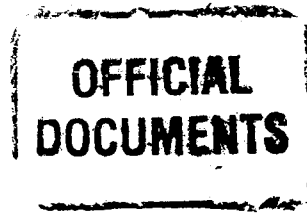


**OFFICE OF THE MINISTER FOR
FINANCE & NATIONAL PLANNING**

Reference: 69G/05



**MINISTRY OF FINANCE &
NATIONAL PLANNING
NUKU'ALOFA
TONGA**

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20th January 2016

Mr Jim Yong Kim
President
The World Bank
Washington, DC, 20433
USA.

Dear President Kim

Re: Letter of Development Policy

In its recent past and present, the Kingdom of Tonga has been experiencing several significant developments. This includes the major political reforms in our country that provide for increased participation by our people and make reform processes more inclusive and open. It also includes increasingly complex global networks, for example, for trade and aid flows, and technological changes that bring us closer to the world through better connectivity—physically and virtually through the advances in the field of information and communication technology. Lastly, it includes changes to our natural environment through climate change and related changes in weather patterns and natural disasters that threaten our very existence. All these present at the same time challenges and opportunities for our country and they have to be reconciled with and addressed in harmony with our traditional culture and values that we firmly believe are the basis for a high quality of life for all Tongans.

In place since December 2014, Tonga's new 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, 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 that severely affected our small, open economy. 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 dynamic 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 and achieve 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. The recent depreciation of the Tongan pa'anga against the United States dollar and the Chinese renminbi significantly pushed up external debt in percent of gross domestic product reflecting this volatility. Increasing climate change effects present new, additional physical and fiscal risks—the reasons for our active advocacy in global fora for the needs of small island developing states including the Kingdom of Tonga.

In light of this situation, our close relationship with our development partners is ever more important and valued. Since 2011 the Government and major development partners have been working together through the Budget Support Management Committee and its joint policy reform matrix process to develop, implement and monitor reforms for us to advance on our development path. This year for the first time we have prioritized and sequenced reforms over a three-year period spanning our fiscal years from 2015/16 to 2017/18, which aims to address some of the reform volatility we encounter in our country as a whole and at policy and administrative levels in the public sector. The current fiscal year's budget support operations continue our close partnership between the Government of Tonga and some of its 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 achieve our country's vision.

Aligned to the priority agenda of Government, the joint reform program aims at building macroeconomic resilience to support inclusive growth and improved living standards. We plan to achieve this through promoting good governance; an inclusive, sustainable and dynamic economy; and quality, affordable infrastructure and services for all.

In the first year of the three-year reform program, a newly introduced tax policy reform package will increase collections and incentives to consume healthy foods, whilst ameliorating adverse impacts. The approval and subsequent implementation of remuneration review recommendations is a crucial step toward prudent public wage bill management. A new medium-term debt management strategy footed on thorough analysis will help manage debt levels and fiscal risks including from foreign currency exposure. Continued procurement reforms help embed and guide the recently established central procurement unit, while a newly established Audit Oversight Committee of Cabinet will scrutinize implementation of audit recommendations across all spending agencies. These efforts will be sustained and gradually advanced over the three year period, as outlined in the joint policy reform matrix.

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 master plan scale, which resulted in a 25 percent cost reduction of the games.

Reforms to establish a sound foundation for a dynamic economy are critical for Tonga's development path. The new government prioritizes inclusiveness of growth to create decent employment opportunities across all of society, including for disadvantaged groups, and across all island groups. As a first step, Tonga will become a member of the International Labour Organization and adhere to its main labor conventions, based on which foundational employment relations legislation will be developed in subsequent years. Furthermore, analytical work has been initiated on several fronts in support of substantial private sector enabling reforms in the second and third year of the reform program. Resulting reforms to business law, foreign investment and in the financial sector represent some of the most significant program policy actions and aim to tap Tonga's growth potential.

Lastly, improving the delivery of basic service will benefit all Tongans. The first year's reform program includes the establishment of a regulatory function for communication services to promote their affordability and access, which will be complemented with broader regulatory reforms for utility providers, continued energy sector reforms and a new competition policy in subsequent years. Sustained public enterprise reforms will further increase efficiency and effectiveness in their operation and encourage private sector participation through public-private partnerships and outsourcing of functions.

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 rationalization in 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.

These reforms are complemented by an ambitious development expenditure program under the new government, initiated through the government budget in fiscal year 2015/16 and expected to continue in subsequent budgets over the medium term. Social sectors remain the spending priority of the new Government. As outlined in the Budget Statement and Estimates for fiscal year 2015/16, new priority expenditure programs include:

- \$2.3 million equivalent (T\$5.0 million) to implement civil service remuneration review recommendations in 2015/16, complemented by rationalizing staffing through careful review of all vacant posts and proposed new posts, with the intention of better aligning staffing needs to required outputs, and reducing the overall staff costs.
- expansion of maintenance programs to protect government infrastructure, including additional allocations of \$0.9 million equivalent (T\$2.0 million) for primary schools and \$1.4 million equivalent (T\$3.0 million) for road maintenance.
- increased operational budgets for priority social sectors, including additional \$0.5 million equivalent (T\$1.0 million) for primary education.
- \$0.4 million equivalent (T\$0.8 million) to implement the National Disability Policy, and \$0.3 million equivalent (T\$0.7 million) for charitable organizations while an allocation of

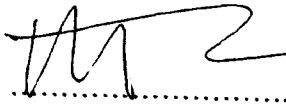
\$1.5 million equivalent (T\$3.4 million) will allow continued implementation of the existing social welfare scheme.

- \$0.5 million equivalent (T\$1.0 million) under the private sector initiatives fund to support youth development and micro finance for women.
- \$0.5 million equivalent (T\$1.0 million) in support of the electricity lifeline tariff to improve access and affordability for lower income groups.
- a new allocation of \$0.6 million equivalent (T\$1.4 million) for the Anti-Corruption Office and Ombudsman to function effectively and independently.
- \$4.5 million equivalent (T\$10.0 million) to further pay off the governments transfer value with the pension fund.

On our quest to promote more efficient and effective public spending, we are further reviewing expenditure of ministries and agencies to redirect spending on non-productive programs and reduce excessive spending on non-priority items such as overseas travel, fuel, and utilities. Together with our ambitious domestic revenue targets, which contribute to reducing dependency on budget support over time, the 2015/16 budget and two-year forward estimates strongly reflect the development aspirations of Tonga.

The Government remains firmly committed to the three-year reform program encompassed in the joint policy reform matrix, which is instrumental to achieving 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,



Aisake Valu Eke

Minister for Finance and National Planning

