development Initiative. It shows that the private sector still faces significant challenges that need to be overcome for the economy to fulfill its long-term growth potential. The decision to undertake a thorough review of the business licensing process is especially welcome.

While the PSA suggests that much remains to be done, the analysis and recommendations contained in this report will help address constraints to private sector growth and development, and improve economic outcomes.

I trust that this PSA will engage policy makers and encourage them to make further progress on necessary reforms.

Xianbin Yao  
Director General  
Pacific Department
### Abbreviations

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<thead>
<tr>
<th>Abbreviation</th>
<th>Full Form</th>
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<tr>
<td>ADB</td>
<td>Asian Development Bank</td>
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<tr>
<td>AusAID</td>
<td>Australian Agency for International Development</td>
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<td>CBD</td>
<td>central business district</td>
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<td>CEDC</td>
<td>Cabinet Economic Development Committee</td>
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<td>GDP</td>
<td>gross domestic product</td>
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<tr>
<td>IFC</td>
<td>International Finance Corporation</td>
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<td>IMF</td>
<td>International Monetary Fund</td>
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<tr>
<td>kWh</td>
<td>kilowatt-hour</td>
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<tr>
<td>m²</td>
<td>square meter</td>
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<tr>
<td>MAFFF</td>
<td>Ministry of Agriculture, Food, Forestry and Fisheries</td>
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<td>NEDC</td>
<td>National Economic Development Council</td>
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<tr>
<td>PRC</td>
<td>People’s Republic of China</td>
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<td>PSA</td>
<td>private sector assessment</td>
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<td>PSDI</td>
<td>Pacific Private Sector Development Initiative</td>
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<td>ROE</td>
<td>return on equity</td>
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<td>SOE</td>
<td>state-owned enterprise</td>
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<td>TCC</td>
<td>Tonga Communications Corporation</td>
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<td>TERM</td>
<td>Tongan Energy Road Map</td>
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<td>TEQ-M</td>
<td>Tonga Export Quality Management</td>
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Currencies

A$  Australian dollar
CNY  Chinese yuan
T$  Tongan pa’anga
$  United States dollar

NOTE REGARDING TONGA’S FISCAL YEAR

The fiscal year (FY) of the Government of Tonga ends on 30 June. FY before a calendar year denotes the year in which the fiscal year ends, e.g., FY2008 ends on 30 June 2008.
Executive Summary

Since 2007, Tonga has undertaken a number of wide ranging private sector-oriented reforms, which will assist in raising productivity and economic growth in the long-run. However, a combination of the impact of the global economic crisis and remaining constraints to private sector development has resulted in a significant erosion of business confidence.

The global economic crisis, and in particular the very substantial decline in remittances, has resulted in an estimated reduction of gross domestic product of 3 percentage points over the FY2009–FY2011. As a result, domestic demand has fallen sharply and government revenues have further declined.

The private sector acknowledges the positive impact of reform. However, low local spending and a reduction in government contracts have led to a substantial decline in demand for Tongan products, while cash flows have been put under significant strain by delays in tax refunds and more vigorous and costly enforcement of business licensing requirements.

Business licensing is imposing a combination of costs and uncertainty, particularly for foreign investors, which has had a damaging effect on investment. Until risks and costs of investment are reduced, the recovery of the economy will be slow and it will be difficult to raise the long-term growth rate.

Infrastructure services are expensive partly because of the high cost of power, which in turn arises from the high cost of fuel landed in Tonga. Although renewable energy investment is underway, this will only reduce the cost of power in the medium- to long-term.

The reform recommendations are:

- Reform the license and permit processes involved in establishing and running businesses, both for Tongans and for foreigners. This involves repealing or streamlining several processes, namely:
  - Repealing the Business Licenses Act 2002 and replacing it with legislation and processes that provide for licensing businesses rather than activities, including abolishing sector licensing except for health and liquor licenses; and
  - Modernizing and simplifying the requirements for obtaining a business visa.
- Restructure revenue collection and processing to speed up tax refunds, initially by allowing offsets of taxes owed by businesses against refunds owed to businesses by government;

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1 Editor’s Note: Subsequent to the Private Sector Development Initiative (PSDI) support in drafting the Business License (Amendment) Bill, the Tongan Parliament passed the Bill in October 2012 although, at the time of printing, the new Act had yet to be released for review.
• Enact key business laws on bankruptcy, contracting, trusts, electronic transactions, and arbitration to fill in the gaps in the commercial legal framework. Complete the transition to a fully electronic company registry and amend the Companies Act to provide for community companies;

• Although a preliminary financial analysis indicated the viability of establishing a fuel tank farm as a possible way to bring down the cost of electricity, a decision to proceed with the proposal should be based on a comprehensive evaluation, which considers the issue from all aspects including finance and the environment;

• Continue with the commercialization and privatization of state-owned enterprises (SOEs) and develop shared services to counteract the lack of capacity and capabilities;

• Prohibit ministries from undertaking commercial activities unless there is a clear need that is not already met by the private sector;

• Reduce the public sector’s wage and salary bill, as a share of total public expenditure, in line with the fiscal responsibility ratios;

• Reform the Ministry of Agriculture and Food, Forests and Fisheries to make it client-friendly. Commercialize and privatize the chemical biosecurity facilities and contract out the agricultural extension services;

• Upgrade infrastructure through greater use of contracting out;

• Seek to develop a credit bureau at the earliest opportunity; and

• Use the National Growth Committee as a vehicle for meaningful engagement between the government and private sector, and use this as a joint government and private sector task force to improve international airlines and shipping services. It is essential that government representation on the committee be at the highest levels to ensure that its deliberations feed into policy discussions more generally.
Diagrammatic Summary

Reasons for Low Growth

Problem: The Tongan economy has grown slowly for many years. Why?

- Pervasive role of the state in the economy
- Outdated and incomplete business laws
- Foreign investors in tourism face great uncertainty
- Damaging and inefficient business licensing regime
- Ineffective agricultural policy

The result: low productivity and low growth

- Inefficient state-owned enterprises tie up capital without contributing to output
- A large public sector imposes a huge financial burden
- Licensing by activity instead of by business imposes large costs and inefficiencies on the private sector

Average growth over 9 years was 1.2%

Real GDP Growth: 2002/03–2010/11: Revised

There has been substantial reform progress since 2008

- An amendment to the Public Enterprises Act, which requires state-owned enterprises to operate on commercial lines
- An amendment to the Companies Act to modernize it and make it suitable for Tonga’s needs
- Privatization of state-owned enterprises
- New Personal Property Securities Act
- Better phytosanitary processing for agricultural exports
- Much of Nuku’alofa has been rebuilt

But reforms have not led to higher growth because of:

- The global economic crisis
- Further damage from the business licensing regime
- Continuing inefficiencies of many state-owned enterprises
- Government budget position has deteriorated
- Unfinished business law reform agenda
- Access to finance has dried up

- Sharp decline in remittances
- Onerous requirements discouraging foreign investment
- Sharp increase in licensing fees
- Increase in number of licenses required
- Tourism licenses only valid for 1 year
- Reimbursement of consumption taxes taking more than 12 months
- Deterioration of infrastructure
- Large increase in public sector wage bill reducing other spending
- Further impact on domestic demand

- Much lower domestic demand

Lower remittances have resulted in gross domestic product declining by at least 3%

Reform Agenda

Tonga has undertaken extensive reform, but remaining constraints offset their effectiveness

Reform Priorities

1. Improve telecommunications through a fibre optic cable
2. Repeal the Business Licenses Act 2002 and replace it with a modern system of licensing by business
3. Enact additional key business legislation
4. Continue with state-owned enterprise reform
5. Upgrade infrastructure through contracting out
6. Reform the Ministry of Agriculture, Food, Forestry and Fisheries to make it client-friendly
7. Provide a forum for government–private sector interaction
8. Implement a credit bureau without delay
9. Speed up the processing of tax refunds
10. Investigate the feasibility of a fuel tank farm for bulk oil storage, to reduce electricity costs
11. Do not make changes to taxes and fees without consulting the private sector
12. Contract out agricultural extension
13. Privatize small state-owned enterprises
14. Continue and speed up commercialization of state-owned enterprises
15. Commercialize and privatize biosecurity facilities

Contracting Code
Electronic Transactions Act
Bankruptcy Act
Arbitration Act
Bar ministries from starting businesses that compete with the private sector
Privatize small state-owned enterprises
Continue and speed up commercialization of state-owned enterprises
Commercialize and privatize biosecurity facilities
Introduction

This analysis is a follow-up to *Transforming Tonga: A Private Sector Assessment*.\(^2\) It assesses progress made until early 2012 in reducing transaction costs and other barriers to growth as identified in the 2008 private sector assessment (PSA). It concludes that Tonga has been one of the leading reformers in the Pacific in improving its business environment. Unfortunately, the combination of adverse macroeconomic shocks arising from the 2008 global economic crisis, poor fiscal planning, and the overly zealous application of the business licensing system, has resulted in many private sector businesses being severely challenged to the extent that their very survival is in question.

The analysis commences with a brief overview of the impact of the global economic crisis on the Tongan economy. This is followed by a recap of the findings of the earlier PSA and the government reform responses in the 3 years since it was published. The remaining constraints to private sector growth are then described. The analysis concludes with further reform recommendations.

For the 2008 PSA, numerous business people and senior government officials were interviewed to solicit their views on issues that impact the private sector. For this follow-up review, many of the same people were contacted to obtain feedback on progress to date and the state of play for the private sector. Overwhelmingly, they pointed to the damaging impact of the global economic crisis on business conditions and on Tonga’s economy. In particular, remittances, which at one point were the equivalent of over 30% of gross domestic product (GDP), declined sharply. This appears to have had a powerful negative impact on consumption. As a result, businesses in Tonga have suffered from substantial declines in the demand for their products and services. Under such circumstances, the only available policy options involve minimizing the damage from events that are beyond the control of policy makers in small open economies, such as Tonga. To some extent this has been done—although, as subsequent discussion will reveal, some measures remain to be implemented.

Even though some major reforms have occurred in the areas of commercial law reform, secured transactions reform, and state-owned enterprise (SOE) reform, there has been limited progress, or even retrogression on a number of key issues identified in the 2008 PSA that underlie the low productivity that has dogged Tonga for many years. Since the long-term prosperity of Tonga is highly dependent on productivity improvements, efficiency increases in the Tongan economy will determine future growth rates. These issues are discussed in more depth in the sections that follow.

Context

Tonga, the Global Economic Crisis, and Public Sector Finances

Figure 1  Real Gross Domestic Product Growth

![Graph showing real gross domestic product growth from FY2003 to FY2011.]


Tonga’s economy was badly affected by the twin shocks of the civil service strike and the civil disturbances in 2005 and 2006, which resulted in gross domestic product (GDP) declining in 2 successive financial years. Subsequently, growth resumed (Figure 1). Recently revised GDP data indicate that the economy expanded in the 4 years to FY2011, in spite of the negative impact of the 25% fall in remittances on consumption expenditure. While inflows have

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3 Remittances are an important source of income for many Tongan families. As a percentage of GDP (national income data are not available) remittance flows to Tonga are among the highest in the world. Remittance inflows peaked at T$213 million in the year to February 2008. (National Reserve Bank of Tonga). They appear to have bottomed out at T$153 million in the year to March 2010, a 28% decline. Remittance flows appear to be highly dependent on economic conditions in the sending country. Since nearly 50% of remittances originate in the United States, the slow recovery of the US economy has had a long-term impact on remittance flows. The International Monetary Fund (IMF) estimates that during FY2011, “remittances dropped by 9.25 percentage of GDP compared with FY2008.”
recovered slightly, the continued weakness in the economies from which most remittances emanate make it unlikely that they will return to previous levels.

Tourism receipts also declined in 2006 during the first impact of the crisis. They subsequently recovered as tourist arrivals increased initially helped by the political uncertainty in Fiji. However, by 2011, tourist arrivals had fallen back to the levels of 2006.

Interviews with government, banks, and the private sector indicate that the global economic crisis caused a decline in private sector investment, which has continued into 2012. The impact on the private sector has been substantial. However, the rebuilding program in the center of Nuku’alofa provided a countercyclical influence and is probably the main reason why the economy registered positive growth over the past 4 years.

The private sector was also impacted by the commercial banks’ consolidation of their balance sheets, in response to the doubtful debts that arose from the lax lending practices in the period to 2008. As a result, private sector credit has contracted for nearly 3 years.

A contributing factor to the decline in government revenue receipts arose from the incomplete implementation of revenue reform. Total current revenue declined from T$162.5 million in FY2008 to T$132.2 million in FY2011. Over the same period, the public sector wage bill rose from T$74.6 million to a projected T$91.5 million, an increase of 23%. As a result, the public sector wage bill rose from 46% of current expenditure in FY2008 to 61% in FY2011.

In mid-2011, the government announced that planned cuts in the number of public sector employees had been postponed even though the Minister for Finance and National Planning, when introducing the FY2012 budget, announced that a deficit was being funded through

Figure 2  Tonga’s Tourism Arrivals

Continuing reform to promote growth.

There is also currently a provision for automatic public sector salary increases each year.

Tonga is a small, remote economy and, over the long term, its prosperity crucially depends on its ability to connect with the outside world. Telecommunications and maritime and air transport facilities are the channels through which these connections occur. The global economic crisis has negatively impacted the capacity and frequency of both shipping and aircraft services to the country. When Tonga and Samoa stopped providing flight subsidies in 2010, Air New Zealand withdrew the weekly Boeing 767 service from Auckland to Los Angeles, which had landed in both countries. Shipping lines have also reduced the frequency of services in response to increased costs and reduced volumes. Connectivity through telephone services has, however, increased, and international call costs have continued to decline as a result of competition. The project to connect Tonga to the western arm of the Southern Cross fiber optic submarine cable will greatly improve internet speed and capacity while reducing costs. This development could open up new business opportunities, such as the development of international call centers, and support growth in tourism and the private sector in general (see Figure 2: Tonga’s Tourism Arrivals).

Impact of the Global Economic Crisis on the Private Sector

Following civil service strikes in 2007, there was a sudden and substantial increase in public sector wages (50%), as documented in the 2008 PSA. The 2008 global economic crisis has subsequently resulted in a continuing rise in public sector wages and salaries in total government expenditure, with further increases expected. To contain the public deficit, the government has sharply cut other government expenditure items, including purchases from the private sector.

The tax authorities have also been searching for additional sources of revenue and cash flow savings. Two particular measures have had a powerful adverse effect on the private sector. There has been substantial pressure on business cash flows from delays in refunds of the consumption tax, which in some cases are more than 12 months in arrears. Refusal by the tax authorities to allow offsets, where taxes owed can be set off against refunds that have not been paid, has compounded the impact. Businesses have been prosecuted for the nonpayment of consumption taxes, even though they were owed hundreds of thousands of pa‘anga in tax refunds. Good tax policy allows for offsets unless there is strong evidence that there is a legitimate dispute regarding refunds.

4 Australia, New Zealand, and the World Bank are providing budget support in 2012 around a common matrix. This includes the following public sector reform: (i) impose a hiring freeze prior to the implementation of the restructure and ensure maintenance of centralized control over any hiring during the restructure process; (ii) ensure effective implementation of human resource reallocation processes during the restructure, without unnecessary recourse to additional hiring; and (iii) agree to guiding principles for the upcoming remuneration review to ensure that the recommendations of the review are consistent with ongoing fiscal sustainability.

5 ADB. 2011. Report and Recommendation of the President to the Kingdom of Tonga for the Proposed Grant of the Tonga-Fiji Submarine Cable (Tonga). Manila. This project is co-financed by ADB ($9.7 million), the World Bank ($16.5 million), and Tonga Cable Limited.

6 In interviews, government officials claimed that there had been a sharp rise in cases where consumption tax returns were incorrect, while private sector business owners felt that this was a stratagem to delay refunds.
While the government undoubtedly needs to improve revenue collection, it should not do so without considering the impact on the private sector. While tax evasion should be prosecuted, if the government simultaneously owes tax refunds to the very firms that it is pursuing for revenue payments, the impact is bound to be negative. Moreover, attempting to raise revenue, which is being spent on public sector wages and salaries, will not increase the willingness of the private sector to cooperate. In all countries where good quality governance exists, there is an implicit compact that the public sector provides value in the form of public goods and services. If these appear to be deficient, then the compact breaks down.

Furthermore, there is evidence that public spending that is dissipated in the form of public sector wage and salary spending has little stimulus impact on the economy compared with infrastructure investment, which is needed urgently. Bringing the wage and salary bill under control is a matter of critical priority.

A further issue results from the increase in taxes (Box 1) and business license fees to raise revenue, combined with much more vigorous enforcement. Tonga’s system of business licensing harms the private sector and discourages investment, which over the longer term will reduce government revenue. The health of Tonga’s economy—and the funds available to the government to implement social programs—depends on a vigorous private sector that actively invests. Viewing business simply as a source of revenue will ultimately harm both investment and government income.

Thus, the global economic crisis has adversely affected Tonga’s private sector both directly, through lower domestic demand, and indirectly, through various other channels, including taxation, licensing, and government purchasing.

**Policy Continuity**

The government that was formed in 2011 following the introduction of full democracy emphasized that its policies will reflect continuity with those of the previous government. The business community affirmed that they preferred to have no radical change in policy reform initiatives. They also recognized the constraints under which the new government had been placed by the global economic crisis. In addition, the business community expressed the hope that the positive reforms that had begun under the previous government would be continued.

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**Box 1 Higher Taxes, Lower Revenue**

The new liquor licensing rules were amended in late 2010 and came into force on 1 January 2011, without any formal consultation with affected private sector interests. The new rules, which reduced the hours licensed premises could serve alcohol to the public, were introduced soon after the excise tax was increased by 5% in October 2010. In August 2011, the excise on imported beer was increased by 20%. The combined impact of these changes has seen beer sales decline by 47% over the January to March 2011 period against the same period in 2010. It has been reported that some businesses in the hospitality industry have lost almost 20 trading hours per week as a result of the changes.

Source: J. Sullivan, Director, AJ & E.
Recent Reforms to Promote Private Sector Development

Tonga has been one of the Pacific region’s leading reformers in a number of areas. In many cases, reforms followed the recommendations of the 2008 PSA (see the Appendix for a complete list of recommendations and private sector-oriented reforms). Since this document updates and extends the PSA, it is instructive to compare reform priorities outlined in the earlier document with what has been achieved. The next section outlines the recommendations and progress to date. The most important include:

- amendment to the Companies Act 1995, to more closely reflect Tonga’s needs and to provide for an electronic registry. The International Finance Corporation (IFC) funded an interim electronic solution to support the company registry. Asian Development Bank (ADB), through the Private Sector Development Initiative (PSDI), is providing financial and technical assistance for the installation of an electronic company registry during 2012;
- reform of the Personal Property Securities Act 2010 and a new electronic registry that went live in April 2011;
- rationalization of a number of SOEs;
- introduction, in 2010, of amendments to the Public Enterprises Act 2002 (Public Enterprises Act), which specify the principal objective of SOEs and the way in which they should be organized, and include enhancements to corporate governance rules as well as the roles and duties of directors and managers;
- initiatives to improve the corporate governance of SOEs; and
- corporatization of the biosecurity heat treatment facility, which is being primarily funded by the Government of New Zealand.

Both private sector and public sector stakeholders indicated strong support for the reforms. Despite the decline in consumption expenditure—which has adversely impacted their businesses—private business owners indicated that the reforms have provided a strong foundation for future economic growth. Senior government officials interviewed expressed similar views.

Examples of how the reforms are being implemented include:

- The Minister of Public Enterprises has been using the criteria set out in the Public Enterprises Act to insist that Tongan SOEs improve their performance.
- All ministers have resigned from the SOE boards, as required by the amended Public Enterprises Act, and have been replaced by private sector directors.
- Banks have transitioned to the new secured transactions framework. In doing so, they found a number of instances of property that had been pledged to several people simultaneously, something that would not have been discovered under the old system.

Many of these reforms were supported by ADB through the PSDI and associated technical assistance projects, as well as technical assistance provided by other development partners, including the Australian Agency for International Development (AusAID), the IFC, and the Government of New Zealand, through the New Zealand Aid Programme.
• The revised Companies Act has substantially reduced the time it takes to establish companies and has improved the transparency of the process. The speed of registration will improve markedly with the new electronic company registry.

Nevertheless, much remains to be done before Tonga has a business-friendly environment. The government still has a pervasive and dampening impact on the private sector, particularly regarding the issues surrounding the licensing regime. During the 2012 Tongan Economic Dialogue, the private sector expressed the view that government employees do not provide good service and treat business with suspicion. These issues take place against the deepening gloom on the part of the private sector with respect to its economic prospects. A National Reserve Bank of Tonga survey of the private sector shows that expectations are for further deterioration in economic conditions, with the manufacturing, wholesale and retail, and tourism sectors all anticipating that the economy will worsen.

Reducing Constraints to Private Sector Development and Reform Progress in Tonga

The 2008 PSA included the following principal recommendations for reform. Progress in each area is shown below the recommendations. The Appendix contains a complete list of the recommendations and progress achieved to date.

Recovery from the Shock of the Civil Disturbances

In 2008, the government announced that the center of Nuku’alofa would be rebuilt utilizing combined grants of A$15 million from the governments of Australia and New Zealand and a concessional loan of CNY440 million from the People’s Republic of China (PRC). The PSA recommended that the government should carefully supervise the quality of construction. In the main, this has occurred. The rebuilding of the central business district (CBD) in Nuku’alofa is now complete.

The Rebuilding of Nuku’alofa

Ten major construction projects have commenced since 2008, which include the reconstruction of Vuna Wharf, the construction of the last phase of Vaiola Hospital, the renovation of the Royal Palace, construction of a new branch of the ANZ Bank, reconstruction of Tungi Arcade, repair and reconstruction of infrastructure in the CBD, and construction of the Taumoepeau, Royco, and Sanft office complexes and the Molisi supermarket.

Due to robust contracting and good project management, this activity has generated some positive benefits for the local economy, at least through first round effects. And although the loan from the PRC was linked to the China Civil Engineering Construction Corporation, the contract required the employment of local workers unless it could be proved that the skills required could not be found within the Tongan labor market. Further, the cabinet set up the Nuku’alofa Development Council, a subcommittee to provide project management oversight. The Nuku’alofa Development Council has been successful in ensuring, for the most part, that buildings meet local building standards and are of an acceptable quality. In a number of cases, construction was contracted out to third-party providers. For example, the reconstruction of Vuna Wharf was subcontracted to Fletchers Construction, a New Zealand-based and internationally recognized construction company.
Related Issues

While construction activity has had some immediate economic benefit and will result in significantly upgraded infrastructure and office accommodation in the CBD, there are potentially negative longer-term issues. The construction has more than doubled the available stock of commercial real estate in the center of Nuku’alofa in an environment of general economic downturn, in which both the government and the private sector are looking to reduce costs. In late 2011, the Public Services Commission, for example, repudiated a 3-year commitment to Tonga Post to lease over 440.5 square meters (m²) of office space at T$250/m². The Public Service Commission moved into the Prime Minister’s office complex on a rent-free basis.

These issues are compounded by the need to service the loan from the PRC. To provide the private sector borrowers with some comfort that they would be able to service the loans used to finance the redevelopment, the government agreed to underwrite up to 1,000 m² of rental space per building, up to a total of 5,000 m² over the total reconstruction project. Much of the newly created space remains empty, with the corresponding implication that the government will be required to fulfill its guarantee and pay the rent. In the medium to long term, the exposure of the government to contingent liabilities from the rebuilding is substantial. The rental underwrite could amount to T$1.5 million per year, payable for the full 30-year term of the loan. The government’s financial exposure will also increase to the extent that the private sector is unable to meet its interest and principal obligations under the on-lending loan arrangements. Tongan officials have indicated that it should be possible to service the debt until the deferred interest payments begin, which will commence 5 years after the initial drawdown of a series of tranches was made in September 2008. At that point, however, without significant economic growth, there could be difficulties making the necessary repayments.

Reducing the Presence of the State in the Economy

The 2008 PSA identified the pervasive presence of the state in the economy as one of the important determinants of the poor performance of the Tongan economy in terms of productivity. Tonga then participated in comparative studies of SOEs in several Pacific countries published in 2009, 2011, and 2012, which concluded that SOEs:

- are a drag on growth;
- crowd out the private sector; and provide costly and inefficient infrastructure.

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9 The government has entered into on-lending loan agreements with the private sector borrowers, whereby the terms of the loan between the government and the PRC lender are generally matched.

10 The underwriting contract does not specify the per square meter rate, but links it to current market rates. At the time of providing the guarantee, the government based its analysis on a rate of about T$300/m².


Continuing reForm to Promote growth

Calculations, shown in Table 1, estimate that SOEs tie up 15%–31% of the total fixed capital stock of the whole Tongan economy. Even using the low end of the estimate, it is clear that the state owns and controls a substantial portion of the capital stock in Tonga. Currently, the contribution of SOEs and their capital stock to GDP is substantially less than it should be. Best estimates show that SOEs contributed only about 6% to GDP in 2008, the latest year for which data are available. The very low efficiency of SOEs constitutes a severe drag on growth. With more effective use of these assets, productivity and long-term economic growth would be far higher. Furthermore, inefficient SOEs raise the cost of doing business for the private sector, further reducing investment and growth.

While comparatively, the Tongan SOE portfolio has outperformed its neighboring island countries, in absolute terms the portfolio’s performance has continued to decline year on year, and only achieved a 2.5% return on equity (ROE) in FY2010, although the decline in performance over the 3 years to FY2010 can be attributed to a number of one-off factors:

- a number of issues contributed to a significant reduction in earnings from Tonga Communications Corporation (TCC), which only achieved a 0.4% ROE in FY2010. In past years, it represented around 80% of the entire SOE portfolio’s net earnings. However, the profitability of TCC will be permanently impacted by the introduction of aggressive competition from Digicel in Tonga. There is no longer any justification

\[\text{Table 1 Economic Impact Indicators for State-Owned Enterprises in Tonga (2008 Estimates*)}\]

<table>
<thead>
<tr>
<th>Indicator</th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>SOEs as a proportion of total fixed assets in the economy</td>
<td>15% to 31%</td>
</tr>
<tr>
<td>SOE contribution to gross domestic product (GDP)</td>
<td>5.5%</td>
</tr>
<tr>
<td>Contribution to GDP per $1 of investment in SOEs</td>
<td>$0.27</td>
</tr>
<tr>
<td>Contribution to GDP per $1 of investment in non-SOE sector</td>
<td>$1.35</td>
</tr>
<tr>
<td>Average GDP growth rate for the economy Fiscal Year (FY)2002–FY2008</td>
<td>1.1%</td>
</tr>
<tr>
<td>Impact of SOEs on GDP growth rate</td>
<td>-1.12% to -0.41%</td>
</tr>
<tr>
<td>Average return on equity of all SOEs FY2002–FY2010*</td>
<td>5.6%</td>
</tr>
<tr>
<td>Average return on assets for all SOEs FY2002–FY2010*</td>
<td>3.4%</td>
</tr>
<tr>
<td>Number of SOEs</td>
<td>13</td>
</tr>
</tbody>
</table>

for the government to own a telecommunications provider, and it should consider privatizing TCC, in whole or in part. The sale of the asset will also provide much needed revenue to the public sector;

- significant losses from the interisland ferry company, relating to the sinking of the Princess Ashika ferry; and
- the addition of two new SOEs (Tonga Airports and Tonga Power), which have very large asset holdings, but achieved low returns in their first period as SOEs.\(^{17}\)

The statistics in Table 1 demonstrate powerfully the negative impact of the current SOE portfolio on the competitiveness of the Tongan economy.

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**Box 2 Privatization**

An argument frequently put forward against the privatization of state-owned enterprises (SOEs), particularly those that are profitable, is that the government will lose the benefit of the ongoing dividend payment. In 2007, the government sold its 75% shareholding in Leiola Duty Free, at the time one of the most profitable SOEs. Was this a bad decision?

A presale valuation of Leiola Duty Free, commissioned by the government and undertaken by PricewaterhouseCoopers in May 2007, indicated a sale range of T$3 million–T$4 million for the government’s 75% interest. The government’s shares were actually sold for T$6.6 million, a 65% premium over the top of the valuation range.

From fiscal year (FY) 2002 to FY2006, the total net profit for Leiola Duty Free was −T$0.14 million, T$0.29 million, T$0.65 million, T$0.79 million, and T$0.46 million. The non-audited profit for FY2007 was estimated to be T$0.99 million. The total profit for FY2002–FY2007 was T$2.25 million; however, the government’s share was only 75% of the total T$1.69 million. Disregarding the net present value of money, it would take 4 years of average profitability before the government would be better off retaining its investment in Leiola Duty Free rather than sell. However, even this analysis is too simplistic, for the following reasons:

- The analysis is based on profitability. However, in cash flow terms, the dividend flow is more important. There is no guarantee that 100% of profit will be paid out in dividends.
- Cash in the bank today is always more valuable than the promise of cash in the future.
- The government eliminated its exposure to the commercial and business risks associated with its investment in Leiola Duty Free.

The government was able to redirect the sales proceeds into other government activities such as repaying debt or into important social needs such as health and education, which arguably have a greater economic value than a commercial investment.

Source: ADB analysis of data provided by the Ministry of Public Enterprises.

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\(^{17}\) As of end 2011, the cost of power in Tonga was T$0.98 per kilowatt-hour (kWh). The government agreed in May 2011 to subsidize the first 100 kWh by T$0.11 for 3 months. This affected 63% of Tonga Power consumers.
State-Owned Enterprises Crowd Out the Private Sector

The problems of low productivity are compounded by the crowding out of the private sector in areas such as telecommunications, printing, waste collection, broadcasting, and financial services where the private sector competes directly with some SOEs. However, these SOEs do not operate on a commercial basis. They have access to subsidized loans and generate low dividend yields, thereby crowding out their private sector competitors, which must achieve a risk-adjusted ROE for their owners and pay commercial interest rates on their debt. Not only do private sector operators have to compete with subsidized SOEs, but also some government departments that engage in commercial activities. The former Ministry of Works and Disaster Management, for example, undertook a commercial septic tank emptying service in direct competition with private sector firms. In mid 2011, the truck used to empty septic tanks was transferred from the Ministry to an SOE, Waste Authority Limited, enabling the SOE to undercut the pricing of the competing private sector providers.

State-Owned Enterprises Provide Costly and Inefficient Infrastructure Services

Power, water, airport, and port services are provided by SOEs throughout the country. For various reasons, the costs of these services are high even in comparison with the high cost of infrastructure services in other Pacific countries. Figure 3 (below) shows the relative cost of power in Pacific island economies, normalized on Solomon Islands, which has the highest cost of electricity to commercial users in the region. The cost of electricity in Tonga is approximately 80% of that in Solomon Islands, substantially above that in much smaller countries, such as Nauru and Palau. Similar comparators, such as Samoa, have much less costly electricity. One of the reasons for the high cost of electricity in Tonga is the inefficient fuel transfer mechanism. Diesel oil, which provides the majority of energy for power generation in Tonga, has to be transshipped through Fiji onto smaller tankers because storage capacity in Tonga is limited. As a result, the landed cost of diesel is high. Although development partners are subsidizing alternative energy facilities, the installation of a fuel tank farm, consisting of large storage tanks, together with other initiatives such as an oil price risk management strategy and a more efficient fuel supply chain, would go a long way toward reducing the cost of electricity. According to some estimates in Tonga, this would result in savings of 20% on the cost of electricity, which would bring the cost of power to below the regional average.

Tonga is committed to moving from a virtual total reliance on diesel for electricity generation to a greater use of renewable energy sources. The Tongan Energy Road Map (TERM), which was adopted in 2010, set an ambitious target of achieving 50% renewable power generation by 2012. TERM has been a successful mechanism to enhance donor coordination and interaction with the government. Tonga’s major donor partners have agreed to work within the TERM structure.

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18 Finding Balance 2011 shows that the Tongan SOEs’ average ROE and cost of debt for the FY2002–FY2009 period were 5.8% and 6.1%, respectively. Further, during that period, the government injected an additional T$15 million into the SOEs.

19 Following the Government of Tonga’s restructure of ministries in July 2012, the Ministry of Works and Disaster Management and the Ministry of Transport merged to become the Ministry of Infrastructure.

20 Estimated return on investment in a fuel tank farm is 15% per year.
The majority of SOEs comprise smaller companies with total assets of $T5 million or less, some competing with the private sector. Six SOEs are in this category, namely, the Tonga Broadcasting Commission, Tonga Market, Tonga Post, Tonga Print, Tonga Timber, and the Waste Authority. These smaller SOEs require as much time for effective ownership monitoring as the larger SOEs. It is recommended that the government look to either merge these SOEs, formally or through the development of shared services; or privatize them, thereby reducing the burden on monitoring resources and freeing up capital.

**Details of the State-Owned Enterprise Reform Measures**

Improving the efficiency of SOEs is an urgent policy priority for several reasons:

- The government is increasingly resource constrained—more efficient SOEs will contribute to reducing the resource constraint.
- Low productivity has been the major cause of low growth. Tongan SOEs, which utilize capital inefficiently, have been one of the major factors in the poor growth performance.
- The competitiveness of the private sector is hampered by high costs of services provided by SOEs.

21 Renamed Tonga Forest Products Limited in 2011.
The government has accepted the need for SOE reform and since 2008 it has, through the Ministry of Public Enterprises, made significant progress. The most notable reforms to date have been the following:

- The government’s 75% shareholding in Leiola Duty Free was privatized in 2008, and all of the assets in Tonga Machinery Pool were sold and the company liquidated in 2009. The boards of 10 of the 13 SOEs were restructured in 2010, with all politicians and civil servants serving as directors replaced with private sector appointees. The financial results for all SOEs for FY2008 and FY2009 were published in local newspapers, in Tongan and English, including brief commentaries on each SOE’s key performance drivers. The publication of financial results has continued as required by the 2010 amendment to the Public Enterprises Act 2002, which is a major step toward improved transparency.

- Rationalization strategies have been developed for all 13 SOEs with assistance from ADB.

- An amendment to the Public Enterprises Act 2002 was enacted in October 2010, introducing significant enhancements to the SOE legislative framework in Tonga. The major enhancements were:
  - The introduction of a principal objective for all SOEs to operate as successful businesses, which is defined as being as profitable and efficient as businesses not owned by the state;
  - Robust community service obligation provisions that require a written agreement, full costing (including a profit margin), transparency, and a clear statement that the government must provide a formal direction to the SOE to undertake a community service obligation before it can be funded;
  - Enhanced director’s duties and obligations that make it clear that all decisions taken by directors must be consistent with the principal objective of operating as a successful business. Provisions dealing with conflicts of interest established in the Companies Act were imported into the Public Enterprises Act, so that they now apply to company and non-company SOEs alike;
  - Improved transparency and accountability in relation to an SOE’s key planning documents such as the business plan, which includes the requirement that a summary of the annual report, prior year’s budget, and next year’s forecasts be published in local newspapers;
  - A prohibition on the appointment of politicians as SOE directors; and
  - Where civil servants are appointed, only one can be appointed to any given SOE, and never as the chairperson.

- The amendment to the Public Enterprises Act 2002 also established a process whereby the Ministry of Public Enterprises could be restructured into an SOE holding company, with all or some of the SOEs transferred into the holding company as subsidiaries.

- In June 2011, the Minister of Public Enterprises successfully applied to have the joint venture company that owns the International Dateline Hotel placed into

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22 However, ministers may be appointed to the board of start-up SOEs for 12 months.
23 The joint venture company is 49% owned by the Government of Tonga and 51% owned by a PRC SOE.
liquidation by the court. This should allow the government to regain control of the hotel—once it has proven its loan to the liquidator’s satisfaction—and then seek private investment or ownership to reestablish the hotel as a high-quality accommodation facility. The government awarded the role of sales agent to the International Finance Corporation (IFC).

- Tonga Power was established in 2008, when the generating equipment and infrastructure was repurchased from private owners. It made a -2% ROE in FY2009. In FY2010, the company’s financial position improved markedly as a result of improved governance and a clear commercial mandate. It achieved an 8% ROE while generating sufficient cash flow to invest T$5 million back into the business and pay the government a T$1 million dividend. It also reduced accounts that were overdue 30 days or more, from T$2 million at the beginning of FY2009 to only T$174,539 at the end of that financial year.

The financial performance of the SOE portfolio is expected to improve over the next few years, provided that the government fully implements the provisions of the Public Enterprises Act and continues with the reform agenda. Indeed the FY2010 ROE of 2.5% showed a solid improvement over the -0.4% ROE recorded in FY2009. Tonga Power achieved a profit of T$3 million (an 8% ROE) for FY2010 and Tonga Development Bank’s profit for the same period was T$1.5 million (also an 8% ROE).

The Minister of Public Enterprises made it clear that directors will be held accountable for poor financial and operational performance, and for timely reporting, as required under the Public Enterprises Act. His resolve was illustrated by the restructuring of the boards of two nonperforming SOEs in February 2011, although the cabinet subsequently reversed one of these restructurings.

However, the Ministry of Public Enterprises and many of the SOEs are constrained by a shortage of qualified personnel, which could frustrate the expected improvement in SOE performance unless the government adopts a more strategic approach to its ownership interest in the SOEs.

**Downsizing the Civil Service**

Despite the recognition that the public sector payroll constitutes a drain on the budget, little progress has been made in reducing the financial burden of the civil service on overall government expenditure (Figure 4). Furthermore, salaries and wages (including retirement contributions) have risen sharply as a percentage of current expenditure since 2008. Essentially, the government has been cutting back on other necessary spending in order to maintain the salary and wage bill.24

While ensuring that wage policy is transparent and predictable, other measures that the government had been considering as part of the policy implementation have not yet been put into place. For example, the salary and wage package initially included abolishing more than 500 vacant positions in the civil service, which would have placed a potential ceiling on the public sector wage bill. This has yet to be implemented. Furthermore, the government has embarked on a rationalization of ministries—effective 1 July 2012—combining, for example,

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24 Although as a percentage of GDP, the public sector payroll, including provident fund contributions, has declined from its peak. Nevertheless, it remains substantially above 2008 levels.
the Ministry of Tourism with the Ministry of Labour, Commerce and Industries (to create the Ministry of Commerce and Tourism). Plans to combine the Ministry of Finance and National Planning with the Ministry of Revenue Services were abandoned, leaving these as stand-alone Ministries.25 However, in announcing the rationalization program, the government advised that there would be no corresponding reduction in civil service numbers.26

The impact of wage policy on the private sector has been substantial. First, the pressure on the budget, an increasing part of which is made up of salaries and wages, has led to the implementation of stringent tax policies including the delays in consumption tax refunds mentioned above. Second, the high wages in the public sector have the unintended consequence of increasing salaries and wages in the private sector, but not as a result of productivity improvements. Third, other government purchasing from the private sector has been reduced to meet the public sector wage bill.

The government has recognized the drain that the wage bill places on public finances and is in the process of reviewing wage policies to reduce the overall burden on the budget. Measures to reduce the impact on spending need to be adopted without delay.


Improving Infrastructure

One of the functions of an effective government is to provide quality infrastructure in the most effective way. The 2008 private sector assessment (PSA) concluded that poor infrastructure added substantially to the costs of doing business in Tonga. However, in the subsequent 3 years, the quality of physical infrastructure in Tonga deteriorated further in a number of areas as budget pressure and claims on revenue from public sector salaries drained resources from maintenance and additional construction.

Roads

Following the government’s decision in 2008 to retrench all of the then Ministry of Works and Disaster Management’s daily paid workers involved in road maintenance in order to save money, little road maintenance has been undertaken on Tonga’s roads. The government’s intention was to contract out road maintenance, but as the budget constraints tightened in FY2009 and FY2010, contracting out did not occur. As a result, the quality of some roads has steadily deteriorated.

However, additional maintenance and construction projects are now progressing. The Government of the PRC has provided a grant to resurface a number of secondary or feeder roads on the main island of Tongatapu, and a concessionary loan for road maintenance within Nuku’alofa and throughout Tongatapu.

ADB has provided a grant of $11.3 million to upgrade two major access roads into Nuku’alofa. The project also involves upgrading the drainage and footpaths to minimize flooding and the flow of pollutants into the adjacent lagoon. The first contract under this project was awarded in August 2008, but the major roadwork component commenced in February 2011 and construction was still underway in November 2012.

The World Bank and the Australian Agency for International Development (AusAID) agreed, in December 2010, to provide $9.3 million under their existing Tonga Transportation Consolidation Project to address maritime issues and support road maintenance. Part of the grant will be directed at developing local road maintenance capacity. The grant will also provide funding to undertake the maintenance work.

Shipping and Air Transportation

With the sinking of the Princess Ashika ferry in July 2009, Tonga was without full ferry services between its major island groups for over a year. While a private ferry operator provided service to most islands, the Niua Group was without a ferry altogether. Furthermore, the private boats were much smaller than the Ashika. The replacement ferry, built by the Government of Japan and gifted to the Government of Tonga, did not commence service until late 2010. Therefore, for more than 12 months, trade within Tonga was severely restricted, with an adverse impact on economic activity and incomes of Tongans engaged in interisland trade.

The global economic crisis substantially reduced the level of imports into Tonga to a point that compromised the viability of some shipping lines. As a result, shipping services have been rationalized, and there is now a conference arrangement with a shipping frequency...
of 15 days that, in turn, has adversely affected the export market. For example, only 50% of watermelon crops are now export-viable.

The cancellation of the Air New Zealand weekly Boeing 767 return flight from Auckland to Los Angeles, which stopped in Tonga and Samoa, has also had an adverse impact on the export of agriculture and fisheries products to Japan, New Zealand, and the United States. Tonga is now primarily served by Air New Zealand’s smaller Airbus and Virgin Samoa’s Boeing 737; neither of which have significant cargo capacity. In mid-2011, Air New Zealand recommenced using the Boeing 767 on a biweekly Auckland to Tongatapu return flight, or when passenger and cargo loads warrant the flight. This means that exporters must work closely with the airline to ensure the larger plane is available when required.

A domestic air service is provided by a New Zealand-owned company, Chathams Pacific. The airline operates a fleet of aircraft including a Convair CV580, Metroliner, a DC3, and a Queen Air. The frequency of the services varies and, while the airline flies to all of the major island groups, some routes are only served every 2 weeks. The return adult airfares between the islands of Tongatapu and Vava’u, and Tongatapu and Ha’apai are T$462 and T$306, respectively. Apart from passenger luggage, very little cargo is carried on these services. Air Pacific announced in December 2011 that it would commence a return service from Suva in Fiji to Tongatapu via Vava’u, which should provide some limited competition for domestic air services and increase cargo capacity. However, by November 2012, the service had yet to commence.

Telecommunications

Tonga is highly competitive in the area of mobile phones, with costs among the lowest in the Pacific. There are two main providers: Digicel and the government-owned Tonga Communications Corporation (TCC). Since its entry, Digicel has experienced explosive growth and now estimates that its market penetration is over 100% (i.e., there are more mobile phone subscriptions than the total of the population). TCC is the sole provider of fixed-line services, with over 9,500 clients, most of whom are commercial customers.

Digicel is innovating rapidly. In January 2011, it introduced Mobile Money, a mobile payments system. By March 2011, the company had 15,000–16,000 active Mobile Money clients.

Competition is also strong in internet services provision. However, due to limited capacity through the existing satellite connection, pricing has been high and connection speeds have generally been slow. Pricing incentives contribute to the slow connection speeds. Both companies had originally based their pricing on connection speeds rather than volume, which encouraged local DVD rental businesses to download videos and produce pirated DVDs for rent, thereby reducing the available bandwidth for other users. In 2011, TCC introduced volume-based pricing to address this issue.

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27 The governments of both countries stopped subsidy payments to Air New Zealand, which resulted in the service being discontinued.
Tonga’s prosperity is crucially dependent on its ability to connect with the outside world. ADB and the World Bank are cofinancing a project\textsuperscript{28} (on a grant basis) to connect Tonga to a submarine fiber optic cable. The total project cost is estimated at $34 million and the government will be investing some $6.6 million into the project. The preferred link is via the existing Southern Cross Cable, which would require a connect point in Fiji. The government is well advanced in its planning and implementation. The contract to lay the cable was awarded in May 2012 and it is expected that the cable will land on Tongatapu within the first quarter of 2013. If managed properly, this development could open up new business opportunities, such as the development of international call centers, and support growth in tourism and the private sector in general.

**Modernizing and Rationalizing Commercial Laws**

**The Companies Act and Registry**

The 2008 PSA identified significant constraints arising from an incomplete commercial legal framework, including an outdated Companies Act, with the additional complicating factor that the company registry was destroyed by fire in 2006. Company law experts, financed by ADB’s Private Sector Development Initiative (PSDI), worked with registry experts from the IFC to implement the necessary legal reform. After extensive consultation, an amendment to the Companies Act was drafted which, among other matters, provided for the establishment of a new electronic registry. The Legislative Assembly passed the Companies (Amendment) Act in September 2009, and the interim registry commenced on 1 December 2009.

However, due to the anticipated funding source becoming unavailable, a fully electronic registry is not in place as yet. As a result, filing of information and searching is limited. For the long-term operational efficiency of the registry and ease of registration, implementation of a fully electronic registry is crucial.\textsuperscript{29}

The amendment to the Companies Act is not as comprehensive as some new Companies Acts in the region, in particular that in Solomon Islands, where the Act allows for the formation of companies that are particularly suited to the communal nature of Pacific countries. For example, in Solomon Islands, there is a provision for the formation of community companies, in terms of which communities can incorporate to manage business activities that are relevant for the community as a whole, rather than those of individual entrepreneurs. Once the Tonga Companies Act is fully functioning with the support of a complete electronic registry, consideration should be given to further amend the Act to emulate the more innovative provisions found in Solomon Islands.

**Filling the Gaps in the Commercial Legal Framework**

The commercial law in Tonga has many gaps, which impact significantly on the private sector. For example, in 2003, an amendment to the Civil Law Act 1996 removed all of the English

\textsuperscript{28} ADB. 2011. *Grant Agreement for Tonga-Fiji Submarine Cable Project between Kingdom of Tonga and ADB.* Manila.

\textsuperscript{29} An electronic registry funded by PSDI has recently been introduced in Solomon Islands. This enables the online incorporation of companies, filing of returns, etc. The registry also supports a robust search capability.
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statutes of general application from Tongan law. As a result, essential statutes such as the Sale of Goods Act, the Trustee Act, and the Insolvency Act no longer apply in Tongan law.

Tonga needs to fill in the gaps in existing legislation, as recommended in the 2008 PSA. In particular, the absence of a Personal Insolvency Act increases the risks to lenders and damages the supply of credit more generally. An insolvency bill was presented to the legislature in 2009, but failed to pass. Resubmission of the bill is strongly recommended.

The private sector would also benefit from codification of the general law of contract. As outlined above, the missing laws create considerable uncertainty for businesses and individuals, and this is acute when forming and enforcing contracts. A codified approach would provide a single binding written text. It would improve accessibility, use, and enforcement of contracts. An earlier diagnostic reviewed the legal framework for contracting in Tonga and recommended a form of codification. This recommendation received universal support from both private and public sector stakeholders.30

As part of this codification, the introduction of a legal framework for arbitration and electronic transactions should also be considered. There has been some work done on mediation, but a modern Arbitration Act with supporting institutions would facilitate rapid dispute resolution and assist with enforcement. Essential to this would be reform of the enforcement of arbitral

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**Box 3  Business Licensing Problems**

Some quotes from a business owner regarding licensing problems

What I want to know is why I now need three licenses to operate, for example

- to import my raw materials (surely that is inherent in running a business in Tonga);
- to trade (e.g., to manufacture goods); and
- to export.

I was told I also need a retail license, though I have not taken this one up yet.

The above procedures are cumbersome and expensive. And to obtain all this, I also needed a tax clearance from the Internal Revenue Department.

Surely, one license should fit all aspects of your business. It is a bit like the restaurant/bar industry with the very high licensing fees.

I thought the whole idea was to encourage tourism, not kill it, as they seem to so successfully be doing right now. Licenses require businesses to close early. But when we have people here, they want to go out while on holiday. And the closing hours won’t affect road traffic accidents. People simply “go through the back door” to get what they want if they really wanted to.

Source: Remarks made in an interview with a Tongan entrepreneur.

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awards, both domestic and foreign. Given the growth in electronic transactions in all areas of the private sector, Tonga must give consideration to enacting an Electronic Transactions Act that would ensure legal certainty for all transactions made electronically. Some countries in the Pacific have already addressed the substantive issues regarding electronic transactions reform, and it would be advisable for Tonga to consider the approaches taken by its neighbors, which are primarily based on the United Nations Commission on International Trade Law Model Law on Electronic Commerce.

Removing the Barriers Created by the Present Business Licensing Regime

The 2008 PSA described the business licensing process as “byzantine,” involving numerous regulations that were difficult to comply with and which greatly increased the challenge/s of doing business in Tonga. It emphasized that the practice of licensing businesses by activities rather than by the business itself imposed substantial costs on the private sector. Unfortunately, little progress was made in this area until November 2011. Rather, it became more costly, with the process seriously undermining the benefits of other reforms at a time when businesses in Tonga were already facing severe problems because of the fall in demand (Box 3).

Box 4 Visa Requirements for Foreign Investors

- Applications must be lodged prior to arrival in Tonga.
- You must provide one recent passport photo (for all applicants included in the application).
- You must provide an application fee of T$345 and any other required fee(s). Please note that the fee must be paid to immigration before application is referred to the Ministry of Labour, Commerce and Industries.
- Application form must be appropriately and fully completed. Please note that one family can share one form.
- Signed declaration (page 3 of the application form) – the applicant’s signature is required (no “sign for” forms).
- You must provide a valid passport.
- You must provide a medical report (in accordance with the prescribed medical form) issued within the past 3 months.
- You must provide a National Police Clearance issued in the past 3 months (for persons over the age of 16) from country of ordinary residence.
- You must provide two current character reference letters from two individuals who have known the applicant for a significant period of time (referee’s full contact details to be provided, which will be verified by the visa officer).
- Please provide a copy of the Foreign Investment Certificate.

Source: Requirements for Obtaining a Business Visa from the Ministry of Labour, Commerce and Industries.

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31 Editor’s Note: Subsequent to the PSDI support in drafting the Business License (Amendment) Bill, the Tongan Parliament passed the Bill in October 2012 although, at the time of printing, the new Act is yet to be released for review.
The Business Licenses Act 2002 and Regulations 2007 govern business licensing in Tonga. The Act and Regulations mandate a licensing framework that is inefficient, costly, and counterproductive to the broader goal of promoting investment, employment, and growth in the country. The private sector identified the licensing framework as one of the main factors responsible for the deterioration of business conditions over the 2009–2012 period.

The requirements of the licensing framework are onerous. The Act requires licenses to be issued for business activities, rather than for an individual business, which is the practice in virtually every other part of the world. Therefore, a single business engaged in a number of activities has to obtain a license for each activity, and each license has to be renewed annually. Since the regulations identify some 100 different activities, the process is tortuous and costly. Most business activities require the approval of several ministries. The process imposes large costs because of the delays and lack of clarity, as well as the improper exercise of discretion in approving licenses, which is not mandated in the Act.

The degree of discretion that is embedded in the process is a particular problem. For example, there are still no clear criteria for meeting licensing requirements, especially in the tourism industry. An additional problem is that the licensing scheme, complex as it is, is now being enforced much more rigorously as the government looks for more sources of revenue. There is a real danger that licensing complexity and enforcement will damage the private sector to such an extent that it will take many years to recover.

The 2008 PSA pointed out that Tonga needed the skills and capital of foreign investors. Yet for foreign investors, the licensing process is even more complicated. Box 4 contains published requirements for business visas. These requirements must be satisfied before the prospective investor enters the licensing process. While many countries have extensive procedures for obtaining a visa, many of them do not need foreign investment as urgently as Tonga. In most countries, business visas are granted for several years and are automatically renewed. In Tonga, the uncertainty arising from having to submit a full application for a business visa every 2 years has a prohibitive impact on foreign investment.

Furthermore, the problems are compounded if a foreigner wishes to invest in the tourism industry. Since business licenses must be renewed every year, there is no guarantee that once the operation is up and running, a license will automatically be granted the following year (Box 5). Few investors would be prepared to make a substantial investment without assurances that the future of the business would not be threatened by the withholding of a license. And even though the government has made promoting tourism a key policy target, there is a clear disconnect between the licensing process and promoting investment in the tourism sector.

For example, a restaurant owned by a non-Tongan has to obtain the following licenses on an annual basis (except for a health certificate, which has to be obtained quarterly):32

- general business license;
- foreign investment certificate;
- liquor license;
- tourist license;

Obtaining the necessary documents could take a full month each year, which imposes a significant cost on business owners. The problem is compounded by missing and unclear legislation governing aspects of the process. Furthermore, the licensing process appears to be directed at increasing revenue rather than licensing or regulating businesses effectively. The government has set revenue targets for ministries responsible for issuing licenses, which undermines the process of licensing businesses. Business licenses should not be a source of revenue, but rather reflect government’s enforcement of minimal regulations. In some cases, license fees have increased by a factor of eight when the 2011 fees are compared to those levied in 2010.33

Using the business license regime to raise government income increases the cost of goods and services, the burden of which is often disproportionally carried by the poorer sector of society. The government recently threatened to close all bonded warehouses. The justification given was to combat smuggling. However, such a policy would cause duty on all goods in existing bonded warehouses to become immediately payable. The concern expressed by the private sector was that the move was motivated not by a desire to combat smuggling, but to improve the government’s short-term cash flow.

More generally, a strong disconnect exists between licensing and the goal of encouraging investment and business growth. Government officials point out that other government departments rely on the Ministry of Labour, Commerce, and Industries to enforce their regulations. However, this is no justification for a process that is imposing severe costs on the private sector and which more than offsets the benefits of Tonga’s extensive reforms in other areas. For example, the Companies (Amendment) Act 2009 has significantly reduced the time needed to register a new company. However, the next step of going through the licensing processes results in substantial delays.

33 The wholesale/retail license fee went from T$1,000–T$8,000 per year in the 12 month period between 2010 and 2011.
The entire framework for business licensing requires review and comprehensive reform, to ensure that the licensing process does not undermine the extensive reforms in other areas of the business environment. Implementation of the IFC’s recommendations is needed urgently. As a consequence of sharing an early draft of this PSA with the then Ministry of Labour, Commerce and Industries, a cabinet paper, sponsored by the ministry, was submitted in November 2011. The paper set out a “Business License Reform Road Map” and recommended a holistic review and the restructuring of the business licensing regime. Cabinet approved the paper and a task force was established to develop and implement the road map. Amendments to the Business Licenses Act (drafted with the support of PSDI) were tabled in Parliament in September 2012. The amendment moves the focus of business licensing from licensing activities on an annual basis to licensing businesses on a multiyear basis. Supporting regulations to implement these changes have also been drafted and have been submitted to cabinet for approval.

Increasing Access to Finance

The 2008 PSA reported that, in terms of several measures, Tonga has the best-developed financial market in the Pacific and that access to finance was, at the time, not a constraint to business expansion. However, in the subsequent period, there has been significant financial disintermediation in Tonga as a result of major changes in the demand and supply of credit. Part of the reason for the previous significant increase in credit was lax lending standards. When the financial crisis commenced, many loans went into default. Tonga went through a substantial construction boom, much of which was financed by credit expansion, as can be seen in the rise of the ratio of private sector credit to GDP from 47% in FY2006 to 55% in FY2008 (Figure 5).

At that point, severe financial disintermediation set in. Following a small decline in the ratio in FY2009, there was a dramatic decline in this ratio to less than 45% in FY2010. At the

![Figure 5 Ratio of Private Sector Credit to Gross Domestic Product](source)

end of 2011, the credit to GDP ratio was below that of 2006. This reflects the moribund state of the economy, together with a very large increase in nonperforming loans with the commercial banks to over 20% at the end of 2009. One of the two major commercial banks had to be recapitalized by its Australian holding company. Essentially, Tonga has experienced a financial crisis that is no different from that which occurred in other parts of the world. The effect of this crisis has been to substantially reduce credit supply as the banks repaired their balance sheets.

The combination of nonperforming loans and the weak economy has resulted in banks sharply curtailing lending with the result that the International Monetary Fund (IMF) now estimates that there is currently a substantial excess demand for credit. By mid-2012, the banking system was very liquid, and lending to business continued to decline, with the banks remaining cautious with respect to new lending. Although nonperforming loans have declined from the peak of nearly 20% of bank lending in 2009 to about 10% of loan portfolios by mid-2012, they remain a substantial reminder of the incautious lending practices of previous years. The introduction of the Personal Property Securities Act 2010 should reduce the risk of lending in the future, but it will take time for the effects of this reform to result in both increased lending and improved lending practices. Furthermore, the recovery of several large nonperforming loans has been hampered by the absence of a personal bankruptcy framework.

The Personal Property Securities Act

The 2008 PSA recommended the introduction of a Personal Property Securities Act in order to improve the framework for securing loans with movable property. The authorities made the introduction of the Act a priority and the Personal Property Securities Bill, which was drafted in 2009, went through additional consultation in early 2010. The draft received strong support from the private sector and financial community, and was submitted to the cabinet for final approval before going to the Legislative Assembly. The Personal Property Securities Act was passed in September 2010. An electronic registry became operational in April 2011.

Over 4,000 registrations that had been filed under the old system were reregistered in the new electronic registry. Banks strongly supported the introduction of the new legislation and, over the medium term, the risks of lending will decline. Analysis of the Personal Property Securities Act 2010 indicates that amendments will be needed, in particular, to deal with the issue of the separation of land and buildings, since in Tonga buildings are considered chattels or personal property. Further implementation of the Act is advisable to acquaint financial institutions with its use and to encourage the extension of its use to a wider circle of potential lenders, including trade credit by businesses.

Credit Bureau

The 2008 PSA also recommended the introduction of a credit bureau. Interest in obtaining credit information has increased in the interim, and the banks are investigating the feasibility of establishing a credit bureau. However, unless there is a significant degree of inclusion of non-bank financial information in a credit bureau, it would not be effective. For example, the tax authorities, Tonga Power, and the Tonga Water Board should also participate. The National Reserve Bank of Tonga has a central role in ensuring the sharing of information that could be used in a credit bureau. Work on a credit bureau is proceeding with assistance from the IFC, but has been delayed. A credit bureau is urgently needed and should be fast-tracked.
Supporting Agriculture, Fishing, and Tourism

Agriculture and Fishing

While agriculture accounts for a little more than 30% of total employment, most of the output is destined for the local market.\(^{34}\) Squash has continued to be exported to Japan and Europe, although volumes have been low. In addition, small amounts of cassava and taro have also been exported. During each quarter from December 2009 to December 2010, revenue from agricultural exports failed to reach T$1 million.\(^{35}\)

The 2008 PSA highlighted issues in two areas:

(i) the failure of Tonga’s biosecurity facilities to meet the import requirements of Australia and New Zealand, which has been a major limitation on the development of sustainable export markets; and

(ii) the ineffectiveness of Tonga’s agricultural extension programs, which failed to meet the needs of producers.

Since 2008, much has been accomplished to address the biosecurity/phytosanitary constraint. A chemical treatment facility was built in 2010 adjacent to the main port in Nuku’alofa, which the Ministry of Agriculture, Food, Forestry and Fisheries (MAFFF) manage. The facility can process produce such as watermelons. In addition, the heat treatment facility, located adjacent to the international airport on Tongatapu, was reestablished in 2010. It can treat produce such as breadfruit, chili, papaya, and tomatoes. The heat treatment facility has been corporatized and registered as a company, Tonga Export Quality Management (TEQ-M), with directors from both the public and private sectors. The government established TEQ-M as a state-owned enterprise (SOE) in 2011 and announced its intention to sell it to the local growers’ federation. The New Zealand Aid Programme has also provided assistance with the procedures and processes component of the biosecurity/phytosanitary framework, and agricultural exporters reported that it has become easier to send agricultural products to Australia and New Zealand.

While both the heat treatment and chemical facilities initially had some operating problems, the heat treatment facility became fully functional in 2011. The chemical treatment facility experienced some operational challenges and, due to poor maintenance by MAFFF, the New Zealand authorities withdrew the interim biosecurity certification in August 2011. The facility operated by TEQ-M has been substantially upgraded through funding from the Government of New Zealand. It achieved certification from the New Zealand Ministry of Agriculture and Forestry biosecurity auditors in May 2010.

The MAFFF has taken the position that it should control and, where possible, operate all phases of the agriculture sector. While the MAFFF indicated that consultations had begun with growers and distributors, private sector agricultural operators still complain that it is failing to

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\(^{34}\) This constitutes wage earners and those who are not engaged in subsistence agriculture.

\(^{35}\) Tonga Department of Statistics and National Reserve Bank of Tonga.
fulfill its roles as a policy advisor to the government and regulator.\textsuperscript{36} One manifestation of this is less than full cooperation from the MAFF in achieving the goal of full commercialization of TEQ-M. This assessment recommends that the chemical treatment facility should also be operated by the private sector, but regulated by the MAFF.

Tongan growers indicated that weak agricultural extension services continue to hinder the development of the agriculture sector. Users of the service report that agricultural extension fails to meet their needs because it is not market oriented. Rather, it provides advice on crops for which farmers maintain there is limited demand. Furthermore, they report that the information provided is of poor quality and limited usefulness. Upgrading agricultural extension to make it demand oriented, or contracting it out to a private operator is needed urgently as part of the MAFFF supporting the private sector in agriculture. Further services could be provided, such as broadcasting prices and market conditions for agricultural products through mobile phones.

These issues are hindering the expansion of the agriculture sector, which not only employs a significant portion of the working population in Tonga, but is also a large potential source of exports. Fundamental reform is urgently needed. In 2011, AusAID launched a regional technical assistance facility, the Pacific Horticultural and Agricultural Market Access Program, with A$12 million of funding. While the facility is relatively new, its establishment is seen as positive by the agriculture private sector.

The fishing industry reports that it is in the doldrums even though fishing stocks, with the notable exception of big-eye tuna, are adequate to support the industry.\textsuperscript{37} The main reasons for the depressed state of the industry are the following:

- Freight costs have soared, which makes it difficult to compete in the high value niche markets. In addition, the cutback in Air New Zealand’s wide-body aircraft flights has made air freighting more difficult.

- Health inspections cause severe problems. Food inspection, including fish exports, is conducted by the Ministry of Health, which does not understand the issues involved in exporting fish. Subsequently, there are often delays in obtaining health certification, with a consequent deterioration in the quality of exports.

- Exports of Tongan fish do not have European Union access, which limits the marketing and export potential of the industry. This, in turn, limits the attractiveness of the sector to potential investors.

- Small domestic fleets cannot benefit from scale economies.

- Fishing policy does not allow transshipment of fish, nor does it allow the refueling of vessels at sea. This has greatly limited the potential of the industry.

- Exports of sea cucumbers declined sharply in 2009–2010 because of overharvesting. Too many licenses were issued, even though scientific evidence suggested limiting the number of licenses.

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\textsuperscript{36} In April 2011, the MAFFF sponsored a paper to the cabinet arguing that the ownership of a commercial forest located on the island of ‘Eua and under the management of Tonga Timber (an SOE) should be transferred back to them.

\textsuperscript{37} One of the last remaining Tongan-owned commercial fishing companies, Alatini Fisheries, was placed into receivership in late 2011.
Promoting Tourism

Tourism arrivals totaled 40,000 in 2011, compared with 45,000 in 2010 and 50,000 in 2009. During 2007–2009, Tonga’s tourism industry benefitted from political uncertainty in Fiji, but this effect appears to have subsided and arrivals in 2011 were no higher than those in 2006.

The Ministry of Tourism held summits in Australia and New Zealand in February 2011 to inform local tour operators and industry representatives of what Tonga has to offer. However, with most Pacific island countries identifying tourism as a key driver of economic growth, it is difficult to see what Tonga’s point of differentiation is compared with the more established markets such as those of the Cook Islands, Fiji, Samoa, Tahiti, and Vanuatu. To address this, the ministry commenced a rebranding exercise and, in April 2011, appointed a New Zealand consultancy, BCG2, to help in this process.

The reconstruction of Vuna Wharf was completed in August 2012, but by October 2012, it had not yet been declared operational. The new facility is close to the center of Nuku’alofa and is expected to have a beneficial impact on cruise vessel visits compared to the old wharf, which is 4 kilometers from the center of town. However, there is still a lack of investment in the supporting tourist infrastructure. While rebranding may help generate an increase in visitor numbers in the short term, if the supporting infrastructure is not in place, then the gains may not be sustainable.

Even if the tourism marketing campaign is successful in raising the awareness of Tonga as a destination and brand, the lack of good-quality medium and large international hotels limits the country’s ability to accommodate higher value tourists. The only large hotel in Nuku’alofa, the International Dateline Hotel, is well below international standards. In the 2009–2012 period, there were a number of potential new hotel projects, but none eventuated. One major constraint is the licensing regime discussed in an earlier section. Although Tongan authorities indicated that tourism investments would be fast-tracked, the legal framework makes any investment in this sector completely dependent upon the goodwill of those in government, which is a risk that few large investors would be prepared to take. The acquisition of the Royal International Hotel near the Fua’amotu International Airport by the New Zealand-based Scenic Hotel Group, which was announced on 8 August 2011, could be seen as arguing against these concerns. However, it appears that the Scenic Hotel Group has entered into a joint venture with the hotel’s first mortgagee following the borrower’s default and has a management contract to manage the Royal International Hotel, but no capital at risk in the transaction.

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For example, there are no public toilets within the entire central business district.
Institutions to Support Private Sector Growth

The National Economic Development Council (NEDC), established prior to 2008, was seen by many as an indication of the government’s commitment to support private sector development. The NEDC was chaired by the Prime Minister and comprised key ministers, such as the ministers of finance; labor, commerce and industries; agriculture, food, forestry and fisheries; and tourism, plus representatives from the Tonga Chamber of Commerce and Industry and, more specifically, representatives from the agriculture, fisheries, and tourism sectors. The intention was that NEDC would establish overarching policies and initiatives to encourage private sector growth. However, it failed to live up to expectations and became ineffective, as it was not supported by the active participation of the Prime Minister and other key ministers.

The government that was formed after the 2010 elections decided not to revive the NEDC, but use the Cabinet Economic Development Committee (CEDC) as the main economic coordination and planning body. However, the private sector is not represented on the CEDC as it was on the NEDC and, as a consequence, there is no body that currently acts as an effective formal link between government and the private sector to debate and set policies that impact on the private sector and the economy. This assessment recommends that private sector representatives be invited to join the CEDC as well as the newly formed National Growth Committee.

The National Reserve Bank of Tonga, in conjunction with the Ministry of Finance and National Planning, sponsored an economic summit in Nuku’alofa, held on 7–8 March 2012. The private sector, relevant government ministries, nongovernment organizations, and representatives from community groups and churches attended the summit. A summary of the main findings and recommendations from this PSA were used as an input to the summit deliberations. An agreed outcome was the establishment of a formal structure to facilitate government–private sector dialogue, the National Growth Committee. At this stage, the relationship of the committee with the CEDC is unclear, and it is too early to tell how effective this structure will be. Nevertheless, its establishment is an important positive development. How the structure of the committee evolves will determine its long-term success, and this assessment urges close coordination with the CEDC.

The Tonga Chamber of Commerce and Industry has continued to be an effective lobbying and coordinating body. The industry representative groups, comprising agriculture, fishing, manufacturing, and tourism, established under the chamber’s umbrella, have been one of the few successes to come out of the NEDC structure.

The other positive initiative to be developed under the NEDC was the Business Opportunity Support Scheme, funded by the Government of New Zealand, with T$250,000 provided from 2009 to 2010. The scheme is designed to provide grants to entrepreneurs to undertake
Continuing reForm to Promote growth

39 The grants were limited to T$30,000 per applicant and applicants were required to contribute at least 30% of the cost of the study. The applications were assessed against a set of criteria by a subgroup of the NEDC called the Business Opportunity Support Scheme subcommittee. By the end of 2010, the bulk of the funding had been disbursed on various projects.

Another ongoing initiative, fully funded by the Government of New Zealand, is the Tonga Business Enterprise Centre. The Centre commenced in November 2010 and also functions within the Tonga Chamber of Commerce and Industry. The Tonga Business Enterprise Centre’s mandate is to support existing private sector small to medium-sized enterprises by providing business advisory services. The Tonga Business Enterprise Centre also provides training using both local and international trainers, and assists businesses and investors with information on available business support resources and the relevant government regulations.
Recommendations for Further Reform

In the areas where reform has occurred, Tonga is one of the regional leaders. The country has made great strides in reforming important parts of the business environment, particularly in business law and some areas surrounding SOEs.

However, reform success depends on ensuring that binding constraints are removed and that investments will not be damaged by arbitrary government actions. Uncertainty is the enemy of investment; by increasing risk, rates of return on investment projects must be so high that very few projects can qualify.

In many cases, the beneficial effect of the reforms to date have been undercut by the constraints created by the business licensing regime, which so undermines the progress made that the business environment is deteriorating rather than improving.

The overall goal of private sector policy should be to make Tonga the investment-friendliest country in the Pacific. To achieve this, the most important priorities for reform are to:

- Repeal the Business Licenses Act 2002 and replace it with legislation that provides for licensing businesses rather than activities. In addition, reduce uncertainties in foreign investment in the tourism industry by modernizing and simplifying requirements for foreign investors to obtain business visas, and allow foreign business investors in Tonga to gain long-term residency. A review is currently underway to improve the licensing and approval process.

- Restructure revenue collection and processing to speed up tax refunds, initially by allowing offsets of taxes owed by businesses against refunds owed to businesses by government in cases where tax amounts are not disputed, or where the amounts disputed fall below a minimum threshold.

- Enact key business laws on bankruptcy, contracting, trustees, electronic transactions, and arbitration to fill in the gaps in the commercial legal framework. Amend the Companies Act to provide for the creation of community companies and, in addition, participate in the regional development of a contracting code. Through PSDI, work will continue in these areas during 2012 and 2013.

- Complete the transition to a fully electronic company registry. ADB, through PSDI, is providing assistance.

- Investigate feasibility of building a fuel tank farm from both financial and environmental aspects, to help policy makers make a decision whether the proposal is desirable to reduce costs of imported fuel and optimize the supply chain and distribution network to reduce the cost of electricity.
• Reduce the size of the public sector wage bill to free up funds for urgently needed infrastructure and social spending.

• Continue with the commercialization of SOEs and develop shared services to counteract the lack of capacity and capabilities, particularly within the smaller SOEs. Where appropriate, privatize the smaller SOEs. Review the options to privatize Tonga Communications Corporation.

• Establish a joint government and private sector task force to work with international airlines and shipping services, to ensure that services are adequate to support Tonga’s international trade in a cost-effective manner.40

• Prohibit ministries from undertaking commercial activities unless there is a clear need that is not already provided by the private sector.

• Reform the MAFF to make it client-friendly. Commercialize and privatize the chemical biosecurity facilities and contract out the agricultural extension services.

• Upgrade infrastructure through greater use of contracting out.

• Ensure that a credit bureau is established at the earliest opportunity.

• Use the CEDC as a vehicle for meaningful engagement between the government and private sector through either regular (at least quarterly) meetings between the CEDC and the Tonga Chamber of Commerce and Industry, or by inviting private sector representatives to attend CEDC meetings. For reform to be effective, understanding between the private sector and the government of each other’s problems and concerns is essential.

To provide prosperity to its citizens and to ensure that Tonga can meet its external obligations, growth that is well above the historic long-term trend rate is required urgently. This implies that further reform needs to occur without delay. The private sector is effective and efficient, but is hampered by substantial barriers to business growth in the form of regulation and transactions costs. Improving the productivity of the private sector—thereby increasing the long-term growth rate—requires a more business-friendly environment. The recommended reforms will go far towards improving Tonga’s productivity, upon which its long-term prosperity depends.

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40 This could be the CEDC.
## APPENDIX

### Summary of 2008 Private Sector Assessment Recommendations and Progress to Date

<table>
<thead>
<tr>
<th>Recommendation</th>
<th>Progress to Date</th>
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</thead>
<tbody>
<tr>
<td><strong>Recovering from Two Shocks to the Economy</strong></td>
<td></td>
</tr>
<tr>
<td>• Rebuild Nuku’alofa as soon as possible.</td>
<td>Rebuild well advanced</td>
</tr>
<tr>
<td>• In undertaking the rebuild, use various sources of funding: in-kind loans, donor grants, commercial banks, and development banks.</td>
<td>Achieved</td>
</tr>
<tr>
<td>• Make sure the rebuild increases local employment.</td>
<td>Contract with People’s Republic of China Civil Engineering and Construction Corporation required use of local labor unless the required skills could not be found within local labor market</td>
</tr>
<tr>
<td>• The rebuilding should be transparent and competitive with open tendering and expert certification so that the construction meets local construction codes and is of good quality.</td>
<td>Achieved in the main through Nuku’alofa Development Corporation oversight</td>
</tr>
<tr>
<td><strong>Reducing the Presence of the State in the Economy</strong></td>
<td></td>
</tr>
<tr>
<td>• Ensure that state-owned enterprises (SOEs) operate on business principles—amend the Public Enterprises Act to include an obligation that SOEs operate as successful businesses.</td>
<td>Achieved through 2010 amendment to Public Enterprises Act</td>
</tr>
<tr>
<td>• Reduce the role of the state in the economy by privatization of SOEs, contracting out, and public–private partnerships (PPPs).</td>
<td>Two SOEs privatized; some contracting out and use of PPPs</td>
</tr>
<tr>
<td>• Continue to downsize the civil service.</td>
<td>Not achieved</td>
</tr>
<tr>
<td>• Formally adopt the guidelines on community service obligations (CSOs) and look to make the provision of CSOs contestable by tendering for minimum subsidies.</td>
<td>Provision of CSOs contracted out in some cases</td>
</tr>
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<table>
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<tr>
<th>Recommendation</th>
<th>Progress to Date</th>
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<tbody>
<tr>
<td>• Develop a PPP policy.</td>
<td>Not achieved</td>
</tr>
<tr>
<td>• Restructure civil service departments, redeploy staff from peripheral to core functions, review business processes for efficiency, and strengthen the code of conduct.</td>
<td>Not achieved</td>
</tr>
<tr>
<td>• Review civil service job levels, salaries, and conditions of service including performance targets.</td>
<td>Not achieved</td>
</tr>
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</table>

**Improving the Infrastructure**

<table>
<thead>
<tr>
<th>Recommendation</th>
<th>Progress to Date</th>
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<tbody>
<tr>
<td>• Before privatizing the power provider, restructure the power sector to encourage competition in generation, transmission, and distribution.</td>
<td>Subsumed under the Tongan Energy Road Map (TERM)</td>
</tr>
<tr>
<td>• Investigate the possibility of improving the cost and availability of internet and other telecommunications services by bringing fiber optic cable to Tonga.</td>
<td>Achieved</td>
</tr>
<tr>
<td>• Improve road infrastructure with increased use of the private sector and develop a long-term funding plan.</td>
<td>Program under way through World Bank Transport Sector Plan</td>
</tr>
<tr>
<td>• Ensure any investment in critical infrastructure includes adequate provision for maintenance.</td>
<td>Achieved in part</td>
</tr>
<tr>
<td>• For port expansion, leverage private capital and expertise through PPPs.</td>
<td>Port Authority used its own cash resources to fund the rebuild of Vuna Wharf which resulted in governance and management changes and work now being undertaken by external contractor with external funding</td>
</tr>
<tr>
<td>• Establish independent cross-sector regulatory authority to deal with competition and consumer protection matters</td>
<td>Not achieved, but will be reviewed as part of TERM</td>
</tr>
</tbody>
</table>

**Rationalizing Commercial Laws and Regulations**

<table>
<thead>
<tr>
<th>Recommendation</th>
<th>Progress to Date</th>
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<tbody>
<tr>
<td>• Create new statutes for the areas that lack them: arbitration, bankruptcy, personal property securities, and electronic transactions.</td>
<td>Personal Property Securities Act adopted</td>
</tr>
<tr>
<td>• Review contract framework with the view to codification.</td>
<td>Not achieved</td>
</tr>
<tr>
<td>• Modify the Companies Act so that transaction costs are lower and it is more relevant to Tonga.</td>
<td>Achieved</td>
</tr>
<tr>
<td>• Introduce a new electronic companies registry.</td>
<td>Partially achieved; hybrid manual/electronic</td>
</tr>
<tr>
<td>• Abolish the Price and Wage Control Act.</td>
<td>Not achieved</td>
</tr>
<tr>
<td>• Streamline the process associated with foreign investment.</td>
<td>Not achieved</td>
</tr>
<tr>
<td>• Continue regulatory reform, especially in the areas of business licensing and foreign investment.</td>
<td>Partially achieved*</td>
</tr>
</tbody>
</table>
### Recommendation | Progress to Date
--- | ---
- Have licensing done by company rather than by activity. | Not achieved
- Use the Task Force on Regulatory Reform as a place from which to forward suggestions to the National Economic Development Council. | Achieved

### Increasing Access to Finance

<table>
<thead>
<tr>
<th>Recommendation</th>
<th>Progress to Date</th>
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</thead>
<tbody>
<tr>
<td>- Pass a law that reforms the personal property securities framework.</td>
<td>Achieved</td>
</tr>
<tr>
<td>- Establish an electronic registry that records what collateral has been pledged.</td>
<td>Achieved</td>
</tr>
<tr>
<td>- Establish a credit information system linked to credit bureaus in Australia and New Zealand.</td>
<td>Not achieved</td>
</tr>
<tr>
<td>- Investigate the feasibility of introducing a microfinance pilot scheme.</td>
<td>Tonga Development Bank has introduced microfinance pilot scheme</td>
</tr>
<tr>
<td>- Promote competition between institutions transferring remittance funds, and use modern technologies such as smart cards and mobile phones to lower fees.</td>
<td>Greater level of transparency has improved competition and Digicel has introduced mobile phone banking</td>
</tr>
<tr>
<td>- Reform exchange control regulations.</td>
<td>Not achieved</td>
</tr>
</tbody>
</table>

### Land and Private Sector Development

<table>
<thead>
<tr>
<th>Recommendation</th>
<th>Progress to Date</th>
</tr>
</thead>
<tbody>
<tr>
<td>- Streamline and modernize the leasehold system and its administration.</td>
<td>Not achieved</td>
</tr>
<tr>
<td>- 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.</td>
<td>Not achieved</td>
</tr>
<tr>
<td>- Have a national debate on how best to achieve improved use of land.</td>
<td>Not achieved</td>
</tr>
<tr>
<td>- Consider extending women’s land rights.</td>
<td>Not achieved</td>
</tr>
</tbody>
</table>

### Making Agriculture a Growth Sector

<table>
<thead>
<tr>
<th>Recommendation</th>
<th>Progress to Date</th>
</tr>
</thead>
<tbody>
<tr>
<td>- Contract out agricultural extension and the phytosanitary processing for exports.</td>
<td>Heat treatment facility has been transferred to an SOE</td>
</tr>
<tr>
<td>- Seek support from funding agencies to deal with Australian and New Zealand phytosanitary standards.</td>
<td>Achieved through New Zealand government funding and the Pacific Horticultural and Agricultural Market Access Program</td>
</tr>
<tr>
<td>- Make the guiding principle of agricultural policy formation the idea that agriculture is the archetypical small enterprise sector.</td>
<td>Not achieved</td>
</tr>
<tr>
<td>- Reform the collateral framework so that it allows equipment to be financed and crops to be used for collateral.</td>
<td>Achieved through the Personal Property Securities Act</td>
</tr>
<tr>
<td>- Privatize the provision of agricultural supplies.</td>
<td>Not achieved</td>
</tr>
<tr>
<td>- Privatize postharvest to the extent possible.</td>
<td>Not achieved</td>
</tr>
</tbody>
</table>

* See Editor’s notes regarding the Business License (Amendment) Bill, passed in October 2012.
Source: ADB internal analysis, including progress comparison with the 2008 Tonga PSA action plan and recommendations


International Monetary Fund. 2011. *Tonga: 2011 Article IV Consultation—Staff Report; Staff Supplement; Public Information Notice on the Executive Board Discussion; and Statement by the Alternate Executive Director for Tonga*. Washington, DC.

International Monetary Fund. 2012. *Tonga: 2012 Article IV Consultation—Staff Report; Staff Supplement; Public Information Notice on the Executive Board Discussion; and Statement by the Alternate Executive Director for Tonga*. Washington, DC.
Continuing Reform To Promote Growth
Update of the Private Sector Assessment for Tonga

This analysis is a follow-up to Transforming Tonga: A Private Sector Assessment. It assesses progress made until early 2012 in reducing transaction costs and other barriers to growth identified in the 2008 private sector assessment. It concludes that Tonga has been one of the leading reformers in the Pacific in improving its business environment, although it has been impacted by the adverse macroeconomic shocks arising from the global economic crisis.

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 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: 1.7 billion people who live on less than $2 a day, with 828 million struggling on less than $1.25 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.