

Appendix A

Republic of the Marshall Islands

FY 2006 Budget Statement

**Accompanying the Introduction of the Appropriation Bill for
Financial Year 2006**

by the

Minister of Finance

Hon. Brenson S. Wase

31st August 2005

FY 2006 Budget Statement

1. Introduction to the FY 2006 Budget

The structure of the Marshall Islands economy means that the quality of public financial management directly affects the well being of all Marshallese, now and in the years to come. The key role of macroeconomic policy is to provide sound and stable financial and economic conditions that are conducive to growth and development.

The Government has returned the nation's finances to fiscal stability in recent years since the difficulties experienced between 1996 and 1999. This stability and the initial tentative steps to recovery taken so far, are expected to continue in the medium term under the careful management of this administration.

The FY 2006 Budget continues this careful management and lays the basis for future growth with substantial investments in improving our children's education as well as large infrastructure investments reinforcing this recurrent investment and upgrading and improving the nation's economic infrastructure.

2. State of the Economy

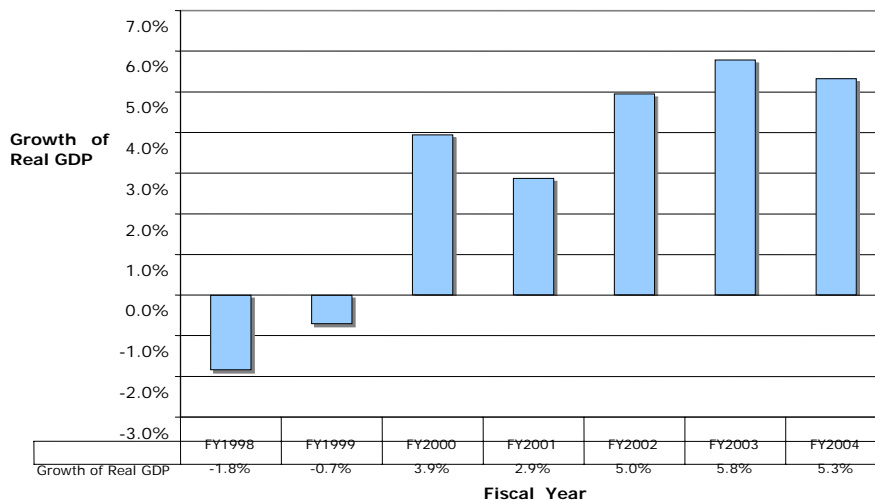
2.1 GDP Growth

The economy has started to show signs of improvement in recent years as the Government begins to reap the benefits of a prudent fiscal policy put in place since the first year of this Administration in FY 2000. Preliminary estimates of Gross Domestic Product (GDP) show promising signs of growth in the economy.

The main measure of economic activity, Gross Domestic Product, showed growth of 6.3% in FY 2004 to \$134.5 million. In real terms (i.e. adjusting for the effects of inflation) the GDP growth has been 5.3% and follows on similar growth levels experienced since FY 2000. Chart 1 shows recent trends in growth of real GDP and reflects the steady performance of recent years coming off the low base of FY 1999.

Chart 1: Real Gross Domestic Product, 1997-2004

Source: EPPSO Preliminary National Accounts



While these growth figures are promising, most of this growth reflects the impacts of the bump-up funds after the end of the first 15 years of the Compact and the one-off impact of the injections of grant funds under the Compact, as amended.

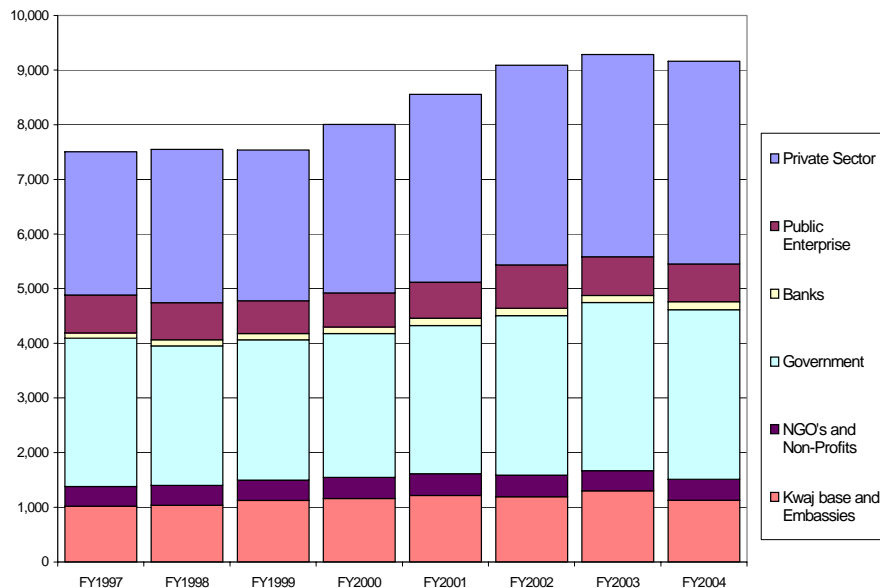
The public sector has grown as these revenues have come into the Government’s budget and the challenge now is to translate this into sustainable growth in the private sector in the medium to long term. It is anticipated that substantial infrastructure developments planned in this year’s budget will help to kick start this process while taxation reforms in the pipeline and further improvements in the business environment will help to place this growth on a sustainable path.

2.2 Employment and Earnings

Employment levels have grown moderately in recent years though this growth has been shared between the public and private sectors. The increase in employment in the private sector is almost exclusively due to the PMOP Loining Plant that closed in late 2004. Chart 3, which shows employment trend since FY 1997, does not pick up this event so employment numbers in the private sector will likely have fallen in FY 2005.

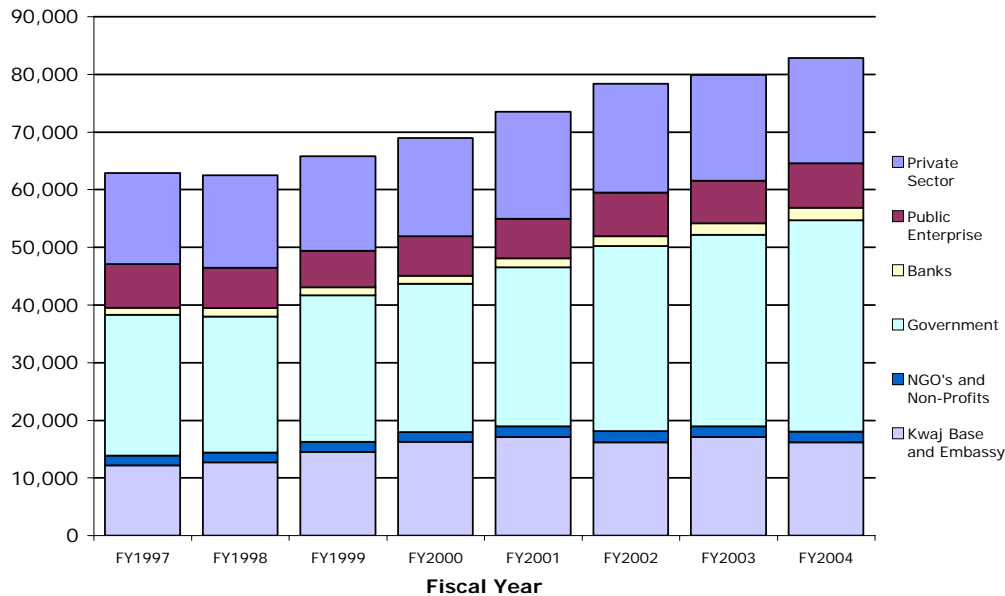
Meanwhile Government employment has also increased since FY 2000 as the Government has recruited to fill essential positions in the public service with more skilled staff after the downsizing efforts before FY 2000. One of the key objectives of the Government now is to keep a lid on Government employment by undertaking a personnel audit of all positions within the Government to verify positions, salary and attendance of staff so that it can better control staffing levels.

Chart 3: Number of Employees by Institutional Sector, FY 1997 - 2004
Source: MISSA



Over the same period total earnings of government employees have increased substantially as can be seen in Chart 4. This is a combination of two factors: firstly the increase in the size of the public service and secondly the harmonization of wage levels in the Ministry of Education when this Ministry’s recruitment of teaching personnel came back under Public Service Commission Guidelines.

Chart 4: Total Earnings by Institutional Sector, FY 1997 – 2004
Source: MISSA



2.3 Government Expenditure and Revenue Trends

Revenue trends over recent years have been dominated by the changes in the grant structures under the Compact of Free Association, as amended. The amended Compact is generous in its provision of funding with the priorities of the new funding reflecting the Government own top priorities of education and health.

Total Compact revenues and other grant funds are predetermined by the Compact agreement and other aid assistance. As a consequence fiscal management tends to focus on the General Fund over which the Government has control of both expenditures and revenues and its policies can significantly effect outcomes.

Chart 2 shows the recent trends in Government General Fund revenues and the projected revenues for FY 2005 and budgeted revenues for FY 2006. It is clear from Chart 2 that tax makes up the vast majority of the government's General Fund revenues. The importance of the General Fund arises from the impact on how these revenues are generated and can have a major impact on economic activity in the country. This reinforces the need for the Government to have an efficient tax and revenue-raising regime.

2.3.1 FY 2004 Budget Outturn

The FY 2004 Government financial audit reported a government net budgetary surplus outcome of \$0.7 million on the general fund. The audit reports that that revenues collected were \$31.6 million while appropriated expenditures were \$30.9 million. This surplus was the result of strong expenditure controls put in place by the Ministry of Finance towards the end of the fiscal year. However, this has resulted in some liabilities remaining on the accounts that were not paid in FY 2004 though services and goods had been provided. The Government though is taking steps to reduce the likelihood of this recurring by being more realistic in its revenue projections as well as ensuring generally accepted accounting procedures are followed.

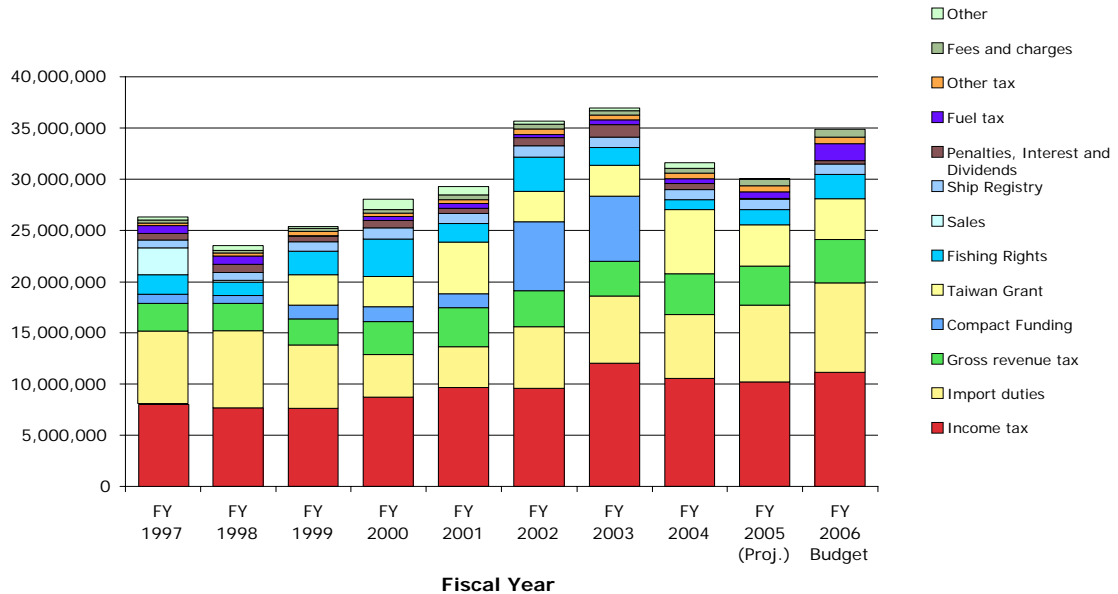
2.3.2 FY 2005 Budget Progress

The FY 2005 Budget is currently projecting a deficit. Revenue estimates for FY 2005 are falling below budgeted figures and this is putting a heavy burden on the Government's financial

position. This was largely a result of over-optimistic revenue estimates based on anticipated revenue flows arising from capital spending budgeted the current year. These capital projects are now coming on line and should lead to a minor revenue stimulus as these expenditures flow through the economy. The Government has put in place expenditure controls to try to bring the FY 2005 budget into balance by year's end.

Chart 2: Central Government General Fund Revenues, FY 1997-2006
FY 2006 General Fund Revenues: \$35.0 million

Source: Government Audit Reports



Income tax, import duties and gross revenue tax are the three main revenue sources in the General Fund. These tax revenues will become more important over time as the Compact base grant is decremented by \$500,000 per year (this decrement is added to the Compact Trust Fund contribution). The Government is looking to reform its revenue-raising regime and improving the business environment so that increased economic activities will replace these revenues. The challenge for the Government is to reform its revenue policies to support economic activity thereby leading to increased taxation revenues to replace this annual decrement. This Budget will take the first tentative steps in this process.

Income taxes are expected to remain stable over the near term, largely tracking employment levels, while import duties have increased with the introduction of the CMI sin taxes in FY 2005. The anticipated revenues from these changes were not fully realised though there has been a significant rise in these revenues. This has prompted the Government to realize the need for more comprehensive and consultative process in addressing tax reform.

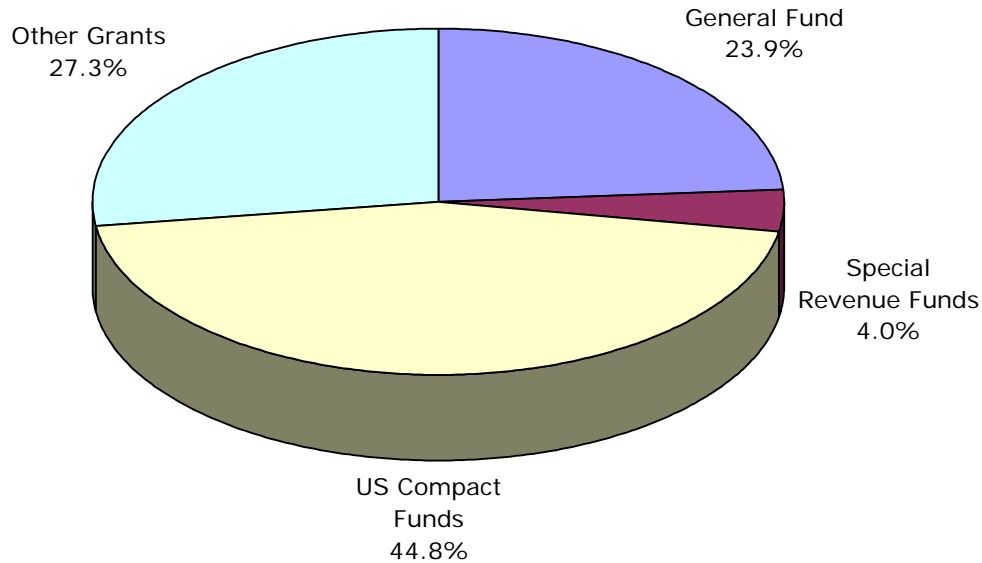
3. The FY 2006 Budget

3.1 Total Revenues

The total budget revenue for FY 2006 is \$146.4 million, which includes a capital budget of \$45.5 million. The recurrent expenditure of \$100.9 million includes all recurrent expenditure from the General Fund, Compact Grants and Special Revenue Funds; in addition to land payments to Kwajalein landowners, investments in the Compact Trust Fund and the KADA Development Fund.

Compact Revenues make up the greatest proportion of the FY 2006 Budget providing \$65.5 million. Other grants, including Federal programs and other capital funding from the Federal Aviation Authority (FAA) and the Republic of China (ROC) contribute \$39.9 million to the budget while General Fund revenues are estimated at \$34.9 million. Special revenues make up the balance of the budget with \$5.8 million. Chart 5 presents a pie graph of the revenue source shares of the budget.

Chart 5: FY 2006 Revenues by Source of Funds
Total FY 2006 Revenues = \$146.4 million



3.2 Compact Revenues

Total Compact funding for FY 2006 is \$65,547,080. Table 1 provides a breakdown of these revenues as they are allocated to their sectors and uses.

Of note in these revenues is the increase in the contribution to the Compact Trust Fund which will be \$8,220,800 in FY 2006. This amount has increased by \$500,000 from FY 2005 plus the inflation adjustment. The incremental increase in the Compact Trust Fund contribution is taken from the Compact Base Grant that has decreased by \$500,000. The contribution to the Compact Trust Fund represents long-term savings that will contribute to future earnings beyond the current economic assistance package and reflects this Administration's commitment to saving for the nation's future.

The reduction in the base grant and the partial inflation adjustment places additional pressure on other revenue sources in the budget, specifically the General Fund, to cover these declines. This highlights the need for the Government to reform its revenue system to encourage future economic activity.

After consultations with the Department of Interior regarding the Single Audit Grant, which is allocated to by the Compact for the Government's single audit costs either up to half or \$500,000 whichever is less, it appears the Government can make a strong argument for the latter based on the total expenditures incurred by the Auditor General's office. This grant is now included in its entirety under Compact revenues.

Table 1: Compact Revenues and Allocations

Compact Component	Amount (\$)	Amount (\$)
FY 2006 Compact Sector Grants Breakdown	FY 2005	FY 2006
Education	\$10,066,921	\$10,834,083
Health	\$5,564,197	\$5,597,181
Private Sector	\$361,943	\$361,943
Capacity Building	\$103,514	\$103,514
Environment	\$202,360	\$202,480
Infrastructure Development	\$12,912,088	\$11,853,028
Infrastructure Maintenance	\$674,287	\$642,651
Sub-total Compact Sectoral Grants	\$29,885,310	\$29,594,880
Ebeye Special Needs	\$3,136,580	\$3,185,560
Kwajalein Impact Fund	\$1,922,420	\$1,952,440
Kwajalein Environmental Impact Assessment	\$202,360	\$205,520
DAEF	\$200,000	\$205,520
Sub-total of Base Grant (non Sector Grants)	\$5,461,360	\$5,549,040
Total Base Grant	\$35,346,670	\$35,143,920
Supplemental Education Grant	\$6,100,000	\$6,268,360
Single Audit Grant	\$310,000	\$500,000
Compact Trust Fund Contribution	\$7,588,500	\$8,220,800
Kwajalein Land Payments	\$15,177,000	\$15,414,000
Sub-total Additional Compact Grants	\$29,175,500	\$30,403,160
Grand Total Compact Payments	\$64,522,170	\$65,547,080

3.3 General Fund Revenues

3.3.1 Overview

The General Fund revenues for FY 2006 are estimated to be \$34,960,944, which represents a 1.8% increase from the FY 2005 budgeted figure. This is below the estimated inflation rate since FY 2005 budgeted figures were optimistic. However, some abnormal items and increases will lead to an expected better performance of recurrent revenues in FY 2006. The major components of FY 2006 revenue are listed in Table 2.

Table 2: FY 2006 General Fund Revenues

Revenue Item	FY 2005 (est.)	FY 2006 Budget
Income Tax	\$10,191,131	\$11,150,670
Import Duties	\$7,518,209	\$8,737,815
Gross Revenue Tax	\$3,837,424	\$4,217,792
Fuel Tax	\$667,256	\$1,683,938
Fishing Rights	\$1,500,000	\$2,380,000
Ship Registry	\$1,000,000	\$1,000,000
ROC Grants	\$4,000,000	\$4,000,000
Fees and Charges	\$669,914	\$686,136
Immovable Property Tax	\$438,553	\$449,517
Other	\$212,591	\$655,076
Total General Fund	\$30,035,079	\$34,960,944

Revenues during FY 2005 have not met expectations, though it is difficult to make accurate estimates due to time lags associated with Income Tax and Gross Revenue Tax collections.

Current estimated collections for FY 2005 are possibly underestimated on these two revenue items with FY 2006 revenue estimates based on conservative growth assumptions from FY 2004 full year figures. The assumptions include an assumption of 2.5% annual inflation for most revenues items but not assuming any GDP growth within these estimates.

The Government is expecting some once-off increases in the areas of Import Duties and Fuel Tax. Import duties are likely to be boosted by approximately \$900,000 by the large capital program in the FY 2006 budget with these projects now liable to pay duties on imported inputs. Correspondingly MEC is scheduled to pay tax on fuel that is sold to foreign fishing vessels refuelling in Majuro. This should lead to an approximate \$1.0 million dollars in additional revenue over and above existing collections.

A further increase in revenues is expected from fishing access fees for distant water fishing nations. These revenues are estimated to reach \$2.38 million in FY 2006 up from only \$1.5 million in FY 2005.

The Government will review the agreement between the Government and the Shipping Registry with a view to enhance the level and timing of revenues currently being received by the General Fund. The existing agreement requires the Ship Registry to pay revenues of \$1.0 million per annum, and this was fixed to reduce the volatility of the payments and also allow for more timely payments from the registry. The agreement was amended to allow the registry to reposition and expand itself in the global ship registry market in the short to medium term, which would lead to increased revenues in the long-term. However, payments still lag and thus the Government is keen to do a cost-benefit analysis of the Ship Registry with a view to at least stabilize revenues in order ensure a reliable cash flow to the General Fund.

Given that the revenues from fishing license fees and ship registry can fluctuate substantially from year to year due to external factors, the Government, through the Medium Term Budget and Investment Framework (MTBIF), is looking to base future estimates of these types of fluctuating revenues on long-term trends. This would require the Government to build up reserves from these sources in years where these revenues outperform long-term trends and draw down reserves during years when revenues fall below these trends, thereby ensuring that revenue levels do not effect ongoing recurrent spending.

3.3.2 Income Tax Restructure

As mentioned already, the Government is looking to improve its revenue raising capability through simplification and streamlining to improve efficiency. The goal is to maintain revenues in the short-term but to encourage economic activity in the long-term. Simplification and fairness are at the center of the Government aims in making these changes and these efforts will involve consultation with the private sector and community. This budget will take some initial steps in this direction.

The existing income tax structure exhibits a number of anomalies that creates an inequitable and inefficient system. The current regime places a heavy burden on low-income earners and their households while high-income earners pay a relatively low amount of tax as a proportion of their income. A progressive tax system encourages a redistribution of income from high earners to those on lower incomes through provision of basic social service such as education and health. The Government wants to relieve the heavy burden on low-income earners by restructuring the income tax regime to improve fairness.

The proposal included here addresses the existing unfairness in the tax structure and is focused on more fairly distributing the income tax burden. Currently the tax regime is regressive with employees earning between \$5,200 and \$10,400 per annum paying a greater proportion of their income in tax than people who earn more than \$26,000 per annum. The Government will be introducing legislation to amend the system but with an effective date likely to be January 1, 2006 to allow those affected to adjust their budgets accordingly.

The proposal is calculated to be largely revenue neutral. Minor changes to the rates and the levels could have a significant effect on the revenues generated and the revenue implications would need to be recalculated.

The proposed regime is listed below:

- retain health and social security contributions at present levels with cap at \$20,000 per annum (\$5,000 per quarter)
- Introduce a tax-free threshold of \$4,160 per annum
- Introduce marginal rate of 12% applying from \$4,161 to \$20,000
- Introduce marginal tax rate of 22.5% applying to every dollar earned in excess of \$20,000 per annum.

Table 3: presents these changes in tabular form.

Table 3: Proposed rates of Wages and Salary taxation

Income Levels (\$)	Government Imposed Marginal Rate¹ (%)	Social Security and Health Contributions (%)	Total Deductions Marginal Rate (%)
0-4,160	0	10.5	10.5
4,161-20,000	12	10.5	22.5
20,000+	22.5	0	22.5

3.3.3 Import Tax Review

The intent of the review of import duties is to simplify its administration while minimising government's loss of revenue. The existing uniform rate is 8% of CIF with a 5% rate applying to foodstuffs. There are also a number of other rates and excises applying to a limited number of goods. The exemptions currently granted add to the administrative complexity of the system and lead to legitimate complaints of avoidance from the private sector.

The Government is submitting a proposal to the current session of the Nitijela to restructure import duties. The specific duties and excises are largely unchanged except for the imposition of specific rate taxes for fuel. The proposed import duty regime would be:

- Uniform rate of 6% of CIF on the value of imports including foodstuffs.
- Introduce specific rate import duties for fuel:

Gasoline	25 cents per gallon (currently 20% CIF value)
Diesel	10 cents per gallon (currently 8% CIF value)
Jet A-1	10 cents per gallon (currently 8% CIF value)
- Retain the import duties at the same levels on other items (e.g. cigarettes, soft drinks, alcohol including sin taxes pending a more detailed review of import duties)
- Eliminate import duty exemptions on all government purchases, projects and public sector enterprises with the exception of diesel generation for MEC and KAJUR.

¹ The marginal rate is the tax rate applied to every dollar applied above a predetermined income level.

Further restructuring of the import duties will be undertaken as part of further tax reform and consultation.

3.3.4 Other Tax Reform

The Government is committed to further tax reform to improve administration of the current tax regime. The Government has initiated a dialogue with the private sector and civil society about ways that this might be approached. Consultations have raised serious issues regarding administration that the Government is already addressing through, among other things:

- Implementation of Taxation and Customs Management Information Systems
- Recruitment of auditors and the introduction of a regular tax auditing program supported by training; and
- Increased penalties and prosecution through regulatory and legislative changes.

The Government plans to introduce further tax reform measures over the next year to help place the government’s revenue base on a more sustainable level.

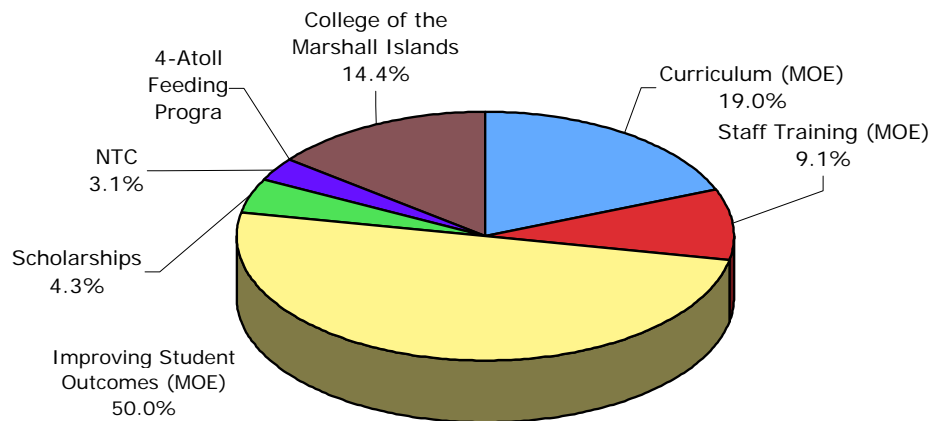
3.4 Expenditure

Expenditure levels for individual Ministries have been kept at similar levels to FY 2005 with the exception of the agencies receiving Compact funds. General Fund expenditures have largely remained at FY 2005 levels since revenues for FY 2005 were optimistic and expenditure levels were raised to meet these revenue increases. Since FY 2006 GF revenues are only marginally higher than FY 2005, individual ministry expenditures have largely been maintained at FY 2005 levels except where specific policy issues will impact on expenditure patterns.

3.4.1 Education Portfolio

Education is the Administration’s top priority. Total recurrent spending across all sources of funding is scheduled to be \$28,136,259 in FY 2006. The portfolio includes the Ministry of Education, College of the Marshall Islands, the Scholarship Board and the National Training Council. Chart 6 breaks down the recurrent expenditure in the Education portfolio in the FY 2006 Budget.

Chart 6: Education Portfolio Expenditure FY 2006
Total FY 2006 Recurrent Spending (excluding capital) = \$28,136,259



Reflecting the high priority of the education sector, the Government will continue to place the greatest share of its expenditure into improving the quality of education in the RMI. The Ministry of Education continues to negotiate the transition to the new Compact arrangements while maintaining its strong emphasis on teacher training and elementary education. The Compact capital grants are almost entirely dedicated to expending educational infrastructure including Phase II of Jaluit High School, Phase II of the Northern Islands High School and the Ebeye High School. The FY 2006 Budget also allocates funds for construction of the Ebeye Elementary School jointly funded through the Compact and a \$1.0 million from the Ebeye Special Needs allocation.

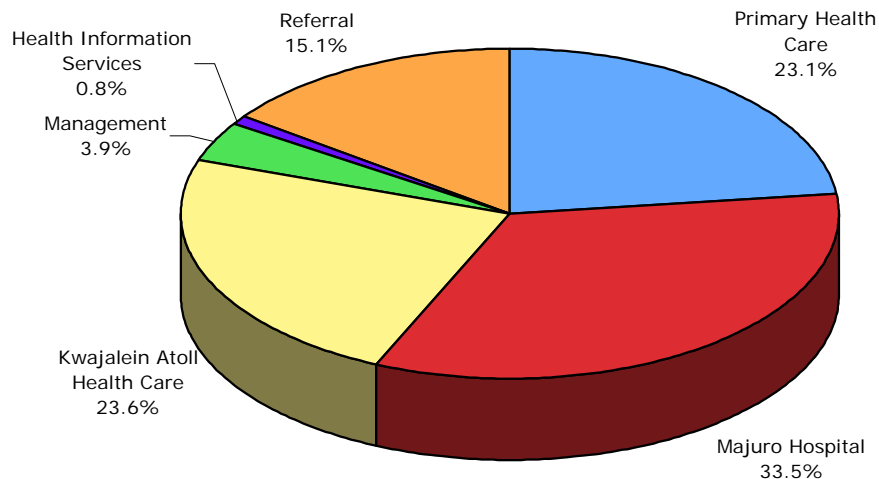
The Government continues to meet its commitment to the College of Marshall Islands (CMI) with an allocation of \$3.0 million to help it meet its accreditation requirements through WASC. Also the Government is looking to build up the National Training Council with a budget from the General Fund and Compact Funds of \$747,486.

3.4.2 Health

The Ministry of Health is also dealing with the transition to the new Compact arrangements. The focus continues to be on preventative and primary health care while also dealing with the coming on line of the Majuro Hospital Facility. The Ministry of Health has embraced the performance based budgeting as a key management tool in the delivery of its desired outcomes.

Total Health Ministry recurrent funding across all funds is \$17,740,417. Chart 7 below outlines the expenditure by Ministry of Health Bureau.

**Chart 7: Administered appropriation (\$) by MOH Bureau FY 2006
Total FY 2006 Recurrent Spending \$17,740,417**



To assist the Ministry of Health with its flexibility in management of its finances, the Government will be introducing amendment to the existing Marshall Islands Health Fund Act to increase the flexibility of use of the Special Revenues available in this fund. At present the Ministry is restricted in its ability to use these funds because of the legislative requirement to allocate 45% to the Health Revenue Fund and 55% for benefits and related fund expenses. This rigidity in the percentage reduces flexibility of the Ministry to provide its services and is in need of amendment to increase flexibility and will ensure that the revenues are still dedicated to legitimate health expenses.

3.4.3 Ministry of Transportation and Communication

The Government recognises that shipping service to the Outer Islands have fallen to unacceptable levels especially considering the size of the Ministry of Transportation and Communication's budget. Shipping services are the lifeline for the Outer Islands so the Government will look to improve services by focussing its expenditures on the ships in best condition while decommissioning a number of vessels and reallocating many of these savings to improve operation of the remaining vessels.

Expenditure in the Ministry of Transportation and Communication will decline by 10.8% in FY 2006 to \$2,273,486 (excluding Special Revenue) but this should lead to better services. The Government will commence operations of the MV Aemman in FY 2006 while four ships will be decommissioned - MV Jobake, MV Jeljelat Ae, MV Litakbouki and the LCM.

The savings from these decommissioned vessels will be reinvested in improving the running of the remaining ships while the Government will continue to support private vessels through its subsidy program. The Government will also look at ways of expanding private sector activity in inter-island shipping services recognizing that often the private sector can provide these service better than the Government as long as the Ministry ensures these operator meet their contractual requirements not to pass on costs to communities in the Outer Islands .

3.4.4 Ministry of Foreign Affairs

The Ministry of Foreign Affairs is maintaining its recurrent budget at the same levels as FY 2005 with an appropriation of \$2,477,577 in FY 2006. However, within this allocation the Ministry may realize significant savings through the consolidation of the New York United Nations Mission into the Washington Embassy. These changes will be studied for possible implementation by early next year. The anticipated savings will be identified within the Ministry to allow the Government to allocate additional resources for such efforts as lobbying costs for the nuclear compensation petition.

3.4.5 Electricity Cost and Subsidies

The Government will maintain direct and indirect subsidies for diesel generation to ensure access to affordable electricity in the Marshall Islands. As mentioned already, the Government will maintain MEC and KAJUR's import duty exemption for the fuel used for electricity generation. This allows these utilities to keep electricity charges affordable for consumers by reducing their cost base, although this is at the expense of a corresponding loss of revenue to the Government. In addition, to these indirect subsidies the Government will provide direct subsidies for electricity generation at KAJUR of \$700,000 and also the Wotje and Jaluit power plants.

The Government is conscious of its use of electricity and its costs to the budget. Ministries will be required to implement energy conservation strategies to limit these costs to reduce electricity bills, especially in light of recent increases in electricity tariffs due to high oil prices worldwide. In this context, the Government is prioritizing the work of the National Energy Task Force to come up with policy on alternative energy technologies.

3.4.6 Tobolar

Production of copra remains a mainstay of income for producers on the Outer Islands . Recognising the import role of copra production on the islands the Government will maintain its 12 cents per pound producer price with a \$900,000 subsidy provided to Tobolar. This is a crucial income source of the Outer Islands and reflects the Government's policy of providing this subsidy to productively employ workers on the Outer Islands but as a way of injecting cash into the island economies. The Government is seriously looking at further use of copra oil as fuel substitute in its vehicle fleet and for use at the KAJUR and other power plants in diesel electricity generation as a way to generate better revenues for Tobolar. In addition, the Government is

encouraging Tobolar to operate its own vessels in order to ensure copra production meets growing demand for coconut oil as a substitute fuel.

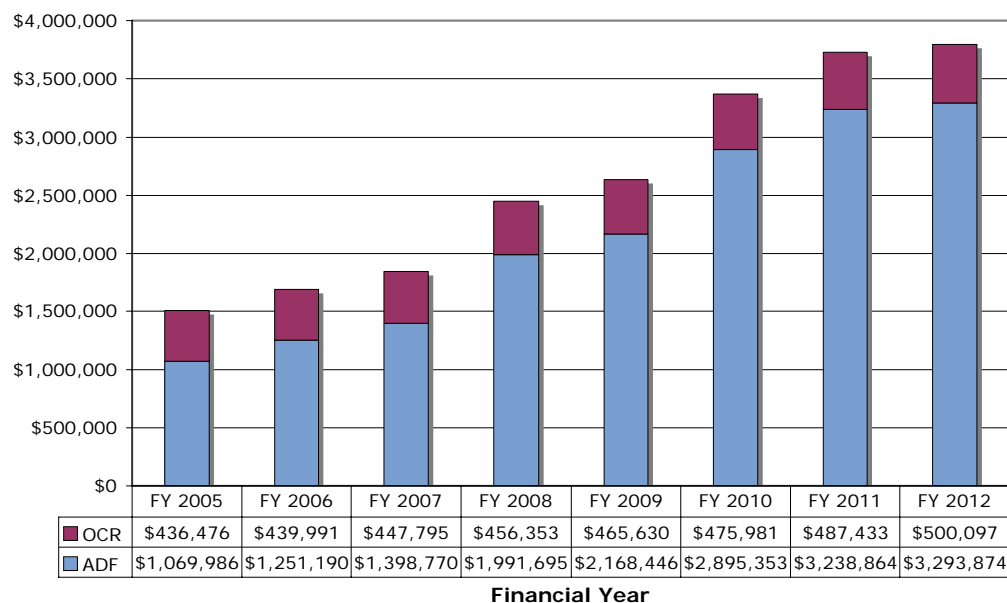
3.4.7 Debt Position and ADB Loan Repayments

Recent policy analysis from EPPSO has reviewed the government’s debt situation. The Government’s debt situation while manageable, is again approaching levels of concern experienced in the 1990s when bond repayments absorbed most of the Compact revenues. By 2001, this debt had been eliminated but during the 1990s the Government had acquired other debts by taking a number of ADB Loans on concessional terms. The ADB lending, while heavily concessional, is not cost free. This is becoming apparent with the ramping up of repayments of much of the ADB lending in the 1990s as the grace periods expire. This will place increasing pressure on the Government’s fiscal situation over the next 5 years and beyond (See Chart 8).

Chart 8: ADB Repayment Estimates by Financial Year, 2005-2012

Source: Asian Development Bank

Note: ADF: Asian Development Fund (Concessional), OCR: Ordinary Capital Resources



The FY 2006 Budget allocates \$1,000,000 to debt repayments though the actual payments are schedule to reach \$1.7 million. If revenue collections exceed expectations the excess revenues will be dedicated to these repayments.

The Government will approach the ADB regarding cancellation or forgiving repayments of non-performing loans, especially where the non-performance resulted from poor project design. This occurred in a number of early loans such as the Ebeye Fisheries Loan, the Basic Education Loan and also the Majuro Water Supply Loan where the Government is now repaying the principle. This should relieve some of the pressure on the General Fund that will be experienced based on the project levels of repayments listed in Chart 8.

3.4.8 Personnel Expenditures – An Unsustainable Trend

During the 1990s the Government was forced to downsize the public service as the wages and salaries bill became an unsustainable burden on the Government’s budget. This resulted when revenues from Compact sources dried as excess funding was dedicated to debt repayments. The

resulting reduction in force (RIF) program reduced the numbers employed by the Government by a third through retrenchments and early retirement.

The RIF ceased in 2000 after the Government achieved the staffing target of 1,484. Since the completion of the RIF the payroll has expanded significantly. The annual Compact decrement of \$0.5 million and the two-third inflation adjustment of the Compact base grant will restrict revenues in years ahead. Correspondingly on the expenditure side debt servicing will place increasing pressure on General Fund expenditures.

The downturn in the RMI economy experienced in 1996 and 1997 was the direct result of the Government’s payroll expanding beyond sustainable levels and serves as a prominent reminder of the potential impact of unsustainable personnel levels on the economy. Despite this recent history, it is alarming to note the recent trend in personnel expenditures as a proportion of recurrent expenditures (See Chart 9). More alarming is the trend in total payroll depicted in Chart 10.

It is clear that personnel expenditures are on the rise again. This is of particular concern because of the rapid increase in overall funding with the extension of the economic assistance under the Compact, as amended, and that much of the increase in funding is actually going towards employment rather than operational expenditures, thereby restricting the ability of the government to deliver services. Hence it is crucial that the Government restrains this growth now and place stricter controls on recruitment.

Chart 9: Personnel Expenditures as a Share of Total Expenditure

Source: Government Audits FY 1993- FY 2004

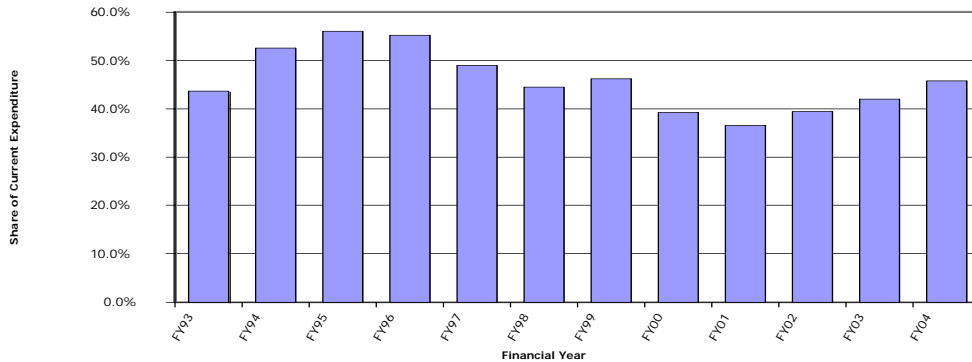
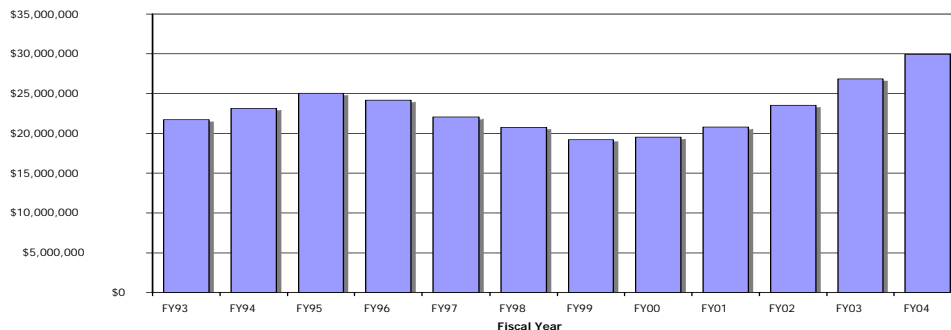


Chart 2: Personnel Expenditures, FY 1993 –FY 2004

Source: Government Audits 1993-2004



3.4.9 Personnel Audit and Housing Expense

The Government recognizes that its personnel expenditures need to be restrained if it is to maintain its fiscal balance. Growth in the Government's payroll is unsustainable and appears to be crowding out employment in the private sector. To keep these costs under control by the Government an internal personnel audit will be undertaken to verify positions, salaries, and attendance among other things. Complementing this, the Government will establish a more rigorous monitoring system for public service employees to improve the budgeting process, given that such a large proportion of the Government's budget is consumed by personnel expenditures.

Complicating this problem is the fact that the Government increasingly recruit overseas employees to fill some skilled positions especially in the Ministry of Health. These employees are entitled to housing allowances included as part of their contract. The cost of housing allowances for these employees in the Ministry of Health alone is approximately \$1.1 million in FY 2006. Across the whole of the public service the total budget for housing allowance is approximately \$1.6 million. To contain this large expenditure item the Government will be reviewing its policy on housing allowances. One action already in place is that the Ministry of Health is trying to recruit single nurses and encouraging nurses to share accommodation to reduce these costs. The Government will in future look to allocate housing allowances commensurate with their salary level of the employee and responsibility of the position. This will be incorporated into future employee contracts for expatriate staff.

3.5 Capital

3.5.1 Education

The capital investments in the education sector have already been outlined above. Table 4 outlines the allocations to these investments.

Table 4: Education Capital Investments FY 2006 Budget

Compact Capital Projects FY 2006	Amount
Jaluit High School Phase II	\$ 1,571,250
Northern Islands High School Phase II	\$ 2,658,750
Laura High School Phase II	\$ 1,255,500
Rairok Elementary School	\$ 2,023,500
Ebeye High School	\$ 2,544,028
Maintenance (Education)	\$ 277,256
Ebeye Elementary School Phase II	\$ 1,800,000
Ebeye Elementary School Phase II (from Ebeye Special Needs grant)	\$ 1,000,000
Total Compact Capital Projects (incl. Ebeye Special Needs)	\$ 13,130,284

3.5.2 Airport Redevelopments

The Marshall Islands Ports Authority, which has the mandate to run the Amata Kabua International Airport, is undertaking essential upgrading of a number of its facilities in FY 2006. The upgrading involves the resurfacing of the airport runway, reconstruction of the taxiway and construction of fire, rescue and tower facilities. The total value of these projects is \$26,000,000 with this funding having been secured through the Federal Aviation Agency (FAA). The individual costs of these projects are listed in Table 5.

Table 5: Airport Capital Projects, FY 2006 Budget

Airport Capital Projects	Amount
Majuro Airport Runway Overlay Project (FAA)	\$ 16,000,000
Majuro Airport Apron Taxiway Reconstruction (FAA)	\$ 5,000,000
Majuro Airport Fire, Rescue & Tower Building (FAA)	\$ 5,000,000
Total Capital from Other Sources	\$ 26,000,000

3.5.3 Outer Islands Transport Infrastructure

Further investments in economic infrastructure are planned for the Outer Islands with capital investments in infrastructure to help shipping access to the island communities and improved servicing. The Government is moving forward with Outer Island Transport Infrastructure project that is being financed by a concessional loan the Asian Development Bank (ADB). This project is worth a total of \$9,995,000 with an estimated \$4,000,000 to be spent in FY 2006. The loan was actually appropriated in a FY 2004 Supplemental Budget but due to implantation delays, the project is now slated to commence in FY 2006. As required under ADB loan conditions, counterpart funding in the amount of \$750,000 has been budgeted for under the ROC capital projects.

3.5.4 ROC Capital Grants

The Government's capital spending is also boosted significantly by the \$6,000,000 capital grant from the Republic of China (ROC). This grant is used for a wide variety of investments including matching grants for projects already mentioned.

The grant also allows the government to undertake many capital investments agreed with agencies in the RMI such as continual capital investment in the College of the Marshall Islands with \$1,000,000 in FY 2006 under a Memorandum of Understanding to support the college so they can maintain their WASC accreditation. There is also an allocation of \$500,000 for capital projects for the Outer Islands and \$300,000 for youth related capital projects to provide facilities that will help provide the youth in the community with meaningful activities to address the prominent youth issues.

Table 6 shows the full list of proposed project to be funded out of the ROC Grant.

Table 6: ROC Capital Grant Projects, FY 2006 Budget

ROC Capital Projects FY 2006	Amount
Infrastructure Maintenance Fund (Compact Matching)	\$ 642,651
Majuro Airport Runway Overlay Project (FAA Matching)	\$ 300,000
Majuro Airport Apron Taxiway Reconstruction (FAA Matching)	\$ 250,000
Majuro Airport Fire, Rescue & Tower Building (FAA Matching)	\$ 250,000
Outer Island Transport Infrastructure Matching (ADB Loan Matching)	\$ 750,000
Laura (Majuro) Agriculture Station (MOU w/ ROC)	\$ 277,349
CMI Capital Improvements (MOU w/ CMI)	\$ 1,000,000
Youth Projects	\$ 300,000
Ebeye Public Work Projects (MOU w/ KALGOV)	\$ 250,000
MIDB Rural Development Programs (MOU w/ MIDB)	\$ 225,000
RMI Capitol Building Repairs	\$ 225,000
Majuro Solid Waste Equipment Replacement & Landfill Works	\$ 200,000
Outer Island Development Projects	\$ 500,000
Alele Museum Roof Repairs	\$ 60,000
Outer Island Airfield Projects	\$ 350,000
Patrol Boat Refit	\$ 120,000
Wotje Public Safety Building	\$ 150,000
MOF Supply Warehouse Repairs	\$ 40,000
Nitijela PA System	\$ 60,000
Laura (Majuro) Fire Truck (USDA Matching)	\$ 50,000
Total ROC Capital Projects	\$ 6,000,000

3.6 Compact Trust Fund

A critical issue for the long-term sustainability of the Government's finances is the establishment and capitalisation of the Compact Trust Fund. The Government will make a contribution of \$2.5 million before the end FY 2005. This will conclude the Government's required contribution under the Compact, as amended which is \$30 million in total. The contribution will be drawn from the "D" Account of the Compact Trust Fund, which was established under the subsequent contributor agreement with ROC.

In FY 2006 the Compact Trust Fund will make an additional contribution of \$8,220,000 to the "A" Account of the Compact Trust Fund. With these contributions the total capitalization of the "A" Account Trust Fund will reach approximately \$55 million.

In FY 2001 the Government provided a \$7.0 million contribution to the capital of the Marshall Islands Development Bank from the Marshall Islands Intergenerational Trust Fund (MIITF). These funds have been dedicated to assisting local companies employing large numbers of Marshallese that were experiencing financial hardship. However, this \$7.0 million investment was provided on commercial terms to the recipients and the returns from this investment with MIDB will be dedicated to the "D" Account of the Compact Trust Fund. The "D" Account of the Compact Trust Fund functions as a buffer account for the Government budget and is completely under the control of the RMI Government. Over time the Government aims to build up to \$10 million as a buffer against unforeseen fiscal difficulties.

The Compact Trust Fund Committee overseeing the operation of the Fund has recently agreed to the full investment of the Trust Fund investment. The Compact Trust Fund, adopting a balanced investment strategy with Goldman Sachs having been appointed as the Compact Trust Fund's investment advisers and First Hawaiian Bank as trustee bank. Goldman Sachs will advise the Compact Trust Fund Committee on the most appropriate investment strategies to maximise the Government's return on the Fund.

4. Concluding Remarks

The FY 2006 Budget is a milestone in the development of the Marshall Islands. It marks another significant step in the Government's move to place the Government's fiscal management on an increasingly sustainable basis and encourage the development of private sector economic activity.

The steps taken in this Budget are the forerunners of more significant reforms. In this reform process the Government has committed itself to continuous consultation with the community, especially the private sector to ensure that all views are heard.