

## Program Completion Report

PCR: TON 33097

# Economic and Public Sector Reform Program (Loan 1904-TON[SF]) in Tonga

September 2005

Asian Development Bank

## CURRENCY EQUIVALENTS

Currency Unit      –      pa'anga (T\$)

		<b>At Appraisal</b> (as of 16 April 2002)	<b>At Program Completion</b> (as of 31 December 2003)
T\$1.00	=	US\$0.446	US\$0.495
US\$1.00	=	T\$2.18	T\$2.021

## ABBREVIATIONS

ADB	–	Asian Development Bank
AusAID	–	Australian Agency for International Development
BMU	–	Budget Monitoring Unit
CAP	–	country assistance program
CPD	–	Central Planning Department
CCR	–	Cabinet Committee on Reform
EA	–	executing agency
EPSRP	–	economic and public sector reform program
GDP	–	gross domestic product
HODs	–	heads of department
HRM	–	Human Resource Management
HRMIS	–	human resources management information system
IT	–	information technology
MOF	–	Ministry of Finance
MOH	–	Ministry of Health
PA	–	public accounts
NZAID	–	New Zealand Agency for International Development
PCR	–	project completion report
PMO	–	Prime Minister's Office
PPAR	–	program performance audit report
PSC	–	public service commission
PSE	–	public sector enterprise
RMS	–	revenue management system
RRP	–	report and recommendation of the President
SDP7	–	7 <sup>th</sup> strategic development plan
SDR	–	special drawing rights
TA	–	technical assistance
US	–	United States

## NOTE

The fiscal year (FY) of the Government ends on 30 June. FY before a calendar year denotes the year in which the fiscal year ends, e.g., FY2005 ends on 30 June 2005.

## CONTENTS

	Page
BASIC DATA	ii
I. PROGRAM DESCRIPTION	1
II. EVALUATION OF DESIGN AND IMPLEMENTATION	1
A. Relevance of Design and Formulation	1
B. Program Outputs	3
C. Program Costs	7
D. Disbursements	7
E. Program Schedule	7
F. Implementation Arrangements	7
G. Conditions and Covenants	8
H. Related Technical Assistance	8
I. Consultant Recruitment and Procurement	9
J. Performance of Consultants, Contractors, and Suppliers	9
K. Performance of the Borrower and the Executing Agency	9
L. Performance of the Asian Development Bank	9
III. EVALUATION OF PERFORMANCE	10
A. Relevance	10
B. Efficacy in Achievement of Purpose	10
C. Efficiency in Achievement of Outputs and Purpose	11
D. Preliminary Assessment of Sustainability	12
E. Environmental, Sociocultural, and Other Impacts	12
IV. OVERALL ASSESSMENT AND RECOMMENDATIONS	13
A. Overall Assessment	13
B. Lessons Learned	13
C. Recommendations	14
APPENDIXES	
1. Program Framework	16
2. Status of the Policy Matrix	18
3. Summary Table of Government Operations, 2000/01–2005/06	28
4. Status of Compliance with Loan Covenants	29

## BASIC DATA

### A. Loan Identification

1.	Country	Tonga
2.	Loan Number	1904-TON(SF)
3.	Program Title	Economic and Public Sector Reform Program
4.	Borrower	Kingdom of Tonga
5.	Executing Agency	Ministry of Finance
6.	Loan Amount	SDR8,020,000
7.	Program Completion Report No.	PCR: TON 916

### B. Loan Data

1.	Appraisal	
	– Date Started	21 Jan 2002
	– Date Completed	26 Jan 2002
2.	Loan Negotiations	
	– Date Started	8 Apr 2002
	– Date Completed	10 Apr 2002
3.	Date of Board Approval	28 May 2002
4.	Date of Loan Agreement	29 May 2002
5.	Date of Loan Effectiveness	
	– In Loan Agreement	27 Aug 2002
	– Actual	11 Jun 2002
	– Number of Extensions	none
6.	Closing Date	
	– In Loan Agreement	30 Jun 2004
	– Actual	23 Dec 2003
	– Number of Extensions	none
7.	Asian Development Fund	
	– Terms of Loan	1% interest rate during the grace period
	– Interest Rate	1.5% thereafter
	– Maturity (years)	24
	– Grace Period (years)	8

## 8. Disbursements

## a. Dates

Initial Disbursement	Final Disbursement	Time Interval
26 Jun 2002	23 Dec 2003	18 months
Effective Date	Original Closing Date	Time Interval
11 Jun 2002	30 Jun 2004	24 months

## b. Amount

Category or Subloan	Original Allocation (SDR)	Date Disbursed	Actual Disbursed (SDR)	Undisbursed Balance (SDR)
1 <sup>st</sup> Tranche	4,010,000	26 Jun 2002	3,859,365	150,635
2 <sup>nd</sup> Tranche	4,010,000	23 Dec 2003	4,160,635	-150,635
<b>Total</b>	<b>8,020,000</b>		<b>8,020,000</b>	<b>0</b>

**C. Program Data**

## 1. Program Cost (SDR)

Cost	Appraisal Estimate	Actual
Foreign Exchange Cost	8,020,000	8,020,000

## 2. Financing Plan (US\$)

Cost	Appraisal Estimate	Actual
Implementation Costs		
Borrower Financed	5,200,000	
ADB Financed	10,000,000	11,097,023
<b>Total</b>	<b>15,200,000</b>	<b>11,097,023</b>

ADB = Asian Development Bank.

## 3. Program Schedule

Item	Appraisal Estimate	Actual
Dates		
First Tranche	Jun 2002	26 Jun 2002
Second Tranche	Mar 2003	23 Dec 2003

## 4. Program Performance Report Ratings

Implementation Period	Ratings	
	Development Objectives	Implementation Progress
31 Mar 2003–31 Dec 2003	S	S
31 Dec 2002–28 Feb 2003	HS	S
30 Jun 2002 –31 Dec 2003	S	S
31 May 2002–30 Nov 2002	S	S
31 Mar 2003–31 Dec 2003	S	S
HS = highly successful, S = successful.		

## D. Data on Asian Development Bank Missions

Name of Mission <sup>a</sup>	Date		No. of Person-Days	Specialization of Members <sup>b</sup>
	From	To		
Review Mission 1	01 Aug 02	06 Aug 02	1	b
Review Mission 2	30 Nov 02	10 Dec 02	1	b
Review Mission 3	17 Mar 03	22 Mar 03	1	b
Review Mission 4	08 Sep 03	11 Sep 03	1	b
Project Consultation Mission	06 Nov 04	16 Nov 04	1	a
Program Completion Review <sup>c</sup>				

<sup>a</sup> review mission, project consultation mission

<sup>b</sup> a – project specialist, b - economist

<sup>c</sup> The program completion report was prepared by Cai Li, Project Specialist.

## **I. PROGRAM DESCRIPTION**

1. Tonga is a small open economy with a population of about 100,000. Since 1998, the Government of Tonga and the Asian Development Bank (ADB) had been in discussion over a reform program. Sluggish economic growth, rising employment pressure, deteriorating fiscal and external positions, and the eroded Tonga Trust Fund<sup>1</sup> further convinced the Government of the need for reform. On the basis of the Government's own reform program and consultations with Tongan civil society, ADB approved the Economic and Public Sector Reform Program (EPSRP) on 28 May 2002. The total loan amount was SDR8.02 million (US\$10 million equivalent), financed from ADB Special Fund resources.

2. The primary goal of the EPSRP was to assist the Government in achieving a sustained and equitable rise in living standards of all Tongans through macroeconomic stability and private sector-led economic growth. The EPSRP focused on two areas of reform—fiscal reform and public service reform, aiming at achieving twin objectives: (i) a sustainable fiscal balance, and (ii) improved service delivery to the private sector and the general public. The logical framework summarizing the goal, objectives, outputs, and performance targets is attached as Appendix 1. The fiscal reform program consisted of three components: (i) strengthening public expenditure management, (ii) enhancing revenue generation, and (iii) improving the efficiency and effectiveness of the use of public resources by public sector enterprises. The specific components of the public service reform program were (i) establishing the institutional framework for a performance-based public service, and (ii) promoting efficient and effective performance management. The policy matrix detailing reform measures is attached as Appendix 2. The Government's own reform agenda, however, went beyond the EPSRP and included financial sector reform and private sector reform. Two technical assistance (TA) grants<sup>2</sup> were provided to formulate the EPSRP and support its implementation.

## **II. EVALUATION OF DESIGN AND IMPLEMENTATION**

### **A. Relevance of Design and Formulation**

3. The EPSRP was in line with ADB's Pacific Strategy for the new millennium (2000–2004), which had five broad strategic objectives: (i) continuing support for economic management, governance, and public sector reform; (ii) promoting private sector development; (iii) promoting a more active role for women in the social, economic, and political spheres; (iv) supporting sustainable environmental management; and (v) supporting poverty reduction. In the area of economic management, governance, and public sector reform, ADB would support deepening of government and public commitment to the reform process, maintenance of stable macroeconomic environment, and enhancement of efficiency and effectiveness of the public service. The EPSRP was designed to address the first two objectives of the Pacific Strategy. It included 40 policy measures, 23 of which aimed at strengthening Government financial management to maintain a sustainable fiscal balance and 14 at reforming the civil service to enhance accountability.

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<sup>1</sup> An off-budget fund established in 1988 to hold proceeds from the sale of passports to Tonga-protected persons. The resources were intended to be used for special development projects and disaster mitigation. The fund was invested almost entirely offshore and by June 2000 was reported to have reached US\$37 million. The fund declined to US\$3 million at end-June 2002.

<sup>2</sup> ADB. 2001. *Technical Assistance to the Kingdom of Tonga for Advising on the Economic and Public Sector Reform Program*. Manila; ADB. 2002. *Technical Assistance Grant to the Kingdom of Tonga for the Economic and Public Sector Reform Program*. Manila.

4. The EPSRP constituted the cornerstone of the ADB country assistance plan (CAP) for Tonga for 2001–2003 and provided a major leverage to promote good governance in Tonga.

5. The EPSRP was supportive of the Government's development strategy and objectives, which were embodied in the Government's 7<sup>th</sup> Strategic Development Plan (SDP7). Tonga had been formulating development plans since 1965. Six previous development plans were for a fixed 5-year period each, with the conventional coverage of the economy from the macroeconomy to the economic sectors, with objectives to be achieved within each plan period. For SDP7, the Government shifted to a strategic approach to economic and social development planning, and adopted a 3-year rolling plan and investment program with a long-term vision. By 2025, it was envisaged that Tonga would achieve overall high quality of life for the people throughout the kingdom. As for SDP7, which covered the period 2001–2004, nine objectives, including improved competitiveness, a conducive environment for the private sector, an efficient and well-structured government sector with good governance and accountability, and a stable macroeconomic environment, were set out. Eleven strategic areas and policy guidelines were identified. Among them, rationalizing the services of the Government and public enterprises, facilitating private sector development, and improving corporate governance and efficiency of the public enterprises received priority. By strengthening macroeconomic management and promoting a performance orientation in the public service, the EPSRP supported the Government's aspirations of long-term growth driven by the private sector and sustained improvement of living standards.

6. The EPSRP conditionality was practical and demand-driven. The design of the fiscal reforms was responsive to the macroeconomic context and the country's needs. Due attention was paid to the institutional capacity and lessons drawn from previous ADB program loans. In 2001, when the EPSRP was processed, the real gross domestic product (GDP) growth rate at 2000/01 prices fell substantially from approximately 6% in 1999/2000 to less than 2% in 2000/01. While government revenue and grants as a percentage of GDP remained stable, total expenditure grew at a quicker pace. As a result, budgetary performance deteriorated markedly. The fiscal deficit rose from 0.2% of GDP in 1999/2000 to 2.6% in 2001/02. The share of wages and salaries reached 57% of government operating costs. The balance of trade, services, and income all worsened, requiring balance-of-payments support. Until mid-2001, the Government drew resources from the Tonga Trust Fund to cover unbudgeted expenditure. The loss of the Tonga Trust Fund resources necessitated fiscal reform to tighten fiscal discipline, reorient expenditure, and enhance revenue generation. The fiscal reform program directly targeted alignment of expenditure with revenue to achieve fiscal balance. It comprised policy conditions of a longer-term horizon, such as a legislative framework for public financial management and a contribution-sharing mechanism for the civil service pension fund, as well as measures of a shorter horizon, such as a hiring freeze and expenditure ceiling. Because public enterprises constituted one of the largest drains on the budget, the EPSRP included legislative requirements to regulate the use of public resources by public enterprises and requirements to run government trading activities along commercial lines.

7. The public service reform program was not designed to improve particular social and economic services to the general public and private sector. Rather, it adopted a long-term vision and pursued basic civil service principles, including merit-based decisions, fairness, equal opportunity, impartiality, accountability, and transparency. Although it will take some time for the benefits to reach the general public and private sector, the devolution of personnel management from the Cabinet downward is a necessary and significant step toward improving the effectiveness and efficiency of the governance system.



8. Economic and Public Sector Reform (TA 3705-TON) (footnote 2) advised the Government on the design of the EPSRP. It provided 33 person-months of individual international consultants and produced three outputs: (i) a comprehensive policy matrix with a detailed implementation schedule which formed part of the policy conditions for the EPSRP; (ii) broad consultations with key stakeholders and civil society, which generated support for the EPSRP; and (iii) social assessments of the reform program and proposals for mitigating measures. The TA provided the required high-level advice and support needed to ensure that the comprehensive reform agenda was results-focused and implementable. The TA is rated successful.

## **B. Program Outputs**

### **1. Strengthened Public Expenditure Management**

9. Since 1998, the Government had undertaken several steps to improve the efficiency of public expenditure management. It shifted from traditional line item budgeting to program budgeting, a more results-based resource allocation system. It introduced computerized Sun and Micropay systems for government expenditure disbursement and wage and salary disbursement, and completed the interface of the two systems. Nine ministries, including the Prime Minister's Office (PMO), Ministry of Finance (MOF), Health, Education, and Inland Revenue, adopted the Sun-based purchase order module. Their purchase orders were prescreened by MOF, and disbursement was subject to their budget ceilings. To contain the share of wages and salaries in government current expenditure, a hiring freeze was imposed from July 2001. Vacancies in government agencies were not filled unless justified and approved by the Cabinet. As a result, the share of wages and salaries in government cash spending was reduced from 57% in 2001/02 to 55.2% in 2002/03, and 51% in 2003/04, which was close to 50%, the performance target. At the time of the program completion report (PCR) preparation, the hiring freeze was still in place and was being strictly enforced. The civil service pension scheme was transformed and was no longer fully paid by the Government. Starting in 2003/04, the individual employee was required to contribute a certain percentage of his basic salary to the civil service pension fund: 5% in 2003/04 and 7.5% in 2004/05. What was more significant in financial management was the promulgation of the Public Finance Management Act in July 2003. The Act strengthened the ability of MOF to maintain the integrity of the fiscal framework. It gave the minister of finance the legislative authority to manage the budget execution process, enforce tighter fiscal discipline, and ensure that government departments do not spend beyond their expenditure allocations. However, the 3-year medium-term fiscal framework was not fully adopted as of the time of PCR preparation because of staff movement. Unbudgeted spending was not curtailed in 2002/03 and 2003/04 due to large equity infusions into the Royal Tongan Airlines and the inability of public enterprises to submit their statements of corporate intent.

### **2. Enhanced Revenue Generation**

10. To generate more revenue, the Government increased selected fees and charges in 2001. It stepped up efforts to collect revenue arrears and limited issuing of new development licenses. To strengthen tax administration, the Government passed the Revenue Services Administration Act in November 2002 and amended the existing tax and customs legislation in 2003. The new legislation laid down the foundation for a general modernization of revenue administration, including redesign of the objection and appeals process, redesign of the penalties regime, provision for seizure of assets to recover taxes, and introduction of the World Trade Organization valuation system. The Government also made efforts to build up institutional capacity for tax and customs administration. A TA was secured from the Australian Agency for

International Development (AusAID) and expatriate advisors for tax and customs operations were recruited. Three senior positions for revenue administration were filled and a training program financed by AusAID was implemented. Total revenue grew by about 21% in 2001/02 over the previous year, exceeding the annual revenue growth target of 10%. As indicated in Appendix 3, the impressive revenue performance was due to a 36% increase in tax revenue. The increase slowed to 3.4% in 2002/03 and 2.9% in 2003/04, but was expected to be 13% in 2004/05.

### **3. Efficient and Effective Use of Public Resources by Public Enterprises**

11. Public enterprises represent a very significant part of Tonga's economy and public sector. Using balance sheet values, the total assets of public enterprises amounted to T\$186 million in 2003 and Government's net investment (including loans) was T\$101 million. Financing this represented a substantial commitment of the budget. In June 2003, the Government's public debt stood at T\$189 million. Its investment in public enterprises was, therefore, equivalent to 53% of public debt. Historically, very few public enterprises had provided dividend returns to the Government. If they did, it had been on an irregular basis. The actual cash returns to the Government in interest and dividends could only be described as modest. The interest due on the loans outstanding in June 2003 totaled T\$1.8 million; however, only T\$0.9 million was received. The sum declared as dividends for the year 2002/03 totaled T\$1.1 million, but a detailed analysis of public enterprise accounts showed that the amount actually paid was \$54,000.

12. The performance of public enterprises had a large impact on overall economic performance and the budget. The Government was therefore committed to public enterprise reform. In 2001, the Government endorsed Public Investment Policies, which set out the principles of divestiture and corporatization. Government trading activities operated by ministries would be divested to the private sectors that were more efficient. Trading activities that provided significant social and economic service would be corporatized. Public Investment Policies also required public enterprises to convene regular board meetings, prepare 3-year rolling business plans and report financial requirements.

13. In October 2002, the Government approved the Public Enterprise Act which became effective in December 2002. The Act explicitly demanded returns on government investment and legalized reporting requirements for public enterprises. It included seven sections, covering formation and ownership of public enterprises, appointment, composition, and responsibilities of the board of directors; obligations of public enterprises; and recruitment of chief executive officers. Under the Act, the minister of finance as representative of the Government was to exercise all rights and powers of the shareholder in public enterprises. Public enterprises were obliged to provide MOF with their balance sheets within 6 months after the Act comes into force and full valuations of enterprises within 12 months. Through a statement of corporate intent, they were to inform MOF not later than 1 month before the start of each financial year of their objectives, nature and scope of the activity to be undertaken, the performance targets, financial performance, financial position, anticipated borrowing and dividend payment, and a projection of corporate intent for the following 2 years. Reports on operations of public enterprises were to be submitted semiannually. Within 3 months of the end of each financial year, consolidated financial statements were to be submitted, followed by an audit report on the financial statements within 6 months of the end of the financial year. The Public Enterprise Act was significant. If strictly enforced, it would enable the Government to monitor public enterprises closely, strengthen public enterprise management, increase transparency of public enterprise activities, and improve the use of public resources by public enterprises.

14. In 2003, the Government corporatized the Machinery Pool and Eua Forestry. The latter was merged with Eua Timber, a public enterprise. The printing department was corporatized in 2004 and the new entity began operations on 1 January 2005. The preparations for corporatizing the post office were completed and final corporatization awaits the approval of the Postal Services Act. Other activities proposed by the Government for corporatization included the Tonga Chronicle, quarry operations of the Ministry of Works, and the survey operations of the Ministry of Lands, Survey and Natural Resources. Furthermore, the Government approved in 2004 a priority list of enterprises for sale, including the Leiola Duty Free Tonga Limited, Tonga Investment Limited, and Sea Star Fishing Company Limited. However, due to various legal issues, the financial problems of the Royal Tonga Airlines, and other issues, progress was limited.

15. After a capital injection of T\$20 million into the Royal Tongan Airlines as of 2003, in May 2004, the Government revisited its policy of supporting the company and chose to place it under liquidation. Should the Government decide to allow the company to continue its operations, the Government, as the major shareholder of the company, would have been obliged to inject a significant level of capital either from its budget or secured commercial bank loans. As the liquidation process has just started, and its completion is difficult to predict according to the Liquidator's reports, it is unclear, at this stage, how much government contingent liabilities will be and what impact they will have on the budget.

16. In spite of the Government's focus on efforts toward public enterprise reform, at the time of the PCR, there were no concrete indications that the public enterprises had improved productivity, and financial and service delivery performance.

#### **4. Institutional Framework for a Performance-Based Service**

17. Before the EPSRP, civil service in Tonga was governed by the Civil Service Regulations known as the Estacode, which covered recruitment, pay, leave, promotions, retirement, discipline, and training. The Cabinet held the power of all appointments and promotions from the lowest to the highest level in the civil service. The system was highly centralized, bureaucratic, duplicating, and in conflict with contemporary principles of good governance, namely, accountability, transparency, efficiency, and effectiveness. In September 2001, the Cabinet established a reform subcommittee chaired by the Deputy Prime Minister to oversee the public service reform program. It authorized the Establishment Office in the PMO to implement the program. The Public Service Act was passed by the Legislative Assembly in November 2002 and became effective in April 2003. The Act established the Public Service Commission (PSC) and clearly defined its roles and functions. The major functions of PSC were to appoint, promote, confirm, discipline and dismiss employees, and formulate salaries, allowances, and other financial benefits for employees. These functions represented the devolution from the Cabinet to PSC of the authority to recruit all public servants below the level of heads of departments. The Act also encompassed devolution of personnel management authority from PSC to the heads of departments and introduced performance orientation in the public service.

18. PSC became operational in July 2003. Its creation demonstrated the Cabinet's intention to establish impartial management of the public service. PSC was chaired by the Prime Minister, with the minister of finance and minister of lands, surveys and Natural resources as commissioners. The arrangement was intended to be a transitional one. The Code of Conduct was approved by PSC as a PSC Instruction in June 2004 and was gazetted. The human resource management handbook was drafted and was pending approval. At the time of the

PCR, PSC was in the process of devolving decisions regarding confirmation of appointment, internal transfer, and term extension to heads of departments.

19. With the promulgation of the Public Service Act and establishment of PSC, the legal and institutional groundwork for performance-based civil service was laid down.

## **5. Efficient and Effective Public Service Operations Through Performance-Based Management**

20. In July 2003, all heads of departments (23) were placed under a 12-month employment contract. In July 2004, PSC placed them under a 2-year contract with no right of renewal. Six months before expiry, all 23 positions will be advertised and open for competition, and a 5-year employment contract will be introduced. The contract includes an annual performance agreement, which consists of eight generic key results areas: department corporate and annual management plan, department annual budget for 2005/06, operating and salary budget expenditure, job description, staff meetings, customer service, reporting to the ministers, and annual report. The annual performance of the heads of departments will be evaluated against the key results areas. In December 2004, PSC approved a performance appraisal and assessment document, and will start to implement the performance appraisal system across the public service on 1 July 2005. The performance agreement and the appraisal system formed the core of the performance-based management system, allowing periodic evaluation and assessment of performance at all levels of the public service.

21. The Human Resource Management Information System (HRMIS) was put in place in mid-2003 with all departments' initial data entered in the system. At the time of PCR preparation, all ministries/departments except the Ministry of Marine and Ports and Palace Office were connected to the system by means of either fiber optics or leased lines. The integration of the HRMIS with the civil service payroll system had been duly achieved. Management reports such as the Staff List Report that was used to calculate total staff salaries for the annual budget review are being generated, replacing existing manual procedures. Three training sessions have been held to help government staff acquire competency in using the HRMIS. A user manual was produced, and the appropriate payroll operations manuals for MOF payroll staff updated. A core competence in PSC was established to manage the HRMIS, and liaise with MOF payroll and IT departments to provide ongoing technical support and problem-solving skills for other users. Lines of communication to the Micropay help-desk and direct personal contact with the designed Micropay account manager in Sydney were also established to provide backup support for more complex issues. Job evaluation and grading of all posts in the public service, following the methodology approved by the Cabinet, were completed and a remuneration policy has been proposed. Manuals for corporate planning, annual management planning, and annual reporting were prepared and approved by the Cabinet. PSC staff and ADB TA consultants conducted several training programs for heads of departments and managers to enhance their planning skills.

22. As the employment contract has been implemented in less than 2 years and the new appraisal system is yet to be launched, it is premature to assess the impact of the performance-based management system and judge whether the system will lead to efficient and effective public service operations.

### **C. Program Costs**

23. The total program cost was estimated at US\$15.2 million. The ADB loan amounted to SDR8,020,000 (US\$10 million equivalent), accounting for 66% of the total cost. The EPSRP cost was based on the estimates of adjustment costs under the EPSRP in the areas of tax administration improvement, corporatization and privatization, and public service reform. Since the EPSRP was built on the Government's own reform agenda, reform activities were mainstreamed into the daily operations of the government agencies concerned. Adjustment costs were met by the budget and funding agencies resources, which include ADB, AusAID, and European Union TAs. The EPSRP loan proceeds were being used to support the balance of payments and continuation of the EPSRP.

### **D. Disbursements**

24. The EPSRP loan proceeds were disbursed in two tranches in accordance with ADB's standard disbursement procedures. The first tranche was released on 26 June 2002 upon loan effectiveness and the Government's certification that the value of eligible imports for the 6 months prior to loan effectiveness was equal to or greater than the amount of requested withdrawal under the Loan Agreement. There was about 9 months delay in releasing the second tranche. In ADB's report and recommendation of the president to the board of directors (RRP),<sup>3</sup> March 2003 was targeted for the second-tranche release. The actual date of disbursement, however, was 23 December 2003. This was not due to noncompliance with policy conditions by the Government. In fact, all six second-tranche conditions were fulfilled as early as 31 March 2003. The disbursement was delayed at the request of the Government, which felt that December 2003 was the opportune time for the release of the tranche.

25. The use of ADB loan proceeds to support the balance of payments was sensible and in compliance with the Loan Agreement. Without disbursement of the EPSRP first-tranche and second-tranche loan proceeds, gross official foreign reserves could have fallen to levels below 2.5 months' imports in 2001/02 and 2 months' imports in 2002/03.

### **E. Program Schedule**

26. The planned program period was 20 months from April 2002 to December 2003, and the planned loan closing date was 30 June 2004. Policy conditions had been substantially complied with by 31 March 2003. Because the second tranche was released in December 2003, the loan account was closed on 23 December 2003, 6 months ahead of schedule.

### **F. Implementation Arrangements**

27. MOF, the Executing Agency, was responsible for overall implementation of the EPSRP. A fiscal reform team comprising five senior government officials was established by MOF to implement the fiscal policy reform measures. The PMO, supported by a secretariat, was another key agency involved to guide, oversee, and coordinate implementation of the EPSRP. The Establishment Unit in the PMO was responsible for carrying out the public sector reform measures and was transformed into the PSC with the promulgation of the Public Service Act. In 2000, the Government established a cabinet committee for reform to recommend and approve the reform agenda. A social and economic monitoring unit was set up by the Central Planning

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<sup>3</sup> ADB. 2002. *Report and Recommendation of the President to the Board of Directors on Proposed Loan to the Kingdom of Tonga for the Economic and Public Service Reform Program*. Manila.

Department (CPD). These institutional arrangements enabled the EPSRP to move forward. There was no major change in implementation arrangements during the program years.

## **G. Conditions and Covenants**

28. The policy matrix of the EPSRP consisted of 40 policy conditions, 23 of which were related to fiscal reform; 14 to public service reform; and 3 to economic and social impact monitoring. The number of the first-tranche conditions was not specified and the loan proceeds were released upon loan effectiveness. For the second-tranche release, six conditions were specified. At the time of the PCR, the policy conditions in the policy matrix had been substantially complied with. Although the wages and salaries share of government current expenditure was projected to remain above 50% by 2004/05, tremendous progress had already been achieved, with the share brought down from 57% in 2001/02 to 55.2% in 2002/03 and 51% in 2003/04. At the time of the PCR preparation, the Government was fully committed to the principle of a balanced operating budget and was strictly enforcing the hiring freeze.

29. The Loan Agreement included 26 covenants, 18 of which concerned loan effectiveness, use of the loan proceeds, reporting requirements, implementation and coordination, implementation of the policy matrix, counterpart funds, special account, and stakeholder participation (Appendix 4). The Loan Agreement was signed 1 day after loan approval and the loan was made effective 1 month and a half afterwards. Use of the loan proceeds (para.25) was in compliance with the loan covenants. As ADB fielded review missions on a quarterly basis to monitor and update the implementation progress of the EPSRP, the requirement for government quarterly reports during the implementation period could have been waived. All covenants related to coordination, implementation of the policy matrix, counterpart funds, and stakeholder participation were substantially fulfilled.

## **H. Related Technical Assistance**

30. The EPSRP was supported by two ADB TAs that recruited consultants to advise on the design of the reform program and assist the Government in implementing the public service reform program. TA 3705 (footnote 2) provided 33 person-months of individual international consulting services and led to the formulation and approval of the EPSRP. The TA is rated successful.

31. TA 3873-Building a Performance-Based Public Service (footnote 2) was processed and approved in conjunction with the EPSRP. The purpose of the TA was to support public service reform and build a performance-oriented public service. Major activities included (i) establishing the institutional framework for a performance-oriented public service; (ii) facilitating good governance practices and strengthening the planning, monitoring, and reporting capabilities of all ministries; (iii) establishing the central HRMIS; (iv) introducing performance accountability for heads of departments; and (v) introducing performance-oriented and merit-based remuneration policies and procedures. The TA provided 33.8 person-months of individual international consulting services: 18.8 from the team leader/public service reform adviser, 4.2 from a HRMIS specialist, and 10.8 from a public sector job evaluation/remuneration specialist-cum-strategic planning/performance management specialist. The TA facilitated the establishment and operation of PSC; proposed a range of institutions such as the organizational structure of PSC, operational and policy manuals for PSC, public sector rightsizing strategy, HRMIS, and job evaluation and remuneration policy; and provided training on corporate planning and performance management. The TA is rated successful.

## **I. Consultant Recruitment and Procurement**

32. No consultants were recruited under the EPSRP. Consultants under the two ADB TAs were engaged in accordance with the *ADB's Guidelines on the Use of Consultants*. The loan proceeds were used prudently to support the balance of payments. Disbursements were made upon loan effectiveness, fulfillment of policy conditions, and MOF's certifications on import values.

## **J. Performance of Consultants, Contractors, and Suppliers**

33. Consultants engaged under TA 3705 gave advice and produced required outputs. Their services led to the comprehensive policy matrix with a detailed implementation schedule that formed part of the policy conditions of the EPSRP approved by both the Government and ADB. Consultants recruited under TA 3873 followed the terms of references. They assisted in establishing PSC, and assisted PSC in developing rules, regulations and procedures governing personnel management; developing the HRMIS system; and introducing the merit-based management system. Their services ensured completion of the public service reform program under the EPSRP.

## **K. Performance of the Borrower and the Executing Agency**

34. The Government was committed to the EPSRP and made genuine efforts toward reform. The policy conditions in the policy matrix of the EPSRP were substantially complied with within the program years. This was not easy, given the time constraint and complex nature, particularly, of the legislative acts. Without political will, the approval of the reform legislations, which provided essential legal basis for the government financial management and public service, could have been long and extended well beyond the 2 years of the program. It should also be noted that the policy matrix of the EPSRP constituted only part of the Government's own reform agenda. The Government was continuing with economic and public service reform and was actively pursuing public enterprise and tax reforms to reduce the strain on the budget and corruption related to trade tax collection. As EA, MOF, with the strong support of the Prime Minister, the Privy Council, and the Cabinet Committee for Reform, played a key role in coordinating and implementing the EPSRP. It worked efficiently and effectively with ADB to push the EPSRP through. The performance of the Borrower and that of the EA are rated satisfactory.

35. MOF had a group of dedicated people with development vision and knowledge of macroeconomic and fiscal management. Although MOF performed satisfactorily, it faced a capacity constraint. For instance, public accounts were being produced 2 years late. Public enterprise reform was being managed by two professionals. The transfer of aid coordination from CPD and migration of staff members due to such factors as low wages and slow career development aggravated the situation.

## **L. Performance of the Asian Development Bank**

36. ADB followed a persistent and patient approach to engage the Government in the reform and win broad-based support for the EPSRP. It had been in dialogue with the Government since 1998 over the need for reform and the content of the reform. In August 1999, ADB submitted to the Government a draft concept paper, including the institutional framework for EPSRP management. Following Government approval in April 2000, the TA for preparing the EPSRP was processed and approved on 22 August 2001, and consultants were fielded in September

2001. ADB started to process the loan on 24 November 2001. The loan was approved on 28 May 2002.

37. During implementation, ADB monitored the EPSRP closely and ensured that the reform program stayed on track. Review missions were fielded on a quarterly basis to keep abreast with the latest political and economic developments, update program progress, continue policy dialogue, and consult with development partners and civil society communities. The first tranche of the loan was released soon after loan effectiveness. At the request of the Government, the second tranche was released 9 months after the target date. The overall performance of ADB is rated satisfactory.

### **III. EVALUATION OF PERFORMANCE**

#### **A. Relevance**

38. The EPSRP is rated relevant at both appraisal and completion. There was no change in the program design. The rationale and design were fully consistent with the Pacific Strategy for the New Millennium, the ADB CAP for Tonga, and the Government's development strategy, all of which stressed sound economic management, good governance, and private sector development as top priorities. The design of the fiscal reform was relevant for ensuring financial discipline, restraining public expenditure, increasing revenue, and reducing the budget drain by the public enterprises. The design of the public service reform program was relevant for laying down a foundation for an efficient and effective civil service.

39. The 40 policy measures were necessary but insufficient to achieve the intended purposes and goal as measured by the performance targets. What would be sufficient remains unknown. It is doubtful that linking more policy measures with tranche releases would have produced a different outcome.

40. Controlling wage and salary bills and imposing the hiring freeze were painful but relevant for dealing with financial problems when sources of revenue were limited. The public service reform was requested by the Government to reduce bureaucracy and improve efficiency. Substantial improvements still need to be done. Nevertheless, the first step in the right direction, which was not easy in the Tongan context, was taken. As to the rightsizing targets, it was wise not to include any when the likelihood of achieving them was expected to be low.

#### **B. Efficacy in Achievement of Purpose**

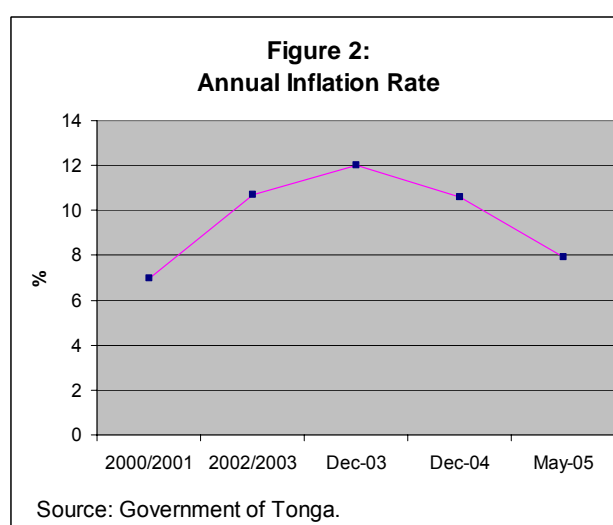
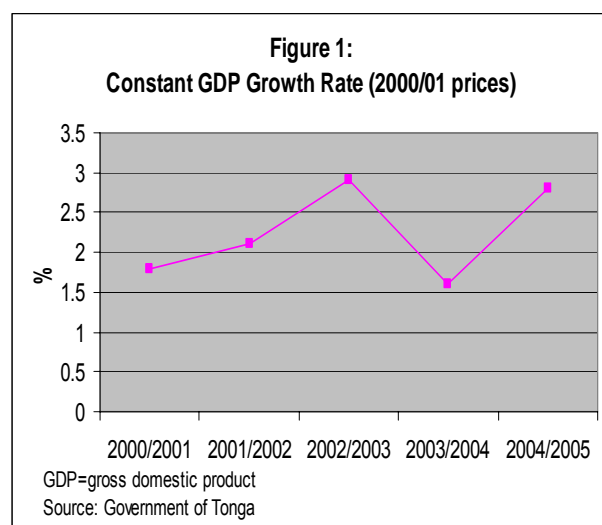
41. The EPSRP is rated less efficacious. It targeted five outputs: (i) public expenditure management, (ii) revenue generation, (iii) effective and efficient use of public resources by public enterprises, (iv) institutional framework for public service, and (v) performance-based management. The Government strove to maintain a balanced operating budget and made substantial progress, with an operating surplus of T\$9.3 million in 2002/03 and T\$3.6 million in 2004/05. The operating deficit of T\$155,431 in 2003/04 was due to the overestimation of grant inflows. Revenue rose from T\$99.3 million in 2002/03 to T\$102.1 million in 2003/04, and was expected to reach T\$117.8 million in 2004/05. The share of wages and salaries of government current expenditure was brought down to near 50%. Three government business activities were corporatized by January 2005.

42. The public service reforms comprised policy measures directed at decentralizing personnel management authority and introducing rules and institutions governing public service operations. With the Government's efforts and ADB TA support, PSC came into existence.



Decentralization of personnel management was under way. The HRMIS was established. Performance accountability was introduced.

43. However, the achievement of most of the performance targets for the five outputs did not lead to the achievement of a sustainable fiscal balance and improved public service delivery to the private sector and the general public, the two objectives of the Program, as well as achievement of 3% economic growth rate and annual inflation rate of 5%. In spite of government efforts, it was estimated that the overall budget deficit was T\$11.2 million in 2002/03, T\$2.6 million in 2003/04, and T\$10.7 million in 2004/05, equivalent to 3.7%, 0.9%, and 3.4% of GDP, respectively (Appendix 3). The substantial increase in budget deficit in 2002/03 reflected the Government's 6.2 million subscriptions to the unissued shares of the Royal Tonga Airlines in that year. Real GDP, in 2000/01 constant prices, expanded by 2.1% in 2001/02, and 2.9% in 2002/03, and was projected to grow by only 1.6% in 2003/04 and 2.8% in 2004/05 (Figure 1). Inflation rose steadily during the program period. It accelerated from 7% in 2000/01 to 10.7% in 2002/03, and to 12% in December 2003. Although inflation has been showing a declining trend since December 2004, it remained at 7.9% in May 2005 and is unlikely to fall below 5% by the end of FY2004 (Figure 2). Public service reform laid down the institutional and legal groundwork for efficient and effective public service. But it was unclear whether this had translated into improved public service. Few signs indicate that public service delivery has been improved and that private sector-led growth is materializing.



### C. Efficiency in Achievement of Outputs and Purpose

44. The EPSRP is rated efficient. Tranche conditions were met as scheduled. ADB missions went to the field on a quarterly basis to continue policy dialogue with the Government and ensure timely program implementation. Laws to regulate financial management, tax administration, and public service were enacted. PSC was established and is in full operation. ADB loan proceeds helped to support the balance of payments. Through the Program, a good working relationship between ADB and the Government was built. It will permit continuing constructive policy dialogue and new opportunities for future cooperation.

#### **D. Preliminary Assessment of Sustainability**

45. The EPSRP is rated less likely to be sustainable if the underlying problems of the fiscal deficit and public service are not adequately addressed. Strengthening expenditure management is important, but public expenditure is difficult to control. Although much of the revenue went to wages and salaries, the remuneration of government officials was still low. According to TA 3873, 30% of government staff were underpaid. Dissatisfaction and low morale in government agencies were evident. Talented people with special skills were exiting to the private sector or abroad, leaving essential vacancies (e.g., accountants) unfilled. The Government was under strong pressure to review its remuneration policy and raise wages and salaries to attract qualified people. The liabilities of the Government to its trade activities and public enterprises were also likely to remain large in the medium to long term. Although the Government took steps to reduce its involvement in public enterprises, it will take some time before it can shift out of the productive sector. Besides, corporatization and privatization will require capital injections, pressing expenditure to rise.

46. To achieve higher living standards and sustainable fiscal position, the economy and revenue sources will need to expand, complemented by strict tax collection. Unfortunately, since 1999/2000, economic activity in Tonga has slowed down. Balance of trade, services, and income all worsened, leaving Tonga more and more reliant on remittances. The disappointing growth performance, particularly in 2003/04, was attributable to a combination of internal and external factors. Internally, the rigid and inflexible economic structure was to blame. During the past 30 years, the Tongan economic structure did not change significantly. Agriculture remained the largest contributor to GDP (27%) and was dominated by a limited number of products like squash and tuna, followed by finance and other services (17.8%); government services (16.2%); and commerce, restaurants, and hotels (14.75%). The manufacturing sector remained insignificant and was likely to decline further. The Tongan economy was also characterized by heavy dependence on imports and a limited number of exports. The low international price for squash exports in 2003/04 reduced export receipts substantially. More recently, high oil prices and the depreciation of the Tongan dollar against the Australian and New Zealand dollars added inflationary pressure and dimmed the prospect of future growth.

47. The EPSRP was institutionally driven. Many institutions were created, including PSC, the Public Finance Management Act, the Public Enterprise Act, the Public Service Act, Code of Conduct, Discipline Regulations, Dispute Resolution Policy, performance agreement, corporate plan, merit-based remuneration policy, and performance evaluation system. These institutions introduced new ideas, values, and principles into the public service, which, if implemented well, will contribute to the change in mind-set and work practices. However, if enforcement is not sound, they may produce little impact.

#### **E. Environmental, Sociocultural, and Other Impacts**

48. The economic and social impact monitoring unit was housed in CPD. As part of the strategy to mitigate possible adverse impacts of the Program, the unit conducted a survey of ex-servants for the National Retirement Fund, drafted a retirement bill, and finished a study on the inform sector. According to CPD, the unit was rarely involved in reform activities and was not able to monitor the economic and social impacts of the Program.

49. In spite of the fact that the impacts of the Program were not monitored, it can be argued that the EPSRP benefited Tongans politically, socially, and economically through its support to the balance of payments. Without the EPSRP, gross official foreign reserves would have fallen

to dangerous levels. Given Tonga's heavy reliance on imports, balance-of-payments difficulties would have resulted in economic and social hardships. The hiring freeze may have had some negative impact on employment, but the impact was limited, as retrenchment and rightsizing envisaged at the appraisal did not materialize. The number of Government employees' remained between 5,000 and 6,000. Even the corporatization of the Machinery Pool and Eua Forestry did not involve retrenchment of people. The EPSRP did not entail any land acquisition and resettlement impacts as envisaged at appraisal. Its impact on the physical environment was also minimal as envisaged at appraisal. There were few indications that women had been disproportionately affected. Hence, environmental, socioeconomic, and other impacts are moderate.

## **IV. OVERALL ASSESSMENT AND RECOMMENDATIONS**

### **A. Overall Assessment**

50. The EPSRP was implemented as conceived. The Government made genuine efforts toward reform and substantially complied with the policy conditions. The promulgation of five legislative acts under the Program illustrates the Government's commitment and willingness to improve governance. The magnitude of the Government's efforts should not be underestimated. Deserving of special commendation was the area of public enterprise reform. The Government clearly recognized the need to divest its trading activities and reduce its obligations to public enterprises. It actively pursued corporatization and privatization and hired a long-term international consultant to assist. Other substantial reforms included tax and budgetary reforms. Unfortunately, many of these accomplishments cannot be captured by the performance indicators and targets. Nonetheless, at the time of PCR preparation, 3 of 11 performance targets were fully achieved, 1 substantially achieved, and 5 partially achieved. Only two of the development goals were not achieved. Following ADB's evaluation criteria, the EPSRP is, therefore, rated partly successful.<sup>4</sup>

### **B. Lessons Learned**

51. The successes and failures of the EPSRP point to a number of lessons. First, the complexity and long-term process of the economic and public sector reform need to be recognized. One short-duration program loan cannot achieve lofty goals involving GDP growth, inflation rate, fiscal balance, efficient and effective use of resources by public enterprises, and improved public services. When designing reform programs, outputs, objectives, and development goals need to be more realistically linked with policy conditionality. Second, careful country analysis and diagnosis of issues are essential to identify and prioritize ADB interventions and designing programs. Third, the program lending modality has limitations in its ability to bring about structural changes. To ensure successful implementation of a program, adequate attention has to be paid to the implementability of the policy conditions. This, however, has to be done, very often, by focusing on specific actions rather than on underlying incentives or institutional capacities. For instance, the EPSRP required actions like corporatization, but had to leave corporate governance unaddressed. Fourth, downsizing of the public service and restructuring of public enterprises are more likely to succeed in a favorable macroeconomic environment, where the Government has financial strength and alternative employment opportunities are available. The EPSRP was designed and undertaken at a time of substantial economic uncertainty, a declining domestic currency exchange rate, rapidly increasing domestic prices, few employment opportunities, and the loss of the Tonga Trust Fund. Such an adverse

<sup>4</sup> This PCR is part of a sample of PCRs independently reviewed by the Operations Evaluation Department. The review has validated the methodology used and the rating given.

environment made a large cut in public sector employment politically, socially, and culturally unacceptable.

### C. Recommendations

52. At the time of PCR preparation, the Government was carrying out economic and public sector reform. Four areas merit ADB and the Government's attention and follow-up actions.

53. **Public Enterprise Reform.** The Government recognized the role of the private sector in promoting economic growth and creating employment opportunities. It made efforts to reduce the dominance of the public sector through public enterprise reform. Unfortunately, as in many other developing countries, those efforts had relatively little near-term impact. Meaningful and sustained private sector development will hinge on the quality of governance. The Government will need to maintain political and macroeconomic stability; create and protect property rights; enforce rules, regulations, and contracts; and provide support services for the private sector to flourish.

54. Tonga, like many other Pacific countries, was noted for a strong tradition of caring for extended families. But this positive family value can sometimes be an impediment to good governance. The Government needs to be impartial in order to enforce rules, regulations, and contracts. The Government may wish to review (and possibly disallow) the current practice of having ministers and heads of departments sit on the boards of directors of public enterprises. It may also wish to strengthen the Public Enterprise Act to include sanctions against noncompliance with reporting requirements for the statement of corporate intent, financial statements, and audited statements.

55. The Government may also wish to review its privatization and corporatization strategy. The issues related to public enterprise reform are whether corporatization and privatization are feasible, how much funding they will require, and whether the reforms will lead to improved performance in the business sector. The Government may wish to conduct rigorous cost-benefit analysis and social and environmental impact assessment for privatization proposals. Useful guidance could be gained from auditing by the auditor general of previous corporatizations and privatizations. In addition to corporatization and privatization, alternative ways to improve the performance of public enterprises may be explored. The type of structure or ownership arrangements may not be the most crucial issue to be addressed at this stage. Application of good management may be the key for public enterprises to deliver economic benefits. In such cases, a competitively tendered management contract to bring in professional managers could be an appropriate and cost-effective solution.

56. ADB may continue to support the Government's corporatization and privatization efforts, and monitor the enforcement of the Public Enterprise Act to contain unbudgeted spending and increase the transparency of public enterprise operations.

57. **Tax Reform.** The Government introduced tax reform in April 2005 as scheduled. The tax reform was intended to be revenue-neutral. But the shift from a trade tax to a consumption tax is administratively demanding. If administrative capacity is lacking, revenue will be eroded. There is also a concern over its impact on inflation. The Government may wish to closely monitor the implementation of the new tax regime.

58. **Operation of PSC.** The establishment of PSC was a major achievement of the EPSRP. PSC has a key role in managing and regulating public service. How it will carry out its mandate

of appointing, promoting, confirming, disciplining, and dismissing government employees has a direct bearing on morale in government agencies and the quality of the civil service. There is also a need for PSC to develop a human resource strategy for the civil service and review the public sector structure to streamline management and reporting, eliminate red tape, and introduce incentives for implementing reforms.

59. PSC introduced the performance management system in public service. There is a need for PSC to review and monitor the performance of the heads of departments. The Government may wish to revisit and adjust the performance agreement, which is reports-oriented. The Government may want to set clear mandates, service delivery objectives and targets for heads of departments, and focus them more on actions to achieve service delivery objectives by evaluating their performance against delivery of targets. In return, the Government may want to give autonomy to heads of departments to manage their human resources and decide on their approaches to deliver the objectives.

60. **Socioeconomic Monitoring.** The social and economic impacts of fiscal expenditure control, revenue generation, corporatization and privatization, and public service reform measures need to be monitored. In particular, the impact of the hiring freeze on employment and institutional capacity, the impact of revenue generation measures on inflation and poverty, and the impact of public service reforms on the quality and efficiency of public sector operations need to be assessed to identify ways forward. CPD may not be the appropriate agency to monitor the Program. MOF and PSC are in more advantageous positions to monitor the fiscal reform and public service reform. As the EA, MOF needs to take the lead in coordinating the monitoring and evaluation of the impact of the Program. An overall socioeconomic assessment should be done by the end of December 2005.

61. **Covenants.** Reporting requirements in the Loan Agreement need to be enforced for a period of 2 more years to enable ADB to continue monitoring the progress of the reform program. The covenants regarding the Special Account in Schedule 5 to the Loan Agreement should be waived because, given the Tongan culture and current economic environment, it is unlikely that rightsizing of public servants will take place in the near future.

62. **Additional Assistance.** ADB has provided a TA for integrated strategic planning, medium-term fiscal framework and budgeting.<sup>5</sup> ADB may want to use this opportunity to conduct policy dialogue with the Government at the highest level to set out realistic objectives, outcomes, outputs, and strategies at the national level, and assist the ministries/heads of departments in translating them into action plans. The government structure, management, employment contract, performance evaluation, and remuneration policy should then be geared to achieving specific targets.

63. While pursuing corporatization and privatization, ADB may assist the Government in tendering management contracts to bring in professional managers to improve the financial performance of the Government's trading activities and public enterprises.

64. **Timing of PPAR Preparation.** Institutions take time to evolve and produce an impact. It is desirable that the PPAR be done in the first half of 2007. This will give the EPSRP a 5-year time horizon, which is normal for any reform program to have its impact felt.

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<sup>5</sup> ADB. 2004. *Technical Assistance to the Kingdom of Tonga for Integrated Strategic Planning, Medium-Term Fiscal Framework and Budgeting*. Manila.

### PROGRAM FRAMEWORK

Design Summary	Performance Indicators/Targets	Monitoring Mechanisms	Assumptions and Risks
<b>Goal</b> The primary goal is a sustained and equitable rise in living standards of all Tongans through macroeconomic stability and private sector-led economic growth.	<ul style="list-style-type: none"> <li>Economic growth rate exceeds 3% by FY2004.</li> <li>Annual inflation rate falls below 5% by FY2004.</li> </ul>	<ul style="list-style-type: none"> <li>Budget statement</li> <li>National accounts</li> <li>International Monetary Fund Article IV consultations</li> </ul>	
<b>Purpose/Objectives</b> The Government will (i) achieve a sustainable fiscal balance, and (ii) provide improved public services to the private sector and the general public.	<ul style="list-style-type: none"> <li>Fiscal rule of expenditure not to exceed revenue is adhered to no later than FY2004.</li> <li>Private sector and general public are satisfied with public service delivery.</li> </ul>	<ul style="list-style-type: none"> <li>Public accounts</li> <li>Results of opinion poll</li> </ul>	<ul style="list-style-type: none"> <li>No natural disasters occur.</li> <li>Political will can be sustained.</li> </ul>
<b>Output 1.1</b>			
Public expenditure management has been strengthened.	<ul style="list-style-type: none"> <li>The share of wages and salaries of government cash spending net of debt service has been reduced from 57% in FY2002 to 50% in FY2005.</li> <li>Annual unbudgeted spending is below 2% of overall budget estimates.</li> </ul>	<ul style="list-style-type: none"> <li>Public accounts</li> </ul>	<ul style="list-style-type: none"> <li>Cabinet does not approve unbudgeted expenditures.</li> <li>Cabinet enforces rightsizing policy.</li> </ul>
<b>Activities</b> 1.1.1. Introduce a rolling 3-year medium-term fiscal framework. 1.1.2. Determine overall expenditure ceilings geared toward reestablishing fiscal balance. 1.1.3 Enact a public finance management act, which will enable the minister of finance to maintain the integrity of the fiscal framework. 1.1.4 Discharge fiduciary responsibilities to the civil service pension fund to the extent required to meet payments for retired civil servants. 1.1.5 Reduce the wages and salaries share of government cash expenditure and redirect spending to improve services.			<b>Major Inputs</b> <ul style="list-style-type: none"> <li>Rightsizing of public service</li> <li>Contribution to the public service pension fund</li> </ul>
<b>Output 1.2</b>			
Revenue generation has been enhanced.	<ul style="list-style-type: none"> <li>Revenue increases by at least 10% in real terms by June 2003.</li> </ul>	<ul style="list-style-type: none"> <li>Public accounts</li> </ul>	<ul style="list-style-type: none"> <li>Private sector enterprises increase profits.</li> <li>Public enterprises pay dividends to the Government.</li> <li>Compliance and enforcement are not subverted by corruption.</li> </ul>
<b>Activities</b> 1.2.1 Fill vacancies of senior positions in tax administration. 1.2.2 Amend current tax and customs legislation. 1.2.3 Establish an implementation schedule for the tax reform.			<b>Major Inputs</b> <ul style="list-style-type: none"> <li>Technical and logistical support for tax administration</li> </ul>

Design Summary	Performance Indicators/Targets	Monitoring Mechanisms	Assumptions and Risks
<b>Output 1.3</b>			
Public sector enterprises (PSEs) use public resources efficiently and effectively.	<ul style="list-style-type: none"> <li>At least two government business activities are corporatized by December 2002.</li> <li>Unbudgeted spending for PSEs is eliminated by FY2004.</li> </ul>	<ul style="list-style-type: none"> <li>Public accounts</li> <li>Annual reports of PSEs</li> </ul>	<ul style="list-style-type: none"> <li>PSEs generate profits and pay an adequate resource rent/dividend to the Government.</li> </ul>
<b>Activities</b> 1.3.1 Formulate a public investment policy. 1.3.2 Develop a corporatization and privatization policy framework. 1.3.3 Enact a public enterprises act regulating the relationship between public enterprises and the Government. 1.3.4 Corporatize selected public enterprises.			<b>Major Inputs</b> <ul style="list-style-type: none"> <li>Transitional cost of corporatization</li> </ul>
<b>Output 2.1</b>			
The institutional framework for a performance-based public service is in place.	<ul style="list-style-type: none"> <li>Public service commission established by December 2002</li> </ul>	<ul style="list-style-type: none"> <li>Cabinet reports</li> <li>Human Resource Management Information System (HRMIS)</li> </ul>	<ul style="list-style-type: none"> <li>Public servants are motivated by merit-based pay.</li> <li>Public sector wages are comparable with wages paid by the private sector.</li> </ul>
<b>Activities</b> 2.1.1 Establish a public service commission. 2.1.2 Introduce an HRMIS. 2.1.3 Implement a devolution policy. 2.1.4 Introduce public service regulations that incorporate the principles of good governance and a code of ethics.			<b>Major Inputs</b> <ul style="list-style-type: none"> <li>Technical Assistance</li> </ul>
<b>Output 2.2</b>			
Efficient and effective public service operations are ensured through performance-based management system.	<ul style="list-style-type: none"> <li>By December 2003 at least 50% of all heads of departments are engaged through performance-based agreements.</li> </ul>	<ul style="list-style-type: none"> <li>Reports of the public service commission</li> </ul>	The performance of heads of departments improves with the introduction of performance agreements.
<b>Activities</b> 2.2.1 Introduce strategic annual plans and performance reports for all departments. 2.2.2 Carry out job evaluation including job grading and classification. 2.2.3 Introduce performance-based agreements for heads of departments.			<b>Major Inputs</b> <ul style="list-style-type: none"> <li>Technical Assistance</li> </ul>

### STATUS OF THE POLICY MATRIX

Primary Objective	Secondary Objectives	Policy/Reform Measures	Status at the Time of the Second-Tranche Release (October 2003)	Status at the Time of the Program Completion Report (April 2005)
<b>1. Fiscal Reform</b>				
A. To achieve a sustainable fiscal balance	To strengthen public expenditure management	Convene regular Cabinet meetings (at least monthly) dealing with overall reform issues.		
A.1		Establish a secretariat within the Prime Minister's Office (PMO) to provide monthly reports to the Cabinet on the progress of overall reform implementation (including the Economic and Public Sector Reform Program (EPSRP)), and to carry out other secretariat functions in support of the overall reform program.	EPSRP management structure was approved by the Cabinet on 23 January 2002.	
A.2		Implement program budgeting and continue with automation of the financial management system.	Cabinet has approved the proposed program-focused structure and presentation of the budget for FY2004. The Audit Department has qualified public accounts (PA) for FY2000. PA for FY2001 has been submitted to the Audit Department for assessment. PA for FY2002 is in progress, awaiting the completion of FY2001 PA. Purchase order module is currently running in the Ministry of Finance (MOF). Ministry of Health (MOH) has been connected, but is not yet in operation. Information technology (IT) section in MOF is establishing a monitoring mechanism. The government IT network: fiber connection has been made from MOF to PMO, police, Legislative Assembly, Department of Environment, Ministry of Education, Ministry of Lands and Survey, and Ministry of Agriculture and Forestry. Ministry of Education, PMO, and Ministry of Agriculture and Forestry have been connected to the system. MOH, Statistics Office, Department of Inland Revenue have been connected and are operating	Cabinet has approved the proposed program-focused structure and presentation of the budget for FY2005.  Audit Department has qualified PA for FY2000 and FY2001.  Purchase order module is currently running in MOF, MOH, Revenue Services, Statistics Department, Environment, Agriculture, Education, and PMO.  The government IT network: fiber and lease connection has covered all ministries and departments except the palace, prison, and defense.



Primary Objective	Secondary Objectives	Policy/Reform Measures	Status at the Time of the Second-Tranche Release (October 2003)	Status at the Time of the Program Completion Report (April 2005)
			through lease line. Interface of systems completed.	
A.3		Introduce and continue a hiring freeze, and other short-term measures necessary to contain expenditure, until fiscal balance is achieved.	Effected 1 July 2001 except for justified recruitment approved by Cabinet. Cabinet reaffirmed this decision in October 2002.	Effected 1 July 2001 except for justified recruitment approved by Cabinet. Cabinet reaffirmed this decision for 2002/03, 2003/04, and 2004/05.
A.4		Secure approval of Cabinet for (i) budget preparation to include an estimate of government revenues from all sources, including anticipated revenues from the Tonga Trust Fund, tax revenues, and departmental cost recovery through fees and charges; and (ii) establishing an overall expenditure ceiling that, on the basis of the forecast, will reestablish fiscal balance between recurrent expenditures and government revenues no later than FY2005.	Budget guidelines for FY2004 were approved by Cabinet in January 2003. MOF and its Budget Monitoring Unit (BMU) started preparation of FY2004 budget. Legislative Assembly approved Government budget for FY2004 in June 2003.  BMU and treasury are assessing cash flow performance for FY2003 on a regular basis. BMU has submitted a report on all extra budgeting by vote for FY2003.	Budget guidelines for 2004/05 were approved by Cabinet in January 2004. Legislative Assembly approved the Government Budget for 2004/05 in June 2004.  BMU and MOF are assessing cash flow performance for 2003/04 on a regular basis. BMU has submitted a report on all extra budgeting by vote for 2003/04.
A.5		Expenditure ceiling will be set to cover all government spending on departmental budgets and public enterprises that can be reasonably foreseen.	BMU and treasury are assessing cash flow performance for FY2003 on a regular basis.	BMU and treasury are assessing cash flow performance for FY2004 on a regular basis.
A.6		Individual expenditure allocations to ministries, although subject to negotiation during budget finalization to be set to not collectively exceed the aggregate ceiling net of nondepartmental expenditure.	Enforced	Enforced
A.7		Secure approval of Cabinet for budget guidelines for FY2003 aimed at reducing the wages and salaries share of government cash spending net of debt services, from 57% in FY2002 budget to 50% in the FY2005 budget.	For FY2003 the budget ratio was 55.2%. For FY2004 budget, the ratio is estimated at 51.0%	For FY2005, the budget ratio is estimated at 53%.

Primary Objective	Secondary Objectives	Policy/Reform Measures	Status at the Time of the Second-Tranche Release (October 2003)	Status at the Time of the Program Completion Report (April 2005)
A.8		Draft a public finance management act and commence legislative process.	Drafting completed	
A.9		Enact a public finance management act designed to strengthen the ability of MOF to maintain the integrity of the fiscal framework.	Public Finance Management Act passed by Legislative Assembly on 5 Nov 2002. Proclamation took place 1 July 2003 in conjunction with the start of FY2004.	Public Finance Management Act passed and enacted.
A.10		Government to discharge its fiduciary responsibility to the former Civil Service Pension Fund by transferring cash or interest-bearing government bonds to the new pension fund to the extent required to meet payments for retired civil servants.	Transfer value is reflected in FY2004 budget. Discussion with Board of Civil Service Pension Fund ongoing.	The old pension scheme under which only the government contribution was replaced with a new arrangement under which employee had to contribute a certain percentage of the basic salary, which was 5% in 2003/04 and 7.5% in 2004/05.
B.1	To enhance revenue generation	Adopt measures to minimize revenue loss and increase revenue generation (including suspension of new development licenses and trade tax exemption, increased administrative fees and charges and collection of revenue arrears, and instructions to departments on keeping their fees and charges current and subject to automatic review every 2 years).	Selected fees and charges have been increased, collection of revenue arrears has been stepped up, and issuing of new development licenses has been limited.	Selected fees and charges have been increased, collection of revenue arrears has been stepped up, and issuing of new development licenses has been limited.
B.2		Amend the current tax and customs legislation to strengthen tax administration and enforcement of compliance in customs, sales, and income tax.	Legislation was submitted and passed by the Legislative Assembly on 6 November 2002. Regulations were approved by Cabinet on 28 August 2003. Public information material on the legislative and regulatory changes was prepared and ready for distribution. Assessment of new tax structure and its implication on economy is ongoing. Public consultations commenced early July 2003. ADB support requested by Revenue Department to help implement the regulations.	Consumption tax was implemented in April 2005. Major public awareness campaign commenced in January 2005. The second phase of tax reform focusing on custom administration modernization and income tax legislation is under contemplation and will be discussed during the 2005 session of Parliament.

Primary Objective	Secondary Objectives	Policy/Reform Measures	Status at the Time of the Second-Tranche Release (October 2003)	Status at the Time of the Program Completion Report (April 2005)
B.3		Suspend extension of credit by government departments and agencies without MOF approval, in accordance with existing legislation. Monthly reports by ministries show no arrears starting March 2002.	Implementation ongoing	Implementation ongoing
B.4		Authorize senior-level staff vacancies in tax administration to be filled.	MOF finalized the recruitment of three senior positions for revenue administration on 24 April 2003. The positions were filled in June 2003. Vacancies in Treasury are currently reviewed.	Various posts in the Inland Revenue were filled during FY2005, in line with the need to strengthen the capacity of revenue services to implement tax reform.
B.5		Implement a training program for staff in tax administration.	Completed under previous Australian Agency for International Development (AusAID) technical assistance (TA) and will commence again after fielding of advisors for tax and customs operations.	Training for auditors to enforce the consumption tax is ongoing.
B.6		Secure TA to support senior positions in tax administration and customs.	AusAID agreed, and Cabinet approved recruitment of one adviser for tax operations and one for customs operations. Tax adviser commenced duty March 2003. Customs adviser will be fielded in November 2003.	AusAID agreed, and Cabinet approved recruitment of one adviser for tax operations and one for customs operations. Both tax and custom advisers are currently working in Tonga.
B.7		Examine costs and benefits of automation of tax administration activities, in particular the introduction of new software for customs administration.	MOF has confirmed the use of the recommended software. New Zealand Agency for International Development (NZAID) has agreed to fund software and adaptation and hardware. A NZAID mission visited Tonga in January 2003 to determine the scope of the required adaptation. The report prepared by NZ Statistics is under review by NZAID.	NZAID has agreed to fund software and adaptation and hardware. Revenue Management System (RMS) is currently in place.
C.1	To improve the efficiency and effectiveness of resource use in the public enterprise sector	Endorse public investment policy. (Completed April 2001)		
C.2		Endorse a corporatization and	Public Enterprise Unit	ADB TA concluded.

Primary Objective	Secondary Objectives	Policy/Reform Measures	Status at the Time of the Second-Tranche Release (October 2003)	Status at the Time of the Program Completion Report (April 2005)
		privatization framework.	prepared a progress report. Asian Development Bank (ADB) TA expected to commence in October 2003. Pacific Enterprise Development Facility approved MOF's request to help restructure/privatize Royal Tongan Airlines.	Corporatization and privatization are ongoing.
C.3		Draft a public enterprise act and commence legislative process.	Completed	
C.4		Pass a Public Enterprise Act establishing rules and procedures regulating the relationship between public enterprises and Government.	Legislation submitted and passed by the Legislative Assembly on 21 October 2002. Regulations are prepared with the support of an ADB TA.	Legislation passed and enacted.
C.5		Corporatize at least two selected government business activities, e.g., Agricultural Machinery Pool, Eua Forestry, Post Office, Government Printing, with a view to reducing government expenditure and/or increasing government revenue.	Preparatory work for corporatization of the Post Office has been completed. Final corporatizing is subject to approval of the new Postal Services Act, targeted for 1 January 2004. Government Printing is targeted for January 2004. Eua Forestry has been merged with Tonga Timber. The Machinery Pool was corporatized 1 July 2003.	In addition to the Machinery Pool and Eua Forestry, Government Printing was corporatized 1 January 2005. Preparations for corporatizing the Post Office were completed. Final corporatization is subject to the approval of the Postal Services Act scheduled in 2005.
2. Public Service Reform				
A.1	To establish the institutional framework for a performance-oriented civil service	PMO will establish a public service reform team to monitor, manage, and coordinate civil service reform.	The team was established by Cabinet Decision (CD) 286 of 20 February 2002. For convenience, most of the reform issues had been discussed at the monthly meetings of heads of department (HODs) before they were submitted to the Cabinet Committee on Reform (CCR). With the formation of the Public Service Commission (PSC), the role of PSRT is redundant. This team is effectively disbanded.	PSC became operational in July 2003.

Primary Objective	Secondary Objectives	Policy/Reform Measures	Status at the Time of the Second-Tranche Release (October 2003)	Status at the Time of the Program Completion Report (April 2005)
A.1.1		Involve selected financial and personnel management responsibilities from the Cabinet to line agencies by: (i) confirming the functions of a PSC, and	All human resource management (HRM) operating functions have been devolved from Cabinet to the PSC.	The principal functions of PSC were confirmed in the Public Service Act.
A.1.2		(ii) Enacting a Public Service Act.	Public Sector Act was passed in November 2002 and received the Royal Assent in January 2003 and published in April 2003. Cabinet approved the establishment of PSC. Commissioners were appointed effective 1 May 2003 and include Prime Minister-chairman; minister of finance; and minister of lands, survey, and natural resources. The position of secretary for PSC has been advertised and applicants interviewed, but no appointment has been made to date.	Former Chief Establishment Officer was appointed to be the Secretary of PSC, effective 1 July 2004. He is on contract for 2 years.
A.1.3		(iii) Approve a devolution policy and implementation plan for the human resource and financial management system (HRMIS).	Cabinet approved the delegation of HRM operational matters to HODs (CD 1360; 12 August 2003). A departmental self-assessment for HRM capacity has been completed by HODs. Departmental HRM capability auditing has commenced with 11 departments completed by early September 2003. The order of delegations has been prioritized and the PSC has approved three HRM activities to be delegation. The HRM functions of internal transfers, confirmation of appointment of new employees and acting appointments were delegated by PSC (PSCD 124 of 8 September 2003) to HODs on 8 September 2003.	Additional functions of "travel and expenses," "training," and "all forms of leave" were delegated by PSC to heads of departments (PSCD No. 40, 28 January 2005).
A.2		Approve a policy paper defining new civil service regulations that incorporate the principles of good governance and a code of ethics, to support building of an efficient and effective performance-oriented civil service	Draft regulation containing values, principles, and a code of conduct was prepared and approved by the CCR and Cabinet in January 2003 (CD 148; 29 Jan 2003). Briefings were held with all departments to familiarize public servants with the Committee, which	A Code of Conduct was approved by PSC on 28 June 2004. Disciplinary Regulations were gazetted on 1 August 2003. The Policy Manual has been submitted to the

Primary Objective	Secondary Objectives	Policy/Reform Measures	Status at the Time of the Second-Tranche Release (October 2003)	Status at the Time of the Program Completion Report (April 2005)
			took considerable time to process the regulations and determined in June 2003 that the disciplinary provisions should become regulations and the matters concerning values, principles, and code of conduct should be resubmitted as policies. These are being reprocessed for separate submission to the CCR, PSC, and Cabinet.	Cabinet for consideration.
A.3		Commence implementation of the devolution policy, and devolve financial and HRM responsibilities to selected ministries and department.	See 2A.1.3.	See 2A.1.3.
B.1	To promote efficient and effective performance management	Prepare a plan to enhance the strategic and management planning, monitoring, and reporting capabilities of each department and commence implementation.	Cabinet approved (CD 477; 26 March 2003) that the proposed corporate plan and annual management plan manual be used by all departments and ministers. Section on annual reporting is under preparation	Heads of departments, senior officials and planning teams of the departments underwent trainings on the principles underlying corporate planning and annual management planning provided in December 2003.
B.2		Develop an HRMIS and implement it within the PMO/establishment division.	AusAID provided funding for 6 weeks to assist with data entry training and developing establishment codes. Training and user manuals have been prepared. All large departments received training in these matters and, as of September 2003 all departments human resource data had been entered in the HRMIS.	The last and third training funded by ADB was provided from 20 March to 3 April 2005 by a Micropay training consultant. The training targeted matching Micropay standard bases, policies, and procedures to those in Tonga and forecasting future developments with a view to maximize utilization of the software.

Primary Objective	Secondary Objectives	Policy/Reform Measures	Status at the Time of the Second-Tranche Release (October 2003)	Status at the Time of the Program Completion Report (April 2005)
B.3		Cause all government departments to prepare and submit to the appropriate authority annual plans and reports in line with the budgetary cycle in a standard-model format.	See 2.B.2.	Submission of annual plans and reports is part of the key results areas in the Performance Agreement of the HODs.
B.3.1		(i) The HRMIS is fully integrated with the civil service payroll system.	MOH and PMO human resource data is integrated with the payroll system. Other departments will be brought on line as they gain access to the systems. Currently, PMO and MOH are on line. Ministry of Education and Ministry of Agriculture and Forestry have been recently connected, but don't have access to the software yet. Several issues have arisen in relation to the operations of the payroll, for example, the issue of payroll numbers and the exclusion of some outer island staff from the active payroll. A payroll review group has been established and is reviewing input mechanisms and procedures to improve the efficiency of the payroll and the relationship to the HRMIS.	Payroll numbers for all employees had been changed to personal file numbers in PSC. A backup had been established for all employees who have left the public service since 1996 and whose personal files were deleted from the system. The HRMIS is now fully integrated with the payroll system.
B.3.2		(ii) HRMIS has the capacity for ministries to direct access and update their human resource databases.	Until the Government has installed a wide area network, direct access to the HRMIS by departments and ministers will be limited. In the interim, it is intended that departments and ministries will have access using PSC, MOF, or other computers that are online.	All ministries, except Ministry of Marine and Ports and Palace Office, have access to Micropay either by means of fiber optics or leased lines. PSC is improving accuracy of data and ensuring full coverage of employees. It is working to bring in Outer Islands employees to Micropay. The inclusion of employees in the island of Eua was completed in March 2005. Inclusion of the rest of the four outer islands will be completed by June

Primary Objective	Secondary Objectives	Policy/Reform Measures	Status at the Time of the Second-Tranche Release (October 2003)	Status at the Time of the Program Completion Report (April 2005)
				2005.
B.4		Secure Cabinet approval of model performance agreements for HODs aimed at raising the level of performance accountability to be formally agreed upon with their ministries.	Cabinet approved HODs performance management system with a performance agreement (CD 1207; 9 July 2003) Transition arrangements have been completed with all HODs signing a 12 months contract of employment (CD 1192; 1 Jul 2003). A draft long-term HODs employment contract has been prepared and is being considered by the CCR. A workshop has been held to complete a draft performance agreement for each HOD. A briefing is planned for all to familiarize ministers with the HODs performance agreements.	All HODs have signed a Performance Agreement with their respective ministers. Their annual performance will be assessed against the key results areas.
B.5.1		Secure cabinet agreement for the implementation of a performance remuneration policy by (i) approving the proposed classifications revised job grades and basic salary structures for implementation.	Cabinet noted the job evaluation system to be used to establish internal relativities between positions. Cabinet approved (CD 478; 26 Mar 2003) the government remuneration policy that includes a policy to link performance with remuneration and a new classification system (CD 519; 2 April and CD 1412; 19 August 2003). Job evaluation of 800 benchmark posts and the slotting of 3,600 other posts are completed. HODs grading have been completed. Draft grading and salary levels have been prepared for all classifications, grades, and "steps." AusAID will provide a short-term consultant to advise the Higher Salaries Review Committee.	The classifications and merit-based remuneration policy was approved and are now standing policies of PSC. The job evaluation results (reclassifications and regrading of all posts in the public service) are now with the Higher Salaries Review Committee.



Primary Objective	Secondary Objectives	Policy/Reform Measures	Status at the Time of the Second-Tranche Release (October 2003)	Status at the Time of the Program Completion Report (April 2005)
B.5.2		(ii) Approving the implementation of a fair, transparent, and objective employee performance review procedure that objectively identifies and recognizes performances.	Performance agreement systems are approved for appraising HODs performance. Draft appraisal process is under consultation and will be finalized in September 2003.	The Guide and the Performance Assessment Form of the Performance Appraisal System were approved by PSC in December 2004. Training sessions were conducted in December 2004 and February 2005 for senior employees responsible for coordinating performance appraisal in ministries and departments. The performance appraisal system for the public service will be implemented on 1 July 2005.
<b>3. Economic and Social Impact Monitoring</b>				
A.	To improve the quality of socioeconomic data production and dissemination	Establish an economic and social impact monitoring unit (ESIMU) in PMO/Central Planning Department (CPD).	Completed 1 August 2002. Operations are ongoing.	
B.		Prepare and submit for ADB review detailed retrenchment plans.	Reform team leaders are currently reviewing voluntary redundancy proposal before submission to CCR. They discussed with project leader and offered TA support for this activity. Compensation strategy for early retirement is in progress	
C.		Ensure that progress reports and assessments of the reform program's social and economic impacts are disseminated within the government and to the general public through government publications and the media.	Exit interviews with resigned staff. Public consultations on all aspects of EPSRP have taken place and consultations continue on the tax reform. Leaflets have been distributed, and radio and TV programs are ongoing.	

**SUMMARY TABLE OF GOVERNMENT OPERATIONS**  
**2000/2001–2005/2006**

		2000–2001	2001–2002	2002–2003	2003–2004	2004–2005
				Outturn Budget		
				(T\$ million)		
1	Total Revenue and Grants ( 1 )	78.5	95.2	99.3	102.1	117.7
2	Total Revenue	76.1	93.2	96.4	99.1	112.0
3	Current Revenue	76.1	93.2	96.4	99.1	110.5
4	Tax Revenue	54.6	74.5	80.7	83.6	88.2
5	Nontax Revenue	21.5	18.7	15.7	15.5	22.3
6	Capital Revenue	0.0	0.0	0.0	0.0	1.5
7	Grants (in cash)	2.4	2.0	2.9	3.0	5.7
8	Operating Expenditure ( 2 )			92.9	102.3	114.1
9	Operating Balance ( 1-2 )			6.4	-0.2	3.6
10	Total Expenditure and Lending Minus Repayments	82.8	99.9	110.5	104.7	128.4
11	Overall Balance	-4.3	-4.7	-11.2	-2.6	-10.7
				(percent of GDP)		
12	Total Revenue and Grants	27.5	33	33	33	37
13	Total Expenditure and Lending Minus Repayments	29.0	34.2	36.8	34.4	41.0
14	Overall Balance	-1.5	-1.6	-3.7	-0.9	-3.4
15	GDP (T\$ million, at 2000/01 constant prices)	285.5	291.5	300.0	304.8	313.3

GDP = Gross Domestic Product.

Source: Government of Tonga.

### STATUS OF COMPLIANCE WITH LOAN COVENANTS

Covenant	Reference in Loan Agreement	Status of Compliance
Loan Agreement (LA), Sec. 3.01	The Borrower shall cause the proceeds of the loan to be applied to the financing of expenditures on the Program in accordance with the provision of the Loan Agreement.	Complied with
LA, Sect 4.01(a, b)	The Borrower shall cause the Program to be carried out with due diligence and efficiency and in conformity with sound public financial management and public service practices.	Complied with
	In the carrying out of the Program, the Borrower shall perform, cause to be performed, all obligations set forth in Schedule 5 to this Loan Agreement.	Partly complied with
LA, Sec. 4.02	The Borrower shall make available, promptly as needed, the funds, facilities, services, and other resources which are required, in addition to the proceeds of the Loan, for the carrying out of the Program.	Complied with
LA, Sec. 4.03	The Borrower shall ensure that the activities of its departments and agencies with respect to the carrying out of the Program are conducted and coordinated in accordance with sound administrative policies and procedures.	Complied with
LA, Sec. 4.04(a)	The Borrower shall maintain, or cause to be maintained, records and documents adequate to identify the Eligible Items financed out of the proceeds of the Loan and to record the progress of the Program.	Complied with
(b)	The Borrower shall enable the Bank's representatives to inspect any relevant records and documents referred to in paragraph (a) of this Section.	Complied with
LA, Sec. 4.05(a)	The Borrower shall furnish, or cause to be furnished, to the Bank all such reports and information as the Bank shall reasonably request concerning (i) the loan, and the expenditure of the proceeds and maintenance of the service thereof; (ii) the goods financed out of the proceeds of the Loan, (iii) the Counterpart Funds and the use thereof; (iv) the implementation of the Program, including the accomplishment of the targets and carrying out of the actions set out in the Policy Matrix; (v) financial and economic conditions in the territory of the Borrower and the international balance-of-payments position of the Borrower; and (vi) any other matters relating to the purpose of the Loan.	
(b)	Without limiting the generality of the foregoing, the Borrower shall furnish, or cause to be furnished, to the Bank quarterly reports on the carrying out of the Program and on the accomplishment of the targets and carrying out of the actions set out in the Policy Letter. Such reports shall be submitted in such form and in such detail and within such period as the Bank shall reasonably request, and shall indicate, among other things, progress made and problems encountered during the quarter under review,	Program progress was updated quarterly by ADB missions.

Covenant	Reference in Loan Agreement	Status of Compliance
	steps taken or proposed to be taken to remedy these problems, and proposed program of activities and expected progress during the following quarter.	
(c)	Promptly after the closing date for withdrawal from the Loan Account, but in any event not later than three (3) months thereafter or such later date as may be agreed for this purpose between the Borrower and the Bank, the Borrower shall prepare and furnish to the Bank a report, in such form and in such detail as the Bank shall reasonably request, on the execution of the Program, including its cost, the performance by the Borrower of its obligations under this Loan Agreement and the accomplishment of the purposes of the Loan.	Complied with. PCR provided in late January 2005.
LA, Sec. 4.06 (a)	It is the mutual intension of the Borrower and the Bank that no other external debt owned a creditor other than the Bank shall have any priority over the Loan by way of a lien on the assets of the Borrower. To that end, the Borrower undertakes (i) that, except as the Bank may otherwise agree, if any lien shall be created on any assets of the Borrower as security for any external debt, such lien will ipso facto equally and ratably secure the payment of the principle of, and interest charge and any other charge on, the Loan; and (ii) that the Borrower, in creating or permitting the creation of any such lien, will make express provision to that effect.	Complied with
(b)	The provision of paragraph (a) of this Section shall not apply to (i) any lien created on property, at the time of purchase thereof, solely as security for payment of the purchase price of such property; or (ii) any lien arising in the ordinary course of banking transactions and securing a debt maturing not more than one year after its date.	Complied with
(c)	The term "assets of the Borrower" as used in paragraph (a) of this Section includes assets of any subdivision or any agency of the Borrower and assets of any agency of any such political subdivision, including the National Reserve Bank of Tonga and other institution performing the functions of a central bank for the Borrower.	Complied with
LA, Schedule 5, I (a)	The Borrower's Ministry of Finance, in its capacity as Program Executing Agency, shall be responsible for the overall implementation of the Program.	Complied with
(b)	The Program Executing Agency shall establish a fiscal reform team composed of five senior government officials.	Complied with
(c)	The Establishment Office in the Prime Minister's Office shall establish and lead a public sector reform team, which shall be responsible for the coordination and	Complied with

Covenant	Reference in Loan Agreement	Status of Compliance
	implementation of the reform activities.	
(e)	The secretariat shall coordinate program implementation on a day-to-day basis, working with the fiscal reform team of the Ministry of Finance and the public service reform team of the Prime Minister's Office, as the case may require. The two reform teams shall report monthly to the Cabinet through the secretariat and the Cabinet committee.	Complied with
LA, Schedule 5, II (a)	The Borrower shall ensure that the policies adopted and actions taken as outlined in the Policy Matrix and as more fully described in the Policy Letter prior to the date of this Loan Agreement shall continue in effect for the duration of the program period; and	Complied with
(b)	The Borrower shall promptly adopt the other policies and take the other actions included in the Program, as specified in the Policy Matrix, and shall ensure that such policies and actions continue in effect for the duration of the program period.	Complied with
LA, Schedule 5, III	Subject to paragraph (c) below, the Borrower shall ensure that the Counterpart Funds are used to finance the local currency costs incurred by the Borrower in implementing the structural adjustments required under the Program.	Complied with
(a)	Immediately after the Effective Date, the Borrower shall establish, in a manner satisfactory to the Bank, a Special Account at the National Reserve Bank of Tonga for the specific purpose of depositing and utilizing at least twenty percent (20%) of the Counterpart Funds.	
(b)	Whenever the Borrower withdraws proceeds of the Loan from the Loan Account, the Borrower shall promptly deposit into the Special Account the pa'anga amounts equivalent to at least twenty percent (20%) of the amount of the proceeds so withdrawn.	
(c)	Except as the Bank may otherwise agree, the Counterpart Funds so deposited into the Special Account shall be utilized to meet the expenditures to be incurred in mitigating the impact of public sector reform. The mitigation costs may include, but are not limited to, the cost of severance and pension benefits (including transfer value), paid to public servants rendered redundant as a result of reform. Severance benefits may include cash payments in recognition of past service, training allowances, relocation allowances and counseling costs.	
(d)	Separate accounts and records in respect of the Special Account shall be maintained in accordance with consistently maintained sound accounting principles and shall be audited annually by independent auditors acceptable to the Bank in accordance with sound auditing standards. Certified copies of such audited accounts and records shall be furnished to the Bank promptly after their preparation, but in any event not later than six (6) months	

Covenant	Reference in Loan Agreement	Status of Compliance
	after the close of the fiscal year to which they relate, or not later than six (6) months after the date of the closing of the Loan Account, as the case may be.	
LA, Schedule 5, IV (a)	The Borrower shall ensure that women are adequately represented on committees, task forces, and other public bodies dealing with the building of a performance-based public service under the Program; and	Complied with
(b)	The Borrower shall ensure that private sector and civil society groups are adequately involved in implementing Program reforms through membership in task forces and committees dealing with reform issues.	Not complied with