

Chapter 3

Reducing the Presence of the State in the Economy

Constraint: *An oversized public sector lowers overall productivity directly and crowds out the private sector.*

A. Tonga has a Large Public Sector

When the public sector, through ownership and employment, controls too much of an economy's assets or workforce, it lowers the long-term growth rate. This happens because of two main reasons:

- First, since economic growth stems from the productive use of capital, if the assets owned by government are not used productively, the growth of the economy as a whole will be reduced. In Tonga, one major constraint on faster growth is the low yield of many government-owned assets.
- Second, a large public sector (the part of the economy in which the goods and services are delivered by and on behalf of the government) crowds out the private sector (the part of the economy in which goods and services are delivered by private enterprise). Some skilled workers and investment opportunities, which would otherwise be available to the private sector, are diverted to the public sector, which typically uses them less efficiently.

This means that the more assets that are under government control, the higher the rates of return must be to the private sector's investments to affect the underperformance of the government's assets. So a large, underperforming public sector holds back the growth of the economy both directly and indirectly.

In Tonga, the state plays a prominent, even dominant, role in the economy. It employs a

large proportion of the working population. Estimates put government employment at about 13% of the labor force. The number of government employees has declined since the downsizing began in 2006, but it is still higher than any other Pacific Island nation. Government wages in 2008 are forecast to be some 14% of GDP, over 30% higher than the average for Pacific Island economies.

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B. Tonga has 17 State-Owned Enterprises

The government is a major provider of goods and services within the domestic economy, both directly and through the enterprises it owns. Through its ownership interest in state-owned enterprises (SOEs), the government is a large investor in the commercial sector within the kingdom. In many cases, the Tongan Government provides services at a loss or below the level of an economic-risk-adjusted return on the assets employed. This is because the government in effect provides free or heavily subsidized capital to the entities it owns and controls.

An SOE, called a *public enterprise* in Tonga, is a company created and owned by a government for the purpose of undertaking commercial business activities.⁹ The state has T\$111.5 million (T\$37 million in loans, T\$74.5

⁹ Public enterprises are established under the Public Enterprise Act 2002. Throughout the Pacific these entities are referred to as either state-owned-enterprises or public enterprises. As the term state-owned-enterprises is more generally used around the world, that term has been used in this report.

million in equity) invested in the 17 SOEs listed in the *Public Enterprise Act*. This is equivalent to 45% of the GDP forecast for 2007/2008. The most recent financial statements of these entities show that their combined profits are equivalent to only 4.8% of the total assets owned by the state. Only 4 of the 17 SOEs earned profits. Over a longer time period, the financial results of SOEs have been even less impressive. In the 8 years from 1999 to 2006,

cumulative net profits were T\$15.9 million, or T\$2 million per year, which means a rate of return that is barely positive. Remembering that SOE assets add up to 45% of GDP, the poor profitability represents foregone revenues that could have been used to improve health and education services. A recent analysis of the profitability of SOEs in Tonga by the Asian Development Bank (ADB) found that the economic value destroyed by SOEs between 2002 and 2006 was T\$34 million, almost exactly 50% spending on education over the same period.

Table 2: State-Owned Enterprise Portfolio (T\$ Million)

Assets	188
Government Equity	68
Net Profits Less Dividends	7
Losses	(1.50)
Net Equity	74.50
Loans to Public Enterprises	37
Total Investments	111.50
Total Government Investments	105
Government Public Debt	209
Loans to Public Enterprises (% of Total Public Debt)	18

Source: Ministry of Public Enterprises 2007.

The SOE portfolio is imbalanced. In addition, there are wide swings in year-by-year profitability because the only companies that earn profits are Leiola Duty Free (now privatized), Tongan Communications Corporation, and the Tongan Development Bank. The ratio of equity to total assets for the SOE portfolio is 65%, indicating a low level of debt for most SOEs, which is fortunate given their poor profit performance. It has the additional benefit that if SOEs are slated for privatization (see page 12), there will not be a lot of preexisting debt that has to be dealt with before sale, which implies a better selling price for the government.

Table 3: Financial Results of Tongan State-Owned Enterprises (T\$ Million)

Year	Profit Making Enterprises	Loss Making Enterprises	Net Profit or Loss
1999	1.2	(5.6)	(4.4)
2000	2.3	(3.7)	(1.4)
2001	4.5	(3.8)	0.7
2002	6.9	16.4	(9.5)
2003	8.1	(1.6)	6.5
2004	8.7	(1.9)	6.8
2005	8.1	(0.2)	7.9
2006	9.3	(0.2)	9.1

Source: Ministry of Public Enterprises 2007.

Because the SOEs crowd out competition from the private sector, underperforming SOEs also perpetuate low productivity, which is a chronic problem in Tonga. Crowding out occurs because the private sector is not likely to want to engage in activities where SOEs are receiving subsidized capital. A recent example is the investigation by the Tonga Water Board (TWB) of the possibility of setting up a water-bottling operation. Currently TWB is operating at a loss. The private sector will certainly be crowded out of that market if the government allows TWB to invest in water bottling. Keep in mind that its existing operations are losing money and TWB is not required to achieve a return that fully compensates for the risks it is taking on existing and new investments.

C. Solutions

The main ways to reduce the size of the public sector are by downsizing, outsourcing (contracting out), and privatizing. When reducing the size of government, the standard for doing so should be informed by a clear idea of the essential functions of government, which in the economic sphere include protecting property rights, providing an effective commercial law framework, ensuring that workers are educated, providing or paying for infrastructure, and making sure that the rules governing the financial system promote access to finance.

Downsizing

With the increase in public sector wages and salaries in 2005,¹⁰ the country could no longer afford to pay so many civil servants. So as well as reducing the crowding-out effect of the high level of government employment and salaries on the ability of the private sector to attract good employees, there is an added macroeconomic reason for reducing the number of people working for the government. The only way to ensure that government revenue is still sufficient to pay for the essential functions of government is to reduce the number of state employees while at the same time improving the efficiency of the remainder. Progress has been made in reducing government employment. In 2006, the number of people employed in the Tongan public sector was reduced by 25%, through voluntary resignation, because of the generous severance packages offered by the government. Although this downsizing was not enough to offset the large wage increases awarded, further employment cuts are planned.

Improving the Quality of the Civil Service

The country's brain drain of skilled workers seeking better opportunities abroad undermines the quality of civil servants (and indeed of the whole working population). With the recent downsizing and the public service hiring freeze, the technical and professional skills in the civil service have been hollowed out: 85% of permanent and casual salaried

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staff is in the junior administrative classes. There has been a drain of well-qualified middle and upper-middle level managers in the civil service as a result of them taking severance packages. In the second level of management and in many ministries at levels immediately below the chief executives or permanent secretaries is a shortage of personnel. In many ministries there are not enough staff members with the knowledge and skills for the work that needs to be done. This limits the government's ability to develop and implement a reform agenda (not to mention fulfill the core functions of government). We encourage a continuation of prudent downsizing, but it needs to be combined with training the staff that remains.

¹⁰ This occurred following the 2005 civil service strike. Wages and salaries were raised above those of comparable workers in the private sector, using a formula known as 60/70/80, which represents the percentage increases in salaries for government employees at various grade levels. A biannual survey of the business community conducted by a local management consulting firm found that while the public and private sector pay rates were similar in 2002 and 2004, in 2006 public sector pay was 40% higher for 80% of the positions surveyed. This risks crowding out private businesses and increasing the public sector deficit.

Outsourcing, or Contracting Out

Other reductions in expenses and improvements in returns on money spent can be achieved through outsourcing (contracting out) and privatization. In fact, contracting out more activities to the private sector is one solution to the shortage of well-qualified public officials. Currently contracting out by the public sector

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to private sector providers is limited. Tonga Airports Ltd. contracts out baggage handling, and the Port Authority, which operates as a landlord port, successfully contracted out stevedoring until 2005, when it then took back stevedoring into its own operations. The Ministry of Works already contracts with the private sector and is considering outsourcing much of its road maintenance operations. Senior government officials have said in recent statements and interviews that they

are determined to do a lot more contracting out to private providers.¹¹ We encourage the outsourcing of as many services and functions as is feasible.

Privatization

Enterprises owned by the state are candidates for privatization as a way to improve their efficiency and allow more money to be spent on other government-provided services, such as health and education. Tonga's Public Enterprise Act of 2002 sets the legal framework for the government's stewardship of SOEs. It is modeled after similar legislation in Australia, New Zealand, and other countries in the Pacific. However, the Public Enterprise Act has an omission that constitutes a major departure from international best practice. The act fails to stipulate that SOEs must operate as successful businesses, usually defined to mean profitable in a way that is comparable to businesses in the private sector. We recommend that the government add such a provision to the Public Enterprise Act. While it may not be possible to find successful businesses in Tonga to compare with, SOEs in other Pacific islands or even just other small economies could be used.

Box 1: Procedures for Contracting Out

- Establish a clear expectation, through statements of corporate intent, which state-owned enterprises (SOEs) will contract out the delivery of functions and services for which they are responsible or provide justification for not doing so. For example, if the Ministry of Works were to retain responsibility for maintaining roads, it would have to show how it could do so more cheaply and/or with better service than a private business.
- Develop a clear policy statement on community service obligations.
- Look for opportunities to make the provision of community service obligations contestable through tendering (making a bid) for minimum subsidies.
- Develop a public-private partnership policy that sets out general guidelines and expectations for contracting with the private sector by ministries and SOEs.

¹¹ Samoa's experience with contracting out is an excellent example of what can be achieved. Since it contracted out road maintenance and construction to private companies, productivity has increased four-fold and 90% of roads are now paved.

In some cases, governments are reluctant to privatize SOEs that are considered dominant in the local market or are involved in “strategic” activities (ones important to national identity or security). SOEs that provide telecommunications, broadcasting, or airline services are seen as strategic in a number of Pacific Island economies, although this view is changing rapidly. While each government must determine its own policies for SOE divestment, many concerns about loss of control can be dealt with through competition, regulation, and innovative ownership structures. This was done with Polynesian Air (renamed Polyblue), the Samoan airline that was partially privatized through a sale of 49% of equity to Virgin and 2% to a private Samoan investor. The government retained a minority stake of 49%, but effective control remained in Samoa.

An immediate candidate for privatization is the Tonga Communications Corporation (TCC), whose establishing legislation stipulates that at least 10% of the equity must be sold. That company and the recently formed Ministry of Public Enterprises (whose job it is to coordinate the stewardship of SOE assets) are looking at options for achieving this. TCC is in a strong financial position and is generating enough cash to meet most of its identified future investment requirements. It is therefore a good enterprise to privatize, either in whole or in part. There are strong reasons for considering an outside investor that could bring much-needed capital and expertise to Tonga. The experiences elsewhere in the Pacific and in the Caribbean demonstrate that when an experienced foreign operator enters the market, prices decline, the number of subscribers increases, and the service area expands.¹²

Tonga would be well served by the government’s freeing up underperforming capital and then using it for new public

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services, such as health and education. Selling these low-yielding assets to private operators would not only raise revenue for investment in infrastructure, but also increase the growth rate. Newly privatized enterprises would probably treat existing customers better—to retain them before seeking to expand. They would be under pressure to obtain a commercial return on their investment.

Concerns about loss of control can be dealt with through competition, regulation, and innovative ownership structures.

The government is looking for ways to allow the public to participate in the benefits of privatization, possibly through share distribution. However, unless there is a market to list and trade the privatized shares on, it is difficult to see how the public could gain financially. Establishing a stock exchange in Tonga would be prohibitively costly. One possibility would be to list a company on the Fiji Islands stock exchange, although its rules, lack of liquidity, and cost would make this difficult. Even in the Fiji Islands, it is not unusual for only a single company’s shares to be traded on any given day. Nevertheless, it is not impossible.

¹² In Samoa, the entry of a new operator, Digicel, has resulted in a 50% decline in call rates and a tripling of the number of subscribers within the space of a year.

In any case, as suggested earlier, the benefits of privatization go well beyond creating broader public ownership. But one should bear in mind that privatization, contracting out, and related solutions, such as public-private partnerships, are not panaceas. Still, they can greatly improve the efficiency of low-performing assets and functions now under government control.

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D. The Government is Already on the Move

Although details of how this should be done have yet to be formulated, the government has announced its intention to reduce the presence of the state in the economy through downsizing, contracting out, and SOE privatization.

Ministers have indicated a desire to see the government get back to its core functions and responsibilities and look for opportunities to outsource or privatize.

The government is exploring ways to contract out the functions of the Ministry of Works and the Ministry of Transport. It has already sold its shares in Westpac Bank for US\$10.45 million, and in July 2008 it completed the sale of its 75% interest in Leiola Duty Free Stores.

Reforming the Public Service

The Public Service Commission is in charge of public sector reform. Its work plan is to modernize the civil service and its administration by the following means:¹³

- Restructuring departments
- Redeploying staff from peripheral to core functions

- Reviewing business processes for efficiency
- Going over the code of conduct with staff members (as a way of promoting ethical behavior)
- Reviewing job levels, salaries, and conditions of service with a view to entering into union-mediated agreements that would avoid the boom-and-bust cycle of salary increases in Tonga
- Building a workplace culture that monitors performance and rewards excellence by having workers and organizations agree to performance targets

The position of the chairman of the Public Services Commission has been part-time in the past, but in view of the restructuring task ahead, a full-time chairman has been appointed.

Restructuring Ministries

Tonga's 18 government ministries have been restructured on paper, and new chief executive officers are being appointed. However, the 26 departments within the portfolios have not been restructured yet. The deep cuts in the public sector have resulted in staff and skills shortages and have increased the responsibilities of those remaining. As a result, the current staff are finding it difficult to devote enough time to fulfilling their primary functions. And they are having trouble setting up a structure and staff to manage outsourcing or cost-recovery models that will pay for themselves.¹⁴

Several ministries complained that they do not have enough funds to undertake basic operations. Concern has also been expressed about the lack of long-term funding plans. The managers of infrastructure assets, such as roads and ports, are dependent on the annual budget cycle to determine spending priorities, while their projects typically last for a number of years.

¹³ AusAID. 2004. *Kingdom of Tonga. Australian Cooperation Strategy 2007–2012*. Canberra.

¹⁴ As is typical of numerous instances of downsizing, many of the best people take "packages" because they are the ones with the most alternatives.

SOE Policy Initiatives

Some recent government initiatives are designed to improve SOE performance, including through greater private sector involvement. These initiatives place Tonga at the forefront of SOE reform in the Pacific, and as they are implemented productivity should increase and the drain on the budget should decrease. The establishment of the Ministry of Public Enterprises will help in the development of a centralized, coordinated approach to the stewardship of SOE assets. The ministry is reviewing how much SOE directors and chief executives are paid. Early indications are of a determination to achieve a higher return on assets, a better use of capital, stronger financial oversight (even to the extent of calling up loans in default), improved management, better monitoring, and stronger governance structures. This should lead to a more focused and commercially oriented monitoring regime.

SOE performance is being improved through

- Strengthening their corporate governance
- Enforcing the government's requirement of a 10% hurdle rate for all investments
- Privatizing some of them—the Ministry of Public Enterprises completed the sale of the government's 75% shares in the now-named Leiola Group Ltd. in July 2008
- Developing policies on pricing, funding, monitoring, and contracting community service obligations (CSOs)
- Continuing the corporatization of government-controlled entities along the lines of Tonga Airports Ltd. (which was corporatized earlier in 2007), Tonga Post, and Tonga Power
- Establishing clear and commercially based policies and procedures for government loans to them

- The phasing out of the practice of appointing government ministers as their directors.¹⁵ A large pool of directors will be developed to allow for competition in choosing the best-qualified directors, and encourage training and development

Human Resource Constraints in the Ministry of Public Enterprises

Within the Ministry of Public Enterprises, the human resource base that can support the measures listed above is thin. The ministry is new and the staff in general is new to the SOE monitoring role. In fact, some deepening and expanding of the skills base in this ministry is needed. ADB is providing on-the-ground assistance through a current technical advisory team. The chief executive officer has only recently started in his new role, and the minister has recently been given the added responsibility of being the minister of finance too. The ministry should quickly determine priorities. It should be given the resources it needs to achieve them.

The deep cuts in the public sector have resulted in staff and skills shortages.

Government is currently undertaking serious efforts, with ADB support, to rationalize Tonga's public enterprise portfolio. This includes restructuring some SOEs, such as the International Dateline Hotel and the Shipping Corporation of Polynesia, and selling either shares in or assets of other SOEs, such as Tonga Machinery Pool and Tonga Timber.

¹⁵ To be completed by the end of 2008

E. Summary of Recommendations

- Quickly determine the priorities of the Ministry of Public Enterprises and give it the resources necessary to achieve such priorities.

Make sure SOEs do, in fact, operate on business principles.

- Make sure SOEs do, in fact, operate on business principles—that they adhere to legal rules established for all companies and that they make enough profit to compensate for the commercial risks they take. Give this a legal basis by adding a provision to the Public Enterprise Act that stipulates that SOEs must operate as successful businesses, comparable to businesses in the private sector.
- Reduce the role of the state in the economy by continued action on privatizing SOEs, contracting out, and engaging in transparent public–private partnerships. Continue downsizing the civil service.

- Formally adopt the already drafted guidelines on CSOs and look for opportunities to make their provision contestable through tendering (making bids) for minimum subsidies.
- Develop a public–private partnership policy that sets out general guidelines and expectations for contracting with the private sector by ministries and SOEs.
- Restructure civil service departments, redeploying staff from peripheral to core functions, reviewing business processes for efficiency, and going over the code of conduct with staff members (as a way of promoting ethical behavior).
- Review civil-service job levels, salaries, and conditions of service, including performance targets.