2nd March 2017

President Jim Kim
World Bank Group
The World Bank
1818 H Street NW
Washington DC 20433
USA

President Takehiko Nakao
Asian Development Bank
6 ADB Avenue
Mandaluyong City
1550 Metro Manila
PHILIPPINES

Dear President Kim and President Nakao,

Re: Tonga Letter of Development Policy

The Kingdom of Tonga is one of the first nations in the world to see in the new dawn each day, and we are similarly committed to being on the forefront of good governance, despite the challenging external environment we are faced with. Tonga, along with many of its Pacific neighbors is increasingly rocked by natural disasters of an unprecedented scale and regularity, and major risks to our land and way of life through seawater incursion and other dangerous effects of climate change. Tonga is also a place of economic dichotomy. We are one of the most distant places on earth from other centres of economic activity, yet strive to be part of global economic community and maintain open borders for trade and goods. As a result, despite its distance, Tonga is one of the most trade-intensive countries in the world.

In place since December 2014, this Government is only the second democratically elected government following fundamental political reforms and the first democratic elections in 2010. Honorable Samuela ‘Akilisi Pohiva is the first people’s representative to become Prime Minister, under the political reforms, which has provided a renewed impetus to focus development on supporting the weakest members of our society to achieve a more progressive Tonga supporting higher quality of life for all. To achieve this, the new Government in close consultation with all Tongans has developed a new Tonga Strategic Development Framework, 2015–2025: A more progressive Tonga: Enhancing Our Inheritance, which provides overarching guidance for the public sector, private enterprises and civil society. At the core of this framework is its focus on inclusiveness and sustainability that we target throughout our actions in pursuit of growth and development.

The Kingdom of Tonga embarked on an ambitious reform program in 2009 in response to the global financial and economic crisis. Reforms implemented to date have strengthened our public financial management systems, increased tax collections and improved public enterprise performance. Through the reforms, our debt position has stabilized, the allocation of public resources is more strategic and their use more efficient. Efforts to establish a more business-friendly environment have already led to tremendous improvements in the ease of doing business and further improvements to the investment climate are underway. Successive governments have been persistent in reform implementation, which led to substantial achievements despite volatile policy-making and administrative capacity in our small country.
At the same time, we recognize that some of the reforms and the deep institutional and structural changes that come with them require time to take root. Tonga is in the middle of a long reform process at which end we see a modernized, performance-oriented and accountable public sector; a vibrant private sector that drives growth and employment; and a strong civil society with healthy social networks that uphold our traditional values and actively participate in political and reform processes. This path requires continuous reform efforts and commitment at all levels of government and our society more widely.

While on this path, we are prepared to encounter and overcome numerous challenges and setbacks. A combination of external factors that include exposure to natural disasters and economic shocks, our extreme remoteness from major markets, limited natural resources, a small population, and wide dispersion of population and land present a constant weight on our shoulders. While we have been able to cope with frequent external shocks in the past, these nonetheless leave us with a growth path well below what we could have achieved otherwise. In addition, they divert attention, capacity and financial resources away from our reform path, thereby requiring even greater efforts to maintain a stable and consistent policy framework to achieve the desired results. While our risk of debt distress has been downgraded to moderate as a reflection of our successful reform efforts and cautious policy decisions, it still indicates that debt thresholds could be breached if there are external shocks or abrupt changes in macroeconomic policies.

This government cherishes, and is building even further on, our close relationship with our development partners. Since 2011 the Government and major development partners have been working together through the Budget Support Management Committee and its Joint Policy Reform Matrix (JPRM) process to develop, implement and monitor reforms for us to advance on our development path. This year marks the continuation of a reinvigorated reform program that was embarked on last year. The current fiscal year's budget support operations continue our close partnership between the Government of Tonga and key development partners by providing not only fiscal resources to support public service delivery but also technical support to the development of sound policies and reforms that help us to achieve our goals.

Aligned to the priority agenda of Government, the JPRM aims at building macroeconomic resilience to support inclusive growth and improved living standards. We plan to achieve this through building a strong fundamental fiscal position; further developing good governance and civil service performance; and engendering a dynamic, inclusive and sustainable economy.

In the first year of this program we introduced tax reforms to raise collections and provide incentives to consume healthy foods by raising the price of some unhealthy foods while cutting duty rates on healthy alternatives. The major new public service remuneration framework was approved, and a new medium-term debt management strategy put in place. New procurement regulations were introduced as were new institutions and processes to manage and ensure appropriate government follow-up of audit recommendations. To support a more dynamic and inclusive economy, a new ICT regulator was established in law, and governance of public enterprises was overhauled by introducing new and more professional "shared boards" of public enterprises.

This year we have improved the strength of the government books further, providing an ideal launching pad for more responsive and better performing public services. Revenue collections have been strengthened further by putting back in place duties on fuel that were
removed during peak oil prices in previous years, while also adding duties on foods that have harmful health impacts in Tonga, to encourage healthy life choices. The FY2018 budget now includes a clear and evidence-based vision for the public finances, which will help guide the economy along a sustainable path, despite the very large shocks that we are regularly beholden to. This strategy encapsulates much work already done by this government, including maintaining the revenue collections that we have built up, firmly keeping external debt to a manageable level and ensuring a sustainable wagebill, so that enough resources go to critical spending for public services and infrastructure. The final element of our fiscal reform program this year is the implementation of a new public sector remuneration framework, which ensures a fair and attractive return for skills and expertise and provides strong incentives for our civil service to perform at their full potential and continue to grow and develop professionally.

A quiet transformation of our public financial management and private sector regulatory frameworks is already well underway; and this program sees through major reforms that will ensure efficient public service resourcing and competitive markets. Following three years of building capacity and structures, this year the government launched a new procurement database which enables the fast processing of large procurement contracts, and monitoring to ensure that all due process is followed and that key performance indicators track the service standards of the public procurement system. As a culmination of a series of procurement reforms, we expect this to provide the basis of continued improvement in the speed of processing, competitiveness and compliance of procurements. Secondly, the Cabinet has approved a draft new Energy Bill which will create a regulatory framework for the whole sector. This Bill will now be carefully consulted to ensure it meets the people’s needs, before progressing to the National Parliament in due course. Tonga has seen great advances in the electricity sector over the past decade, including through the establishment of an independent electricity regulator. We are now extending this model in a cost-effective way to mandate an independent regulator for all energy sub-sectors to provide a similar level of effective regulation in the sectors of critical importance to both business and households in Tonga.

Finally, the private sector can be a driver of growth, even though we face an uphill struggle to deliver an effective economic strategy in a region where costs are high and markets small. Government efforts supported under the JPRM framework previously have helped reinvigorate the tourism sector by rebuilding and bringing under international management the largest hotel in Tonga, the Tanoa International Dateline Hotel. If you have not yet had the opportunity to visit, I warmly extend an invitation for you to come and stay here. We want to bring in more international investors like this, and to do so we have approved a new Foreign Investment (Amendment) Bill to go to Parliament which will make it far easier for investors to come here, and open up more areas of the economy to competition. Finally, our ongoing public enterprise reform program, which as a result has led to Tonga having the best-performing public enterprise portfolio in the Pacific region, is continuing. This year, we have carried out two substantial transactions – the first is a long-term concession over commercial forestry assets, which will bring in investment in new plantings, improve environmental management while ensuring adequate safeguards, and create sustainable jobs and livelihoods over the long-term. Secondly, the Government has agreed for a transaction to sell a minority share of Tonga Cable Limited to a private telecommunications operator, Digicel, which means the company is now jointly owned by Government, and the two main telecommunications operators – Digicel and Tonga Communications Corporation – putting them on a level playing field and bringing new capital to TCL for future investments in high-speed and affordable internet connectivity throughout the country.
Furthermore, we are committed to prudently manage fiscal risks that stem from the ongoing civil service reform and the Pacific Games hosting in 2019, both of which have the potential to derail our targeted fiscal balances and debt position in the medium-term. Exemplary of our prudent fiscal risk management is the commitment to finance Pacific Games investments without taking on new debt, and a recent reduction in the scale of the master plan which resulted in a 25 percent cost reduction of the games. We have now secured the majority of Pacific Games funding from grants from partners and are confident the full cost will be met in a prudent manner.

On the fiscal side, expected outcomes of these reforms over the three-year period are an increase in domestic revenue mobilization as a proportion of gross domestic product, a reduction in the public wage bill as a proportion of domestic revenue and improved value-for-money in public procurement. We also expect further improvements to the business environment resulting in increased interest from foreign investors in Tonga and growing private sector credit through a better functioning financial sector and business law environment, among others. In terms of infrastructure and service delivery, we anticipate consistently improving public enterprise performance and better regulation of goods and services, especially utilities.

The Government remains firmly committed to the three-year reform program encompassed in the joint policy reform matrix, which is instrumental to achieve the country's ambitious development targets. The Government looks forward to continued active engagement of its major development partners, including the Asian Development Bank and the World Bank, in Tonga's reform and development process.

Yours sincerely,

[Signature]

Dr. the Hon. 'Aisake Valu
Minister for Finance and National Planning