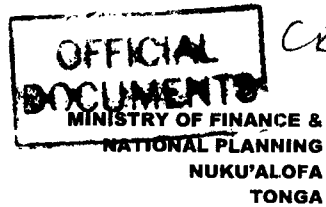




**OFFICE OF THE MINISTER FOR
FINANCE & NATIONAL PLANNING**

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25th September, 2014

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

Dear President Kim,

Re.: Letter of Development Policy

As reflected in our ongoing policy reform partnership with the World Bank over the last four years this Government has overseen significant reforms that have helped to modernise government processes, set in place the foundations for a more sustainable fiscal base, corporatise and improve the efficiency of Public Enterprises and deliver a series of business-friendly reforms to cut red tape and improve the environment for businesses.

Over the same period, the Tongan people have faced numerous setbacks, including the decline in remittances and dip in tourism demand arising from the Global Economic Crisis, severe spikes in the price of fundamental import products like diesel and foodstuffs, and most recently the terrible Cyclone Ian that devastated parts of the Tongan isles in January 2014. We have got back up after each of these shocks and recovered. However, the impacts and losses linger well after the event, and manifest themselves in a lower rate of economic growth than we could otherwise have expected thereby increasing hardship amongst some of the population and a strain on the fiscal and human resources of government.

Despite the external challenges we face, we firmly believe that the course we have set is the right one. With the sustained effort and continued advancement in key areas of reform, we will be in a better position to make good progress to deliver on the promise of the Tonga Strategic Development Framework (TSDF) for "a just, equitable and progressive society in which the people of Tonga enjoy good health, peace, harmony and prosperity, in meeting their aspirations in life". It is with this in mind that myself and my fellow ministers applaud the progress that this Development Policy Operation represents, not just in providing essential fiscal resources to support enhanced service delivery, but the effective knowledge and strong policy partnership that assists us in implementing key reforms.

There are four enabling themes in the TSDF, which will underpin the achievement of its objectives. These concerns progress towards a more efficient and effective government – including efficient government services to facilitate private sector growth through regulatory and

licensing reforms, improving the macroeconomic environment and fiscal management, ensuring the sustainability and accountability of public enterprises, and ensuring a more coordinated whole-of-government partnership with development partners.

Each of these enabling themes is reflected in the Bank's DPO, which is the fourth successive DPO focused on these themes, and is coordinated with other budget support partners. All the policies represented this year reflect achievements that are key to achieving the government's priority development objectives.

The first component of the Government's reform plan is strengthening public financial management. Under previous operations, Government instituted a new process for in-year fiscal reporting, submitted to the Audit Office all the outstanding financial statements, tabled in Parliament all audited annual financial statements of Government that have been completed up to the financial year 2011/2012, implemented new Contingency Fund controls and launched a new procurement reform action plan. Over the last year, the structure of the Ministry of Finance and National Planning has been amended to establish a new Central Procurement Unit which provides a central oversight function to ensure compliance and improve value for money in procurement across all of government. A newly issued Treasury circular establishes a new threshold over which the CPU will exercise oversight of procurement methods. Another key part of our drive to improve effectiveness of public funds is the implementation of a newly aligned corporate planning and budgeting framework. In the Annual Budget for Fiscal Year 2014/15, the majority of appropriations are now better linked to organizational units, which in turn have specific deliverables, providing greater transparency and oversight over the use of public monies. Again, this reform has been complemented by a Treasury circular that establishes a MFNP pre-approval for transfers to ensure the reforms are built into every ministry's budgeting.

The second component of the Government's reform plan is strengthening fiscal policy. Under previous operations, the Government took decisive action to better manage the public service wage bill and embarked on two important programs on tax and expenditure reform. The Government reviewed tax policy and administration and took steps towards implementation of significant tax policy and administrative reforms, including the small business with natural resource tax regimes being considered. Work is being done for publication in the annual budget statement of the full costs of tax expenditure. This year the government has implemented two tax reforms that acknowledge and seek to address the competing priorities of tax policy --to provide a solid revenue base whilst also supporting other national development priorities. In that light, Cabinet has moved to standardize and make more transparent the hitherto ad-hoc tax exemptions available to potential investors, by establishing a Revenue Policy Committee to advise on all requests and make public a set of eligibility criteria for prospective investors in priority sectors under the TSDF. Secondly, Tonga has recognized the urgency of the non-communicable disease crisis gripping our region, and as part of a broader set of measures, in the Annual Budget for Fiscal Year 2014/15 introduced amended excise duty rates to increase the duty on harmful products like tobacco and high fat and sugar foods, whilst easing rates on healthy choices.

The third component of the Government's reform plan is enhancing the business-enabling environment. Under previous operations, the Government has improved the business regulatory environment, with important changes to the business licensing regime and associated Business Names Act made that will substantially reduce compliance costs associated with registering and operating a business, and a revised framework for receivership prepared. Efforts have also been made to improve the efficiency of public enterprises, especially those that operate in key sectors, with the audited accounts of key public enterprises now available to the public. There will be a review of those public enterprises that could be considered with good potential for partial and/or full privatization under the prevailing economic conditions.

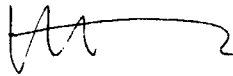
The government has a long-standing priority to provide more affordable energy, cognizant of the challenges and cost structures faced by Tonga Power Limited. Following a detailed study and public consultation, the Government has moved to implement an electricity lifeline tariff for the first time in Tonga, which will deliver large savings to the poorest households, but crucially not impact on TPL's ability to operate competitively. Over time we will continue to focus on further electricity tariff reform that supports greater generation efficiency. The World Bank has been a long-standing partner in supporting the work on this policy and we wish to recognize the significance of a reform that addresses complex multi-sector policy challenges. While we are continuing to improve the competitiveness of our other PEs, the difficult economic environment and costs of doing business in Tonga continue to make themselves known. Unfortunately, we were not able to finalise the comprehensive process of concessioning the International Dateline Hotel after the selected bidder backed out at the last minute. Nevertheless, we are exploring all avenues to find a solution for this tourism sector flagship hotel. We have initiated a second round of bidding, and should that not be successful, would like to actively engage with the World Bank Group to consider other options for private sector involvement in the Dateline.

Finally, we want to strike the right balance between providing opportunities and jobs for Tongans whilst at the same time welcoming investors and entrepreneurs from abroad that bring capital, skills and the know-how to help us prosper. In light of that, the Government has recognized that the foreign investment regime is overly burdensome and restrictive, and has set in place a plan to bring it in line with our economic growth priorities, especially encouraging investment in commercial agriculture, fisheries and tourism. In reviewing the framework over the last year, it is clear that a significant number of rules and regulations that stretch across two Acts need to be revised, and the changes will need to be consulted on. That is why this year we have launched a new policy framework for foreign investment, an implementation plan and public consultations, which will lead up to revised legislation next year. This is an important reform that this government, a broad group of civil society stakeholders and business leaders, and the Tongan people at large, recognize as crucial in getting the business environment right, and we are confident reforms will be carried forward in a spirit of bipartisanship under any future government.

The development aspirations of Tonga are strongly reflected in this year's budget, which was passed by Parliament in June. The budget included a continued emphasis on reprioritizing expenditure within sustainable fiscal limits in order to achieve better service delivery. It also provided for the continuation of the Social Protection program started in the previous financial year. The Government also remains determined to take the measures necessary to regain the fiscal space needed for Tonga to be able to respond to future economic shocks and natural disasters.

Despite the ongoing challenges that will no doubt come our way in the coming years, the Government is firmly committed to implementing this medium-term reform program. The Government looks forward to the continued active engagement of the World Bank in Tonga, in order to support this reform process.

Yours sincerely,



Aisake Valu Eke

Minister of Finance and National Planning

