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## SUMMARY

1. Since its previous Trade Policy Review in 2014 and until 2017, Tonga's economy grew at a strong pace, supported by construction and remittances-fuelled private consumption, as well as by an accommodative monetary policy stance. Real GDP grew on average by 2.35% (FY 2013/14-FY 2018/19) annually, compared with 1.27% (FY 2006/07-FY 2011/12) at the last period. A succession of natural disasters, namely the extensive damage caused by Tropical Cyclones Gita (2018), Tino (2020), and Harold (2020), and the large COVID-19-pandemic-induced contraction in global economic activity brought about a significant economic downturn. Apart from some temporary spikes in 2017-18, inflation remained low, reflecting favourable developments in international food and fuel prices. An Economic and Social Stimulus Package worth TOP 60 million was put in place to fund the National Action Plan for combatting the COVID-19 pandemic.
2. Tonga launched a comprehensive tax reform aimed at increasing revenue, addressing inequality, and discouraging consumption of various products deemed unhealthy. Changes were made, *inter alia*, to the pay-as-you-earn income tax, the consumption tax, excise taxes, and import duties. In their pursuit of fiscal consolidation, the authorities also took steps to improve public finance management and avoid non-concessional borrowing. However, Tonga's public debt remained above 41% of GDP during the review period, and the overall risk of public and external debt distress remains high. Various initiatives aimed at modernizing the monetary policy and macroprudential frameworks were undertaken as well. Despite the progress made, the toolbox of the National Reserve Bank of Tonga remains limited, comprising minimum reserve requirements for banks, the remuneration rate on required reserves, and foreign exchange controls.
3. Tonga's national currency remains in a pegged exchange rate arrangement, which may have an impact the economy's resilience to external shocks. In 2018, the legislation on capital controls was consolidated in a new Foreign Exchange Control Act and an Exchange Control Directive. Having reached 15% of GDP in FY 2014/15, the current account deficit narrowed to some 1.5% of GDP in FY 2018/19, reflecting steady improvements in the primary and secondary income balances that compensated somewhat for the widening merchandise trade deficit. The reserves coverage was in the range of seven to eight months of prospective imports during the review period. However, Tonga's foreign exchange reserves remain prone to rapid declines, given the country's high vulnerability to external shocks and significant external debt.
4. The relatively high exposure of Tonga's economy to international trade and its degree of openness continued to be reflected in a relatively high ratio of its total trade (exports plus imports) in goods and services to GDP. This ratio increased from 75% in FY 2013/14 to 87.2% in FY 2018/19. Cross-border trade trends reflect the challenges posed by Tonga's remoteness from international markets. New Zealand and Australia accounted for some 40% of Tongan exports in 2019, up from 32% in 2014. New Zealand also remained the principal origin of goods imported into Tonga, followed by Singapore and the United States. Main exports continue to be vegetable products (mainly squash, root crops, and coconuts) and live animals (mostly seafood).
5. According to the authorities, between 2014 and 2019 the bulk of foreign direct investment (FDI) into Tonga originated from China. FDI inflows were primarily channelled into services, notably professional services and tourism, followed by manufacturing/processing activities. During the review period, Tonga made efforts to ameliorate the legal framework governing its investment regime and undertook a landmark improvement in dispute settlement by acceding to the 1958 United Nations Convention on the Recognition and Enforcement of Foreign Arbitral Awards. Its lists of activities prohibited, restricted for foreign investors, and reserved for Tongan investors remained unchanged. Implementation of the new Foreign Investment Act 2020 and the review of its Foreign Investment Regulations, aimed at reducing the number of reserved activities and expanding the list of restricted ones, are under way. So far, no investment promotion via income tax incentives has been in place. Tonga's limited network of international investment agreements remained unchanged.
6. Since 2014, Tonga has implemented certain institutional changes and updated some of its trade-related policies in line with its broader strategic development framework. Its constitutional framework remained unchanged. Laws were consolidated, e-government initiatives were undertaken, and Tonga acceded to the 2003 United Nations Convention Against Corruption.

7. Tonga remains committed to the multilateral trading system, but its participation in WTO activities was relatively limited due to, *inter alia*, its lack of permanent representation in Geneva. It maintained its WTO commitments unchanged, and it is making efforts towards ratifying the Trade Facilitation Agreement (TFA) in 2021. During the review period, Tonga continued to follow a regional and international integration policy mainly focused on the Pacific region; the sole substantive development was its accession to the Pacific Agreement on Closer Economic Relations Plus (PACER Plus), whose tariff commitments are to be implemented within a 25-year timeframe. A few WTO notifications indicating the absence of relevant legislation (safeguards, subsidies and countervailing measures, and preshipment inspections), contact points (TFA, Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS Agreement), and trade in services), and dates of definitive implementation of TFA Categories B and C commitments were submitted during the review period; the authorities intend to have all outstanding notifications submitted by February 2021. Tonga was a recipient of Aid for Trade support.

8. The general thrust of trade and trade-related policies was revised in several areas. The simple average applied MFN tariff decreased from 11.5% in 2013 to 10.4% in 2020, reflecting mainly an increase in the share of duty-free tariff lines. Most import duties eliminated over that period concerned agricultural products. The simple average rate on dutiable lines remained virtually unchanged. All tariff lines remain *ad valorem* and therefore transparent; the tariff structure involving four non-zero rates (one fewer than in 2013) remains simple. Overall tariff dispersion remains relatively significant, with rates ranging from zero to 20%. Tonga has bound all tariff lines at *ad valorem* rates of either 15% or 20%. In 2020, the simple average bound tariff rate was 17.6%, some 7.2 percentage points higher than the average applied MFN rate. Applied MFN rates on four tariff lines partially exceeded their bound level.

9. A business licence remains the only prerequisite for engaging in cross-border trade. Importers have the choice to fulfil customs formalities themselves or to engage the services of professional customs brokers. According to the authorities, Tonga applies the WTO Customs Valuation Agreement and uses the transaction value of goods as the primary method. The customs legislation does not contain any provisions on non-preferential rules of origin. Having ratified PACER Plus, Tonga enacted regulations on the corresponding preferential rules of origin in December 2020.

10. Import licensing requirements continue to be used mainly for national security, public safety, health, and environmental reasons. Non-automatic licensing requirements apply on a number of imports (e.g. medicines, alcoholic beverages, tobacco, and cigarettes). The legal instruments governing restricted imports are not consolidated, and the granting of licences is administered by several line ministries and government agencies. According to the authorities, an import ban on lamb and mutton breast meat was implemented on 1 July 2020 to discourage unhealthy lifestyles. No legal and institutional framework for the application of contingency measures exists.

11. Tonga does not levy any export taxes; exports also remain exempt from internal taxes (zero-rated for consumption tax purposes). The exportation of green and mature coconuts remains reserved for Tongan businesses. The Ministry of Trade and Economic Development assists exporters with overseas publicity, participation in trade fairs and exhibitions, market research and development, and facilitation of business negotiations.

12. Tonga expanded considerably the list of excisable goods and modified some of their rates as part of its broad reform to reduce the consumption of what is considered unhealthy food and to address non-communicable diseases. Excise taxes on certain imported and locally produced goods (e.g. sausages, instant noodles, toilet paper, ice cream, beer, spirits, unmanufactured tobacco, and tobacco products) are still applied in a non-uniform manner, thus affording local producers a considerable tax advantage. The consumption tax on goods and services was maintained at 15%.

13. To promote investment or achieve social objectives, Tonga maintains some indirect tax and non-tax (mostly activity-specific) incentives, involving duty and tax exemptions, preferential credit, and targeted subsidies, which are in general very limited in terms of scope. Exemptions from excise and consumption taxes were granted to various sectors, economic activities, and specific users (notably state-owned enterprises). The list of exemptions broadened with new tax exemptions for the tourism and construction sectors, as well as in response to the COVID-19 pandemic. A tax exemption remains in place for fuel used by fishing vessels, domestic airlines, and ferries, as well as in diesel power generation and village electricity and water supply. The main beneficiaries of customs duty and tax concessions were importers of fuels and public enterprises. The Government

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Development Loans programme was also reviewed in 2020 and extended for another five years, with additional resources earmarked for the fisheries and tourism sectors in response to the COVID-19 pandemic and Tropical Cyclone Harold. These loans are also directed to another five sectors, i.e. agriculture and forestry, manufacturing, livestock, construction and utilities, and retail and wholesale.

14. To strengthen the development and application of food standards, Tonga updated its legislation on food safety by adopting the Food Act in 2014, which was reviewed and replaced in 2020. It has still to develop a legal and institutional framework for the adoption of standards, technical requirements, and conformity assessment procedures.

15. Tonga continues without a legal and institutional framework governing competition policy. Competition-related provisions remain limited across different laws. A price-control mechanism for certain food products, chemicals, fuels, and services remains in place. State involvement in the economy remains significant, as the implementation of the 2007 public enterprise reform programme was slow. Tonga identified seven public enterprises that could be reformed by conducting privatization, restructuring, outsourcing, or implementing another form of public-private partnership (PPP); reform plans for three of them were completed during the review period, whereas for the remaining enterprises the process is ongoing. Tonga made substantial progress in implementing its 2013 government procurement reform strategy, which involved regulatory and institutional changes leading to a more centralized procurement system by significantly reducing the relevant threshold. This threshold was subsequently increased from TOP 7,500 in 2016 to TOP 20,000 in 2019 without attaining its pre-reform level of TOP 100,000. This reform included the adoption of a new set of regulations.

16. During the review period, the regulatory framework governing intellectual property rights (IPR) remained virtually unchanged. According to the authorities, IPR protection follows to a large extent the TRIPS Agreement, with some exceptions where the level of protection under domestic legislation is in general higher, e.g. utility models and moral rights for works, which are not covered under the Agreement.

17. Agriculture remains an increasingly predominant economic activity despite the impact of natural disasters. Its contribution to GDP rose from 14.2% in FY 2013/14 to 17.7% in FY 2018/19. The main agricultural products remain root crops, squash pumpkins, and kava. Food security challenges persist, as Tonga is a net importer of staple foods whose self-sufficiency remains to be addressed together with other government policy objectives including climate-resilient agriculture, the enabling environment, subsistence-level production, import substitution, and export orientation. Certain regulatory and institutional changes were undertaken. Average tariff protection levels on agricultural products (WTO definition) dropped considerably (from 10.7% to 7.7%), and non-tariff measures were introduced to encourage healthy food consumption. Trade-related support, including a state-run pack-house, soft loans, and sector-specific tax incentives, remained available to producers and/or exporters.

18. Fisheries remain important to the economy (accounting for 26.6% of exports in 2019), despite a slight reduction of their contribution to GDP (1.9%, FY 2018/19). Government policy was aimed at maximizing the sustainable contribution of the sector to food security and economic growth. A separate Ministry of Fisheries was established in 2016. Regulatory changes related to, *inter alia*, fisheries issues of coastal communities, whereas action was taken to strengthen Tonga's framework against illegal, unreported, and unregulated fishing. Average tariff protection levels were reduced significantly, i.e. from 10.6% in 2013 to 0.9% in 2020. A resource rent on the local value of commercially exported marine products continues to be charged. Activity-specific tax and non-tax incentives were available to fisheries stakeholders.

19. Tonga remains heavily dependent on petroleum imports to meet its energy needs for electricity and transportation, but initiatives for raising renewable energy sources helped reduce its dependency level. Policy initiatives for energy efficiency were pursued. Tonga Power Limited, the vertically integrated and entirely state-owned utility, continues to own and operate virtually all in-front-of-meter electricity generation, as well as all transmission and distribution assets; its management has operated under a PPP arrangement since 2019. Electricity tariffs remain high by international standards but, despite differences in generation cost, they remain standardized across islands; a cross-subsidized "lifeline tariff" applicable to residential consumers remains in place. Legislation for seabed minerals was passed, although mining remains at the exploration stage.

20. The contribution of the manufacturing sector, concentrated in a few activities (e.g. food and beverage), slightly declined (5.2% of GDP, FY 2018/19). Average tariff protection levels for manufacturing products were slightly reduced (11.5% in 2013 to 10.8% in 2020). Activity-specific tax and non-tax incentives involving customs duty, excise tax, and consumption tax concessions on inputs and soft loans were available to manufacturers.

21. Services remain the main, albeit slightly declining, contributor to GDP (49.2% in FY 2018/19); services trade performance remained better than that of goods. Tonga's relatively extensive commitments under the General Agreement on Trade in Services (GATS) remain unchanged; its regional trade agreements also cover trade in services, and GATS+ commitments were undertaken under PACER Plus. The structure of the relatively small, well-capitalized, and profitable banking system remained virtually unchanged; its regulatory framework was updated in certain areas, and the non-performing loans ratio reduced. The insurance market is being developed; a new insurance bill is being prepared. Telecoms connectivity improved, and the market's duopolistic structure remained unchanged; new legislation was passed, and a regulator was established. Transport services remain crucial for Tonga's economic development and competitiveness. Several policy initiatives intended to address transport-related challenges were undertaken, and new air transport legislation was passed. Air and maritime transport continued to receive support including under the fuel concession scheme. Cabotage is allowed only under certain circumstances in maritime transport services. Tourism and its linkages with other activities (e.g. transport, fisheries, and e-commerce) were the subject of major policy papers, and a separate Ministry of Tourism was established in 2015. Tax and non-tax incentives supported the development of tourism business operators. Distribution services remained of major importance to the economy; concessional loans supported small-scale wholesale and retail trade, and progress was made in enhancing the legal and regulatory frameworks for e-commerce, which is at a nascent stage.

22. Tonga's growth prospects are subject to considerable uncertainty related to the impact of the COVID-19 pandemic and natural disasters on economic activity, as well as to developments in remittances inflows and assistance from development partners. Future prosperity and sustained growth depend on the implementation of further fiscal consolidation, economic diversification, and productivity-enhancing reforms, as well as on addressing issues relating to infrastructure, regulatory uncertainty, investment framework, and state involvement in the economy. These and related reforms would increase the resilience of Tonga's economy, its ability to cope with external shocks, and its integration into the multilateral trading system, thus enabling it to continue meeting its economic and welfare objectives.