



Federated States of Micronesia

Fiscal Year 2006 Economic Review

August 2007



US Department of the Interior
Office of Insular Affairs

GS GRADUATE
SCHOOL USDA

CURRENCY EQUIVALENTS

Currency Unit — United States Dollar (US\$)

ABBREVIATIONS

ADB	—	Asian Development Bank
Amended Compact	—	Second phase of the Compact, FY2004–2023
BPS	—	Budget Preparatory Software
BSS	—	Basic Social Services
c.i.f.	—	Cartage, insurance and freight
CIP	—	Capital Improvement Project
Compact	—	FSM Compact of Free Association with the United States
Compact I	—	First 17 years of the Compact, FY1987–2003
CPI	—	Consumer Price Index
CTF	—	Compact Trust Fund
DEA	—	Department of Economic Affairs, FSM
DOI	—	Department of Interior, U.S. Government
EPIC	—	Economic Policy Implementation Council
ERP	—	Early Retirement Program
ESC	—	Executive Steering Committee
FDI	—	Foreign Direct Investment
FEMA	—	Federal Emergency Management Agency
FIAS	—	Foreign Investment Advisory Service
FMIS	—	Financial Management Information System
f.o.b.	—	Free on-board
FPA	—	Fiscal Procedures Agreement
GDP	—	Gross Domestic Product
GRT	—	Gross Receipts Tax
HIES	—	Household Income and Expenditure Survey
IMF	—	International Monetary Fund
MTN	—	Medium Term Notes (Compact-backed bonds)
NGO	—	Nongovernmental Organization
OCM	—	Office of Compact Management, FSM
OIA	—	Office of Insular Affairs,
PFTAC	—	Pacific Finance Technical Assistance Center
PIER	—	Pacific Island Economic Report
PMCB	—	Performance Management Capacity Building
PSDP	—	Private Sector Development Program
PSE	—	Public Sector Enterprise

PSRP	—	Public Sector Reform Program
SDP	—	Strategic Development Plan
SEG	—	Special Education Grant
SGS	—	Sustained Growth Strategy
TA	—	Technical Assistance
TRTF	—	Tax Reform Task Force
U.S.	—	United States
VAT	—	Value Added Tax

NOTE

The Federated State of Micronesia government's fiscal year (FY) ends on September 30.

TABLE OF CONTENTS

	Page
List of Tables	v
List of Figures	v
List of Appendix Tables	vii
Foreword	ix
I. Introduction and Summary	x
II. Review of Economic Developments	1
A. <i>Growth and Employment</i>	1
1. Economic Growth	1
2. State Economic Developments	4
3. The Structure of the Economy	11
4. Sectoral Developments	13
5. Incomes, Distribution, and Poverty	15
6. Employment	17
7. Wages	18
B. <i>Monetary Developments and Prices</i>	20
1. Prices	20
2. Money and Banking	22
C. <i>Balance of Payments and External Debt</i>	25
1. Balance of Payments	25
2. External Debt	28
D. <i>Fiscal Developments</i>	29
1. Fiscal Policy Framework	29
2. Recent Fiscal Performance	34
III. Policy Developments, Prospects, and Issues	41
A. <i>Public Expenditure Management</i>	41
1. Public Sector Reform	41
2. Performance Management and Information Systems	43
B. <i>Private Sector Development</i>	47
1. The Private Sector Development Program	47
2. Tax Reform	52
C. <i>Outlook</i>	55
1. Adjustment to the Amended Compact	55
2. Adjustments in Kosrae and Chuuk	56
3. Short-term Prospects	57
4. Long-Term Perspectives	58

LIST OF TABLES

		Page
Table 1	Average Real GDP Growth per annum by State and Economic Sector	1
Table 2	Population by State and annual average growth rates	15
Table 3	Real GDP per capita	17
Table 4	Employment Growth Rates by Sector and State	17
Table 5	Real Wages and Differentials by Sector and State	19
Table 6	Balance of payments	26
Table 7	U.S. Annual Compact Grants and Contributions to the Trust Fund	30
Table 8	Comparative Analysis of Fiscal Structure	35
Table 9	PSRP Workforce and Payroll Reduction Performance	42
Table 10	Compliance with PSDP policy reform conditions and overall score	52
Table 11	Capacity Building Sector Transition and Compact Fiscal Adjustment	55

LIST OF FIGURES

		Page
Figure 1	Real GDP Growth	3
Figure 2	FSM real GDP by sector	4
Figure 3	Chuuk State Real GDP by Sector	5
Figure 4	Kosrae State Real GDP by Sector	8
Figure 5	Pohnpei State Real GDP by Sector	9
Figure 6	Yap State real GDP by sector	11
Figure 7	The Institutional Structure of the FSM Economy	11
Figure 8	Visitor Arrivals to the FSM	14
Figure 9	GDP per capita, migration and population growth	16
Figure 10	Employment by sector	18
Figure 11	Change in CPI - Domestic and Imported Items	20
Figure 12	Commercial bank loans and deposits	23
Figure 13	Commercial Bank Credit by Sector	24
Figure 14	FSM external debt	28
Figure 15	FSM external debt ratios	29
Figure 16	FSM Consolidated Revenues and Expenditures	34
Figure 17	Alternative growth scenarios, GDP per capita	59

Figure 18 Comparison of the Third Summit dismal scenario with performance

60

LIST OF APPENDIX TABLES

		Page
Table 1a	FSM Gross Domestic Product	S1
Table 1b	Chuuk Gross Domestic Product	S2
Table 1c	Kosrae Gross Domestic Product	S3
Table 1d	Pohnpei Gross Domestic Product	S4
Table 1e	Yap Gross Domestic Product	S5
Table 2a	FSM Tourist and Visitor Arrivals by Year and Nationality	S6
Table 2b	Chuuk Tourist and Visitor Arrivals by Year and Nationality	S6
Table 2c	Kosrae Tourist and Visitor Arrivals by Year and Nationality	S7
Table 2d	Pohnpei Tourist and Visitor Arrivals by Year and Nationality	S7
Table 2e	Yap Tourist and Visitor Arrivals by Year and Nationality	S8
Table 3a	Employment by Industry, FSM and States	S9
Table 3b	Employment by Institution, FSM and States	S12
Table 3c	Average Nominal Wage Rates by Institution, FSM and States	S14
Table 3d	Average Real Wage Rates by Institution, FSM and States	S16
Table 4	FSM Commercial Banking Survey (US\$ Millions)	S18
Table 5a	FSM CPI Index	S19
Table 5b	FSM CPI Index, Domestic Items	S20
Table 5c	FSM CPI Index, Imported Items	S21
Table 5d	Chuuk State CPI Index	S22
Table 5e	Kosrae State CPI Index	S23
Table 5f	Pohnpei State CPI Index	S24
Table 5g	Yap State CPI Index	S25
Table 6a	Imports by Major Category FSM and States	S26
Table 6b	FSM Balance of Payments	S27
Table 6c	FSM External Debt	S29
Table 7a	FSM Consolidated Government Finances (GFS Format)	S30
Table 7b	National Government Finances (GFS Format)	S32
Table 7c	Chuuk Government Finances (GFS Format)	S34
Table 7d	Kosrae Government Finances (GFS Format)	S36
Table 7e	Pohnpei Government Finances (GFS Format)	S38
Table 7f	Yap Government Finances (GFS Format)	S40
Table 8a	National Government Finances (Audit Format)	S42
Table 8b	Chuuk State Government Finances (Audit Format)	S44

Table 8c	Kosrae State Government Finances (Audit Format)	S46
Table 8d	Pohnpei State Government Finances (Audit Format)	S48
Table 8e	Yap State Government Finances (Audit Format)	S50
Table 9	Net Air Passengers from the United States	S52

FOREWORD

This report has been prepared to assist the Government of the Federated States of Micronesia (FSM) and U.S. Department of Interior to fulfill their respective reporting obligations under the Compact of Free Association with the United States. In the case of the FSM, the nation is required under Title One Section 214 to report to the U.S. President on the use of sector grant assistance and progress in meeting mutually agreed program and economic goals. In the case of the United States under Title One Section 104.h the President is required to submit a similar report to Congress concerning developments in the FSM. This report has been prepared under a grant from the Department of Interior and administered through the Graduate School, USDA. However, it is not intended to directly fulfill the reporting requirements of the two governments. Rather it is intended to provide an assessment of FSM economic performance, its policy environment and, a set of economic statistics. It is envisaged that much of the material will be directly relevant for the two reports. However, the reporting requirements of the two governments are different and thus not all the material will be relevant to both reports.

The report is comprised of two parts: a descriptive section of economic developments in the FSM and discussion of policy developments, prospects, and issues. The descriptive section takes a standard macroeconomic approach and includes discussion on economic growth and employment, monetary developments and prices, the external sector, and fiscal developments. In the policy discussion the report is intended to review key topical areas rather than provide a comprehensive review. Discussion focuses on public expenditure management, private sector development, and the short- and long-run outlooks. Following the descriptive and analytical sections, a comprehensive set of economic statistics is provided.

The author would like to express thanks to the many people who have contributed and made this report possible. First, to Glenn McKinlay who compiled and updated most of the economic time series database and in particular the national accounts. Second, to the Department of Economic of Affairs and Sancherina Salle, who supported the project during the field work and provided much important information. To Evelyn Adolph of the Department of Administration and Finance who also provided insight on the tax reform initiative and general policy issues. Lastly, to Steve Medlin and Bill Oakes who provided status reports on the implementation of the new financial information management systems and the performance management capacity building project

Mark Sturton

I. INTRODUCTION AND SUMMARY

This review has been prepared to assist both the FSM Government and the United States in the fulfillment of their respective obligations under the Compact. In the case of the FSM the amended Compact states under Title One Section 214 that:

“The Government of the Federated States of Micronesia shall report annually to the President of the United States on the use of United States sector grant assistance and other assistance and progress in meeting mutually agreed program and economic goals. The Joint Economic Management Committee shall review and comment on the report and make appropriate recommendations based thereon.”

In the case of the United States the President is required to submit a similar report to the Congress concerning similar developments. Under Title One Section 104.h of the amended Compact it states:

(1) REPORT BY THE PRESIDENT.—Not later than the end of the first full calendar year following enactment of this resolution, and not later than December 31 of each year thereafter, the President shall report to Congress regarding the Federated States of Micronesia and the Republic of the Marshall Islands, including but not limited to—

- (A) general social, political, and economic conditions, including estimates of economic growth, per capita income, and migration rates;*
- (B) the use and effectiveness of United States financial, program, and technical assistance;*
- (C) the status of economic policy reforms including but not limited to progress toward establishing self-sufficient tax rates;*
- (D) the status of the efforts to increase investment including: the rate of infrastructure investment of U.S. financial assistance under the U.S.-FSM Compact and the U.S.-RMI Compact; non-U.S. contributions to the trust funds, and the level of private investment; and*
- (E) recommendations on ways to increase the effectiveness of United States assistance and to meet overall economic performance objectives, including, if appropriate, recommendations to Congress to adjust the inflation rate or to adjust the contributions to the Trust Funds based on non-U.S. contributions.*

The review is presented in two parts: a review of economic developments, and a section on policy developments, prospects, and issues. While this report relates to the fiscal period FY2006, analysis of developments in that year alone would provide a limited and one-sided view. The approach has been rather to review developments in a broader context since FY1995 so that a more informed assessment can be made. The first section of the report, the review of economic developments, updates the FY2005 Compact report, but focuses and adds reference to FY2006. The content of the review of economic developments follows a standard macroeconomic approach and discussed economic growth

and employment, prices, money and banking, the balance of payments, and, finally, fiscal developments.

In the second part of the review the discussion comprises three sections: public expenditure management, private sector development, and Compact adjustment and the economic outlook. In the mid-1990s the nation embarked on a program of public sector reform assisted through an Asian Development Bank (ADB) program loan. This review looks at the changes made during the Public Sector Reform Program (PSRP) and whether they remain in force. In particular, trends in public sector payroll are examined. Although not part of the PSRP, a system of performance budgeting and management were introduced by the FSM. The amended Compact also requires that performance measures be established and monitored. The review examines the effectiveness of the current system and measures needed to improve its effectiveness. Critical to the needs of fiscal and performance management is the implementation of a modern financial management information system (FMIS). The FSM, with support from the Office of Insular Affairs (OIA), has recently embarked on the implementation of a new FMIS. The review indicates progress with implementation and highlights important considerations for future development.

In 2003 the FSM embarked on a Private Sector Development Program (PSDP), a loan-assisted program supported by the ADB, designed to improve the environment for private sector development. Progress in the execution of the policy components and fulfillment of the conditions of second tranche draw down are reviewed. Tax reform has been an important component of the reform agenda and although implementation has been slow, it appears now to be finally getting underway. While greater tax effort is now too late to assist in the adjustment to the phase out of non-conforming uses of the capacity building grant, the need for tax reform to provide an adjustment mechanism to the annual decrement that supports the private sector remains important.

The third section of the policy review is concerned with short and long-term prospects of the FSM economy. Adjustment to the phase out of non-conforming uses of the capacity building grant in Kosrae and Chuuk states is considered and the likely prospects of the economy over the next two years FY2008 and FY2009. While the forecast is only a best estimate of likely developments, it provides a convenient mechanism to examine the impact of the transitioning of the capacity building sector grant, and implementation of the infrastructure sector grant, which has been stalled during the first 4 years of amended Compact. Discussion proceeds to the long-run, and compares recent performance with the “sustained growth strategy” adopted by the FSM at the Third Economic Summit. Analysis indicates that actual performances falls short even of the “dismal scenario” also outlined at the summit, and indicates the need for immediate fiscal stabilization and completion of the adjustment process to the new requirements of the amended Compact.

II. REVIEW OF ECONOMIC DEVELOPMENTS

A. Growth and Employment

1. ECONOMIC GROWTH

1. This section of the economic review is concerned with economic performance of the FSM in FY06; the third year of the amended Compact period. However, in order to explain and understand recent economic developments, it is necessary to place the developments of FY2006 in a longer-term perspective. While economic developments will be reviewed over the FY1995–FY2006 period, a brief recap of the major features of Compact I is helpful. The structure of Compact I economic assistance from FY1987–FY2003 was front-loaded with two stepdowns after 5 and 10 years entailing a 15 and 22 percent reduction in base grant funding. The transfers were only partially indexed to U.S. inflation, resulting in a real reduction in resource flows amounting to an annual average decline of 4 percent. Provision was made for a further two years of funding through FY2003, but at the average level of funding during the first 15 years. The original Compact period thus incorporated three large distinct fiscal shocks and challenges to the economy: two negative ones requiring substantial downward adjustment and a third “bump-up” in resources requiring measures to limit unsustainable increases in public expenditures.

2. Before discussion of the economic performance comment on the base year of the review period, FY1995, should be made. FY1995 was the height of economic activity during Compact I when real gross domestic product (GDP) reached a peak. From that point until the end of Compact I, and even to this day, real GDP has failed to return to its zenith. It could be argued that this period is not a suitable point for analysis. However, FY1995 is the midpoint during the 1990s, precedes the impact of the second step-down, and provides a suitably long period to review developments.

3. Economic developments since FY1995 are described in Table 1. From FY1995 until FY2007 (projected) the economy declined by 0.2 percent, reflecting economic per-

Table 1 Average real GDP growth per annum by state and economic sector¹

	FY1995-FY2007			2nd Step-Down FY1995-FY1997			Final Phase Compact I FY1997-FY2003			Compact II FY2003-FY2007		
	GDP	Gov	Private	GDP	Gov	Private	GDP	Gov	Private	GDP	Gov	Private
Chuuk	-0.6	-2.3	0.4	-12.9	-14.1	-32.2	3.1	2.6	8.5	-4.2	-6.7	-4.3
Kosrae	-0.6	-0.3	-1.9	-4.4	-0.9	-7.0	2.6	2.6	2.6	-3.9	-3.9	-4.6
Pohnpei ²	-0.2	-0.8	-0.7	-6.8	-4.6	-7.5	0.9	-0.2	-0.5	-0.5	-1.7	2.2
Yap	0.5	-0.7	0.3	0.9	-2.9	-0.2	0.8	-1.8	3.3	-1.8	0.1	-5.1
FSM	-0.2	-1.2	-0.4	-7.1	-7.2	-11.2	1.7	0.8	2.5	-2.2	-3.3	-1.4

Notes 1 Growth rates computed using least squares.
2 Pohnpei inclusive of national government.

formance in each of the four states. Growth in Chuuk and Kosrae recorded an annual decline of -0.6 percent, and while Pohnpei hovered around zero with only Yap managing to sustain a positive growth of 0.5 percent. While growth of the public sector declined in all states, private sector activity remained positive in Chuuk and Yap, but actually declined in both Kosrae and Pohnpei. Although FY1995 represented the high point of Compact I, resulting from a rapid expansion in the public sector, the overall result since that time is extremely disappointing: GDP growth declined and the private sector contracted.

4. The period FY1995 through FY2006 can be usefully analyzed in three separate intervals: the impact of the second step-down: FY1995–1997, recovery and the final phase of Compact I: FY1997–2003, and the start of Compact II: FY2003–2007. The second step-down of Compact I in FY1997 was large in magnitude and required a painful adjustment. Supported by an ADB Public Sector Reform Program Loan, an Early Retirement Program (ERP) was initiated to reduce the number of public servants to an affordable level. By loan close-out in December 1999 the work force had been reduced by 23 percent against a target of 27 percent and the wage bill had been cut by 29 percent against a target of 35 percent through reductions in the number of hours in the working week. . While not fully meeting the targets, the program was successful in terms of fiscal adjustment and avoided a potentially destabilizing financial situation. Balance with respect to recurrent operational expenditures was restored by the end of FY1998. Not unsurprisingly, the adjustment required to restore balance after the second step-down had a significant impact on the economy. The government contribution to GDP declined by an average annual rate of 7.2 percent between FY1995 and FY1997, while total GDP fell at an annual rate of 7.1 percent. The private sector was severely affected and declined by 11.2 percent annually over the period.

5. While the second step-down in Compact funding imparted a significant downward shock on the economy in FY1997, the economy recovered some of the lost ground in the following two years through the end of FY1999 despite poor fiscal management and increasing expenditure overruns in Chuuk State. From the start of FY2000, with adjustment to the second step-down complete and the Chuuk crisis resolved, the FSM economy performed adequately through the end of the Compact I period. During FY2002 and FY2003, the economy continued to expand, benefiting from the infusion of the bump-up funds despite the requirement the United States had imposed that the FSM should set aside \$30 million of the additional resources for contribution to the amended CTF. Overall during the final period of Compact I from FY1997-FY2003, the economy grew by 1.7 percent per annum, with an expansion in the public sector of 0.7 percent per annum, and an annual average private sector growth of 2.1 percent.

6. Turning now to economic developments during the amended Compact period FY2004 through FY2007, Figure 1 indicates the annual growth of the economy. It shows that after a period of growth in FY2002 and FY2003, boosted by the infusion of the bump-up funds, the economy went into recession in FY2004 as the level of Compact receipts fell to the new lower negotiated levels. This was a reduction from \$84 million (the

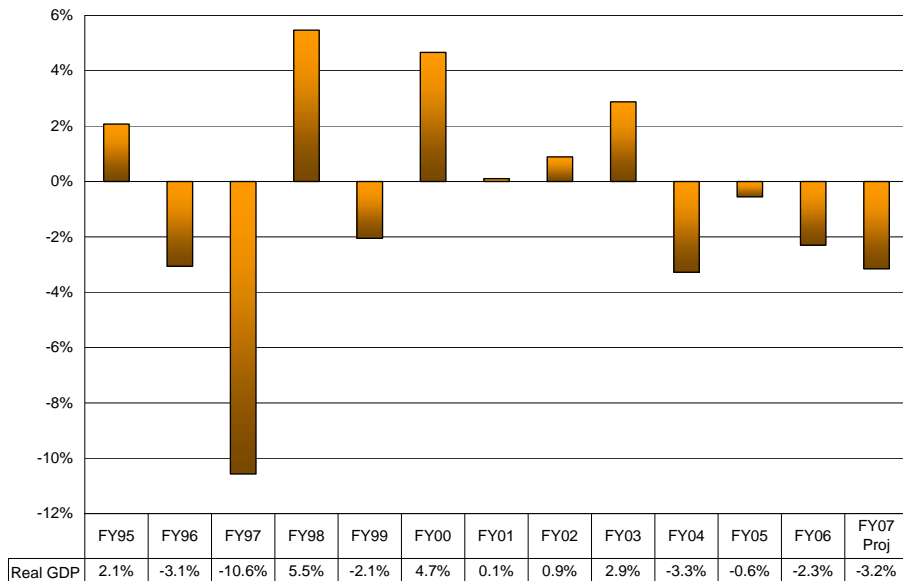


Figure 1 Real GDP growth (percent)

Compact I level without bump-up) to \$76 million. Projections in the Strategic Development Plan (SDP) had anticipated a reduction in GDP of 6 percent, but the actual outcome reveals a decline of 3.3 percent. The transition to the amended Compact thus turned out not to have been as severe as anticipated. A major component of the impact was the loss of the energy subsidy no longer available under the amended Compact in those states that had failed to operate their utilities on a cost recovery basis. In Yap the state suffered from the impact of Typhoon Sudal in April 2004, which significantly depressed output. The outcome in FY2004 further reflects a variety of Compact implementation issues which reduced the absorptive capacity to effectively utilize the available resources.

7. The inability of the FSM to establish a satisfactory mechanism for the disbursement of the infrastructure grant resulted in an almost total absence of use of this resource between FY2004 and FY2007. Absorptive capacity constraints also prevented the FSM from fully using the five operational grants. Of the total budget of \$59 million in FY2004, the FSM was unable to expend \$6.9 million. However, by FY2006 capacity constraints in the use of the five operational grants had been largely overcome. The fact that the impact on the economy of the failure to fully use the amended Compact resources was not as pronounced in FY2004 as the figures would suggest, reflects the historically low level of absorptive capacity, a level that has perhaps not been fully realized. On the positive side, the inability of the FSM to use the infrastructure grant, amounting to 30 percent of available Compact resources, represents the potential for economic expansion in the future once implementation issues have been resolved.

8. Figure 2 provides further information on recent economic developments by sector and the sustained collapse in the economy since FY2003. While the SDP had envisaged a short adjustment to the new environment of the amended Compact and return to economic growth from FY2005 onwards, the FSM economy has contracted in each year since FY2003 and GDP has fallen by 9.0 percent overall. The public sector indicates continuing decline resulting from the reduced levels of funding under the amended Compact, and phase out of the use the capacity building sector grant to fund non-conforming purposes. A very significant decline is projected for FY07 based on reduced levels of public expenditures in Chuuk. Reflecting reduced demand from the public sector, private activity also collapsed and has fallen in each year since FY2000. Overall economic performance since the commencement of the amended Compact has been dismal, reflecting Compact implementation problems and failure of any positive response from the private sector.

2. STATE ECONOMIC DEVELOPMENTS

i Chuuk State

9. Compounded by the reduction in Compact flows, Chuuk State suffered a severe financial crisis in the mid-1990s due to weak fiscal management (see Figure 3). Chuuk ran up large arrears with domestic and international vendors and failed to make allotments on public servant payroll. At the height of the crisis in FY1996 the state had accumulated debts of over \$17 million—equivalent to 30 percent of state GDP. However, in late FY1996 the state initiated a recovery program with conditioned financial support

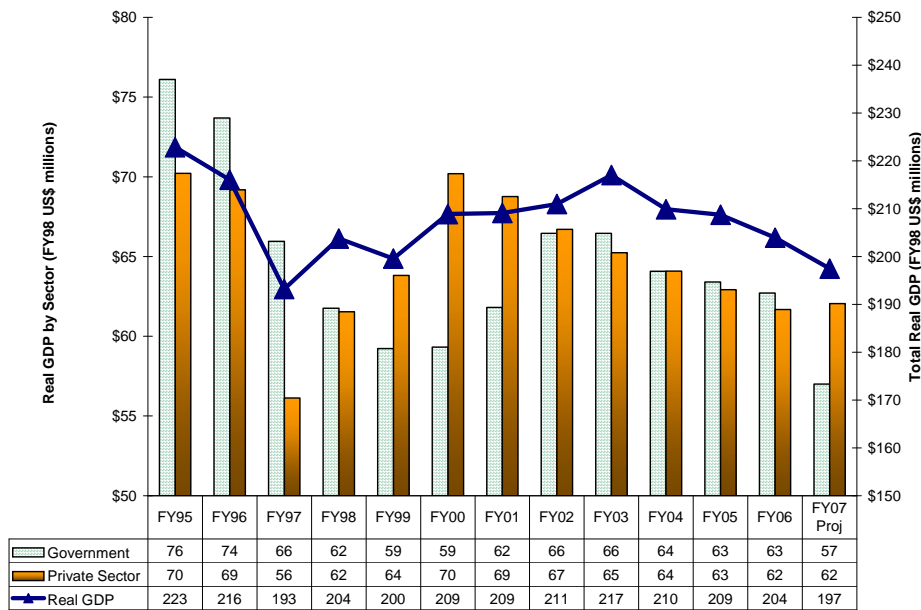


Figure 2 FSM real GDP by sector (FY1998 US\$ millions)

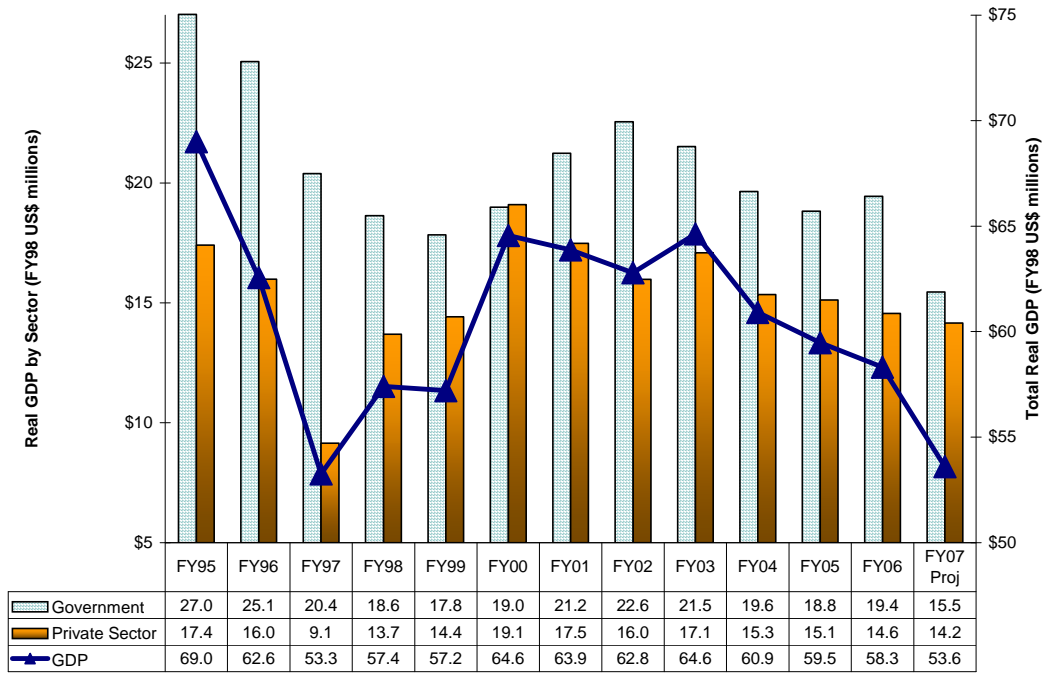


Figure 3 Chuuk State real GDP by sector (FY1998 US\$ millions)

from the National Government. That program, coupled with the Early Retirement Program and reduction in the biweekly pay period to 64 hours, rapidly reversed the adverse fiscal position. By the start of FY2000 the state had repaid essentially all of its recorded arrears and was running a significant structural surplus in terms of its recurrent operations. Coupled with an airport renovation project, an increased capacity to implement development projects, and a return to a 72-hour biweekly pay period, state economic activity increased by a sizeable 15 percent in FY2000 after several years of negative growth between FY1996–FY1998. However, the level of economic activity has still to attain that achieved in FY1995.

10. The return to fiscal discipline in Chuuk lasted only four years. The elections in March 2001, revenue overestimation based, return to an 80-hour pay period in FY2001, uncontrolled off-island medical referrals, and a significant increase in hiring of contract workers led to a rapid deterioration in the state’s fiscal position. During FY2002 the state returned to paying employees’ net pay only, essentially defaulting on approximately 60 percent of employee deductions to vendors, banks, the FSM tax authority, and the Social Security Administration. As the crisis broke, it was estimated that the state had again run up arrears to the sum of \$9 million compounded by as much as \$6 million owed to complete land purchase agreements entered into without adequate authorization and appropriation. As a consequence of these developments the state economy failed to sustain the recovery initiated in FY2000. State GDP declined by 0.9 percent in FY2001 and 0.8 per-

cent in FY2002, despite the infusion of the bump-up funds. In FY2003, expenditures were reigned in to meet commitments to set aside the state's share of the bump-up funds. However, the expansionary impact of individual family grants from the Federal Emergency Management Agency (FEMA) to compensate households for the destruction caused by Typhoon Chata'an stimulated economic activity and the state GDP grew by 2.9 percent.

11. In FY2004 the Chuuk economy fell by a substantial 5.7 percent, reflecting a variety of factors. First, the state had to adjust to the reduction in funding after the bump-up" funds ran out in FY2003. Implementation of the amended Compact and lower levels of funding reduced government activity to more normal levels. Second, FY2003 had been an unusual year, resulting from the stimulus to economic activity from Typhoon Chata'an. In FY2004 the state did not benefit from the additional resources and economic activity again declined. Third, the amended Compact entailed a loss of the energy grant, which resulted in reduced public enterprise value added. And finally, the state continued to suffer from the financial crisis and delays in vendor payments adversely affected private sector profitability.

12. FY2005 saw continued reductions in both private and public sector activity and GDP fell by 2.4 percent. Utility prices were raised from ¢16 to ¢24 to restore profitability after the loss of the energy grant but the sector continued to be plagued by inefficiencies and power outages. Coupled with increasing food prices and the impact of the worldwide increase in fuel prices, the state Consumer Price Index (CPI) rose by 3.3 percent. In FY2006 under a new administration, the state payroll expanded by 20 percent and the bi-weekly wage cost rose by 14 percent. With continued pressure on the utility corporation from increasing world energy costs, electricity prices stood at ¢32 at the end of the fiscal year. Overall the state CPI rose by 5.5 percent. With an unsustainable expansion in public expenditures, fiscal stability came under severe pressure, and arrears mounted. The FY2007 budget entailed a return to the size of government payroll existing in FY2005, but with the need to phase out the use of non-conforming activities from the capacity building grant, previous overspending and overestimation of revenues, these measures were inadequate to resolve the crisis. In FY2007 state GDP is projected to have fallen by 8.1 percent, the state government is reputed to have debts amounting to over \$40 million and to be insolvent.

ii Kosrae

13. Of all the FSM states, Kosrae is the one most dependent on public sector activity; it has failed to generate an active private sector. While the state achieved the ERP targets in the PSRP set for personnel, the gains have been largely eroded through increases in wages, which are now above their pre-reform levels. As a result, recurrent expenditures have returned to their former levels. In FY2002 Kosrae opted to draw down the state's share of the bump-up funds for public expenditures, and the biweekly payroll was increased from 56 to the former level of 64 hours. However, in FY2003 the state made provision to set aside an amount greater than the one-year level of the bump-up funds to con-

tribute to the amended Compact Trust Fund. As a consequence of the additional expenditures in FY2002 the economy expanded by 4.9 percent, but state GDP fell by 2.4 percent in FY2003 (see Figure 4).

14. The first year of the amended Compact had a significant negative impact on the state economy, which experienced a large drop in GDP of 4.1 percent, as public expenditures fell back from their prior bump-up levels to the reduced amounts of the amended Compact. The outturn was similar to that of Chuuk, but with reduced impact. The loss of the energy grant also affected public enterprise profitability with adverse consequences for GDP. In FY2005, utility prices were doubled to compensate for the loss in the energy grant and to restore viability in the sector, but at $\phi 17$ a unit remained well below cost. FY2005 saw a large increase in inflation of 8.6 percent in the state, in part due to the increase in the utility prices, but also due to a substantial increase in food prices, the impact of the worldwide increase in fuel prices, and a general increase in prices. Since the CPI is used as the GDP deflator the increase in CPI had a significant impact and real GDP fell by 6.0 percent. In FY2006 and FY2007 these trends continued and GDP fell by 3.3 and 0.3 percent, respectively. However, the failure of the state to adjust the level of public expenditures down from the bump-up period in FY2002-FY2003 had resulted in an unsustainable fiscal position. With the need to phase out the use of the capacity building sector grant from non-conforming uses, which in Kosrae’s case had been back loaded to FY2008 and FY2009, the state was confronting imminent collapse in the run up to the

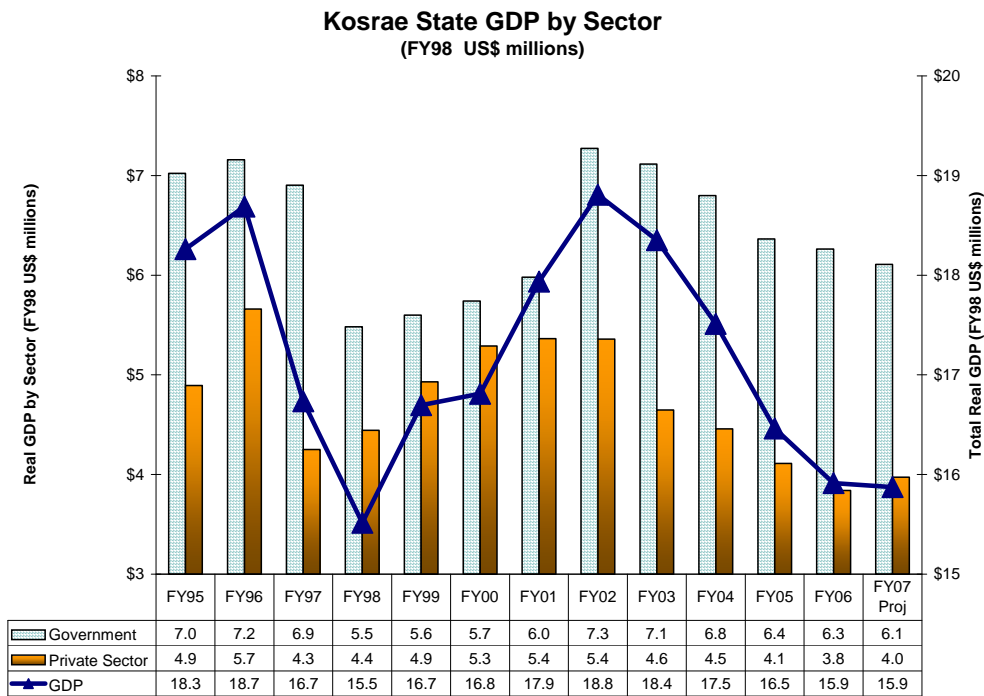


Figure 4 Kosrae State real GDP by Sector (FY1998 US\$ millions)

FY2008 budget unless radical remedial action was considered. Kosrae state strategy to resolve the fiscal crisis is taken up in other parts of this report.

iii Pohnpei

15. Pohnpei state experienced a substantial reduction in economic activity during the second step-down, and state GDP declined by an annual average of 6.6 percent during FY1995–FY1997 (see Figure 5). From FY1997 through FY2001 economic activity stagnated and GDP rose by only 1.1 percent over the four-year period. While the public sector continued to contract, the private sector was able to hold its ground, but not sufficiently to stimulate sustained economic growth. An inward-oriented policy environment and high levels of investment in unprofitable public enterprises contributed to economic stagnation. However, the state maintained a tight grip on fiscal policy subsequent to the reforms initiated in FY1996.

16. In FY2002 economic growth was strong and state GDP grew by 5.4 percent as the state fully utilized the available bump-up funds and benefited from an additional increase in resources after the final repayment of the Medium Term Notes (MTN) in FY2001. (The state issued a series of MTNs, or Compact-backed bonds, in the early 1990s to fund investment in public enterprises.) In the final year of Compact I, FY2003, economic forces were mixed. The state legislature opted to fully fund a return to an 80-hour pay period so as to stimulate economic activity, but also committed to fully meeting its con-

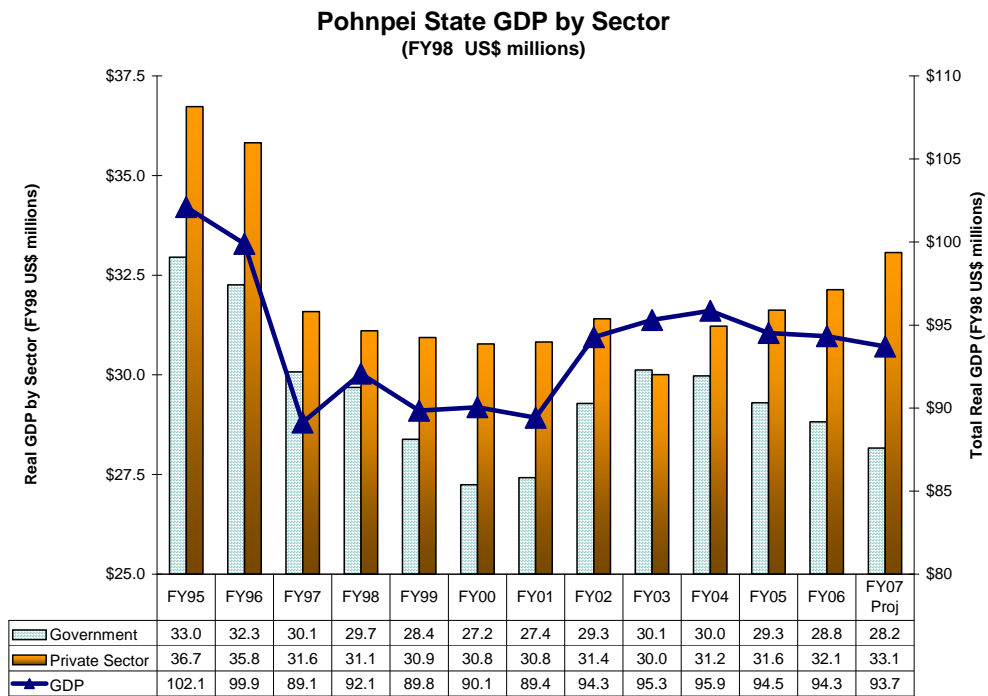


Figure 5 Pohnpei State real GDP by sector (FY1998 US\$ millions)

tribution to the Compact Trust Fund in only one year rather than setting aside the additional bump-up funds over two years. This sterilized and offset the impact of the return to the 80 hours and the economy recorded a slight increase of 1.1 percent in FY2003.

17. Perhaps surprisingly, the Pohnpei economy weathered the implementation of the first year of the amended Compact without any undue adverse impact, and GDP grew by 0.6 percent. Unlike Chuuk and Kosrae, Pohnpei State had transitioned the use of the energy grant from subsidizing utility prices in the mid 1990s and thus avoided the associated reduction in public enterprise valued added. However, a 35 percent increase in tariffs to ¢31 per unit was required in FY05 to compensate for the increase in world fuel prices. Pohnpei state hosts the national government, which was largely unaffected by the decline in Compact resources. The more developed nature of the state economy and higher revenue effort implied the state was able to make the adjustment to the new Compact regime without suffering the negative impact of the transition to a sector grant approach.

18. In FY2005, the economy managed to hold its own in nominal prices with expansion in the private sector due to increased building and construction projects, and in government services. However, as in both Chuuk and Kosrae, Pohnpei suffered from a significant boost in inflation of 4.8 percent, reflecting increases in food prices, the impact of worldwide increases in fuel prices, and a general increase in prices. The substantial increase in CPI negated the nominal expansion in GDP and, overall, the real economy contracted by 1.4 percent. In FY2006 and FY2007 the state economy is estimated to have contracted by 0.2 and 0.7 percent, respectively. The public sector, both the state and national governments, continued to contract in real terms, but was offset by rising real sector activity. The source of real private sector growth is surprising and requires additional investigation. Unlike, her sister states in Chuuk and Kosrae, Pohnpei has not funded general government from the capacity building sector grant and is thus not confronted with the same fiscal crunch and a more favorable outlook might be expected.

iv Yap

19. The Yap state economy achieved the highest rate of economic growth of all FSM states during Compact I although not without significant volatility. While the state underwent a public sector contraction similar to the other states after the second step-down, the private sector managed to remain buoyant and assisted the state in maintaining positive GDP growth during FY1995–FY1997 and through the end of Compact I. While it is difficult to attribute the success of the state to any one particular factor, it has maintained stable fiscal policies, and perhaps a more laissez-faire policy environment. The state achieved the best outcome in the PSRP, meeting its ERP targets and achieving the cost-savings anticipated. These policies were maintained through the end of the original Compact period, and the state avoided the temptation to utilize the bump-up funds to temporarily inflate public expenditures. Since that time, however, there has been some expansion in the fiscal policy stance and the state has avoided the need to phase out funding general government operations through use of investment earnings. A main weakness in

the state’s performance has been a lack of transformation of the loss-making public enterprise sector.

20. Figure 6 summarizes economic performance since FY1995. Subsequent to the adjustment to the second step-down the public sector continued to contract through FY2001. Yap pursued a very conservative fiscal stance during this period, largely underspending the available resources during Compact I and accumulating the savings in substantial reserves. While these policies have served the state well, the rules of the amended Compact do not permit savings of unspent resources. In FY2004 the lack of absorptive capacity resulted in the state only spending \$6 million of the available \$10 million. In FY2005, however, the state improved its performance utilizing over 90 percent of available funding.

21. The advent of the amended Compact saw a significant reduction in the state economy of 6.2 percent in FY2004. The reduction was largely due to the impact of Typhoon Surdal rather than any negative adjustment to the new regime. While government value added actually expanded by 0.7 percent and the private sector contracted by a similar amount, subsistence production for own consumption fell significantly. Yap, like Pohnpei state, had also transitioned out the use of the energy grant to subsidize utility prices. However, the state continues to maintain a sizeable array of public enterprises, and in

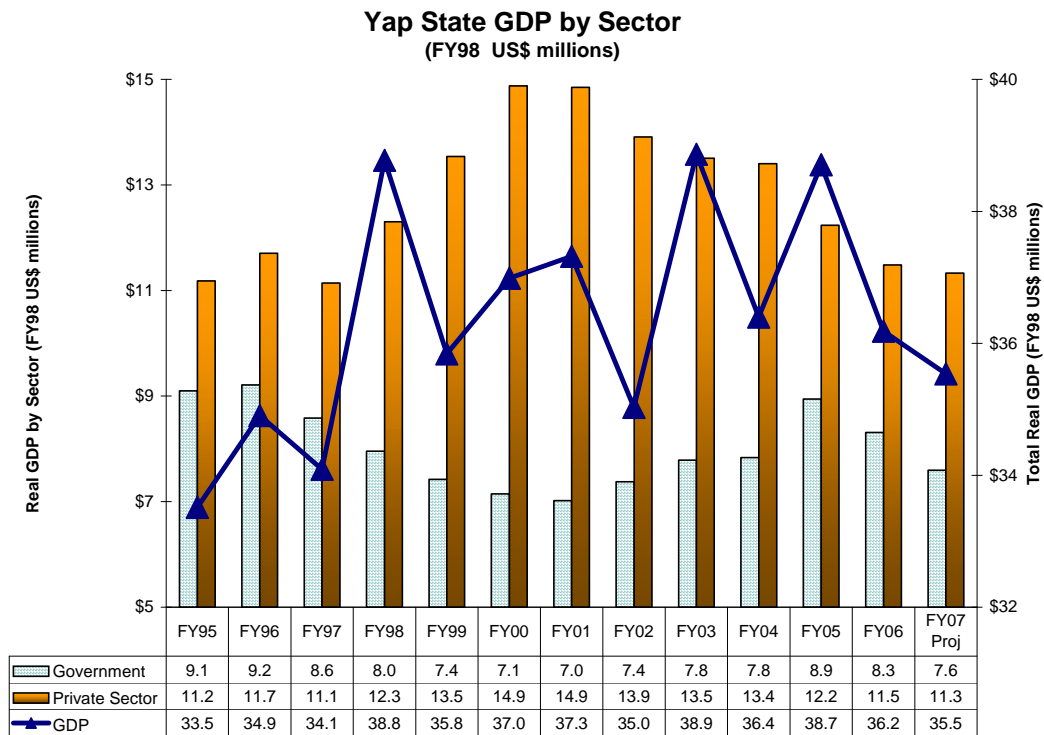


Figure 6 Yap State real GDP by sector (FY1998 US\$ millions)

FY2004 reduced profitability in the fishing sector contributed significantly to the reduction in GDP.

22. In FY2005 the economy rebounded by 6.3 percent fueled by the infusion of FEMA funds to support rehabilitation and reconstruction. Despite significant additional demand for private sector services and the construction of the Southern Road system, closure of the two garment factories resulted in an 8.7 contraction in private sector activity. Additional funds from FEMA enabled the public sector to grow by 14.1 percent, and increased profitability in utilities due to a hike in water charges enabled the public enterprise sector to record a real growth of 14.2 percent. As in the other states, inflation also picked up in Yap and recorded an increase in the CPI of 3.3 percent due to higher food prices, world fuel prices, and a general increases in prices. Although the use of FEMA funds continued to stimulate the economy in FY2006 economic activity fell by 6.2 percent reflecting the sizeable increase of 4.9 percent in the rate of inflation and substantial reduction in operating surplus of the state owned fishing enterprise. The state economy is projected to decline by 1.8 percent in FY07 reflecting a more conservative fiscal position. Like Chuuk and Kosrae, Yap initially funded a significant proportion of general government from the capacity building sector grant. However, in FY2006 the state decided to draw on its substantial investments to fund these activities. Whether the use of Yap state's carefully accumulated resources to fund public sector operations is sustainable in the long-term requires investigation.

3. THE STRUCTURE OF THE ECONOMY

23. The structure of the FSM economy is dominated by a large public sector with a dependent private sector producing non-traded goods that provide services to the government and its employees. While the lack of disaggregated national accounts statistics by industry inhibits a review of structural change in the economy, the data series does permit an analysis by institutional sector (See Figure 7 for changes between 1987 and 2007.) The share of the private sector expanded by 3.1 percent during the first half of the period as the Compact supported the development of a modern cash economy. However, since that period the share of the private sector has declined by 0.3 percent. This is a disappointing result and indicates loss in momentum in the attainment of the Compact objective of self-reliance. In part the failure to expand the role of the private sector reflects the adjustment to the new regime and regulations of the amended Compact. However, it also indicates a failure to implement the reform agenda adopted at the third FSM economic summit and development of a public sector and policy environment that supports private initiative.

24. While sustained improvement of the share of the private sector has not been achieved, the government sector declined significantly throughout, and its share fell by 1.7 and 6.8 percent, respectively between the three periods. The decline in government reflects two major forces: a reduction in the size of government due to the lower levels of Compact assistance especially the impact of the second step-down, and the restructuring of the public sector through the creation of Public Sector Enterprises (PSE). In part, the

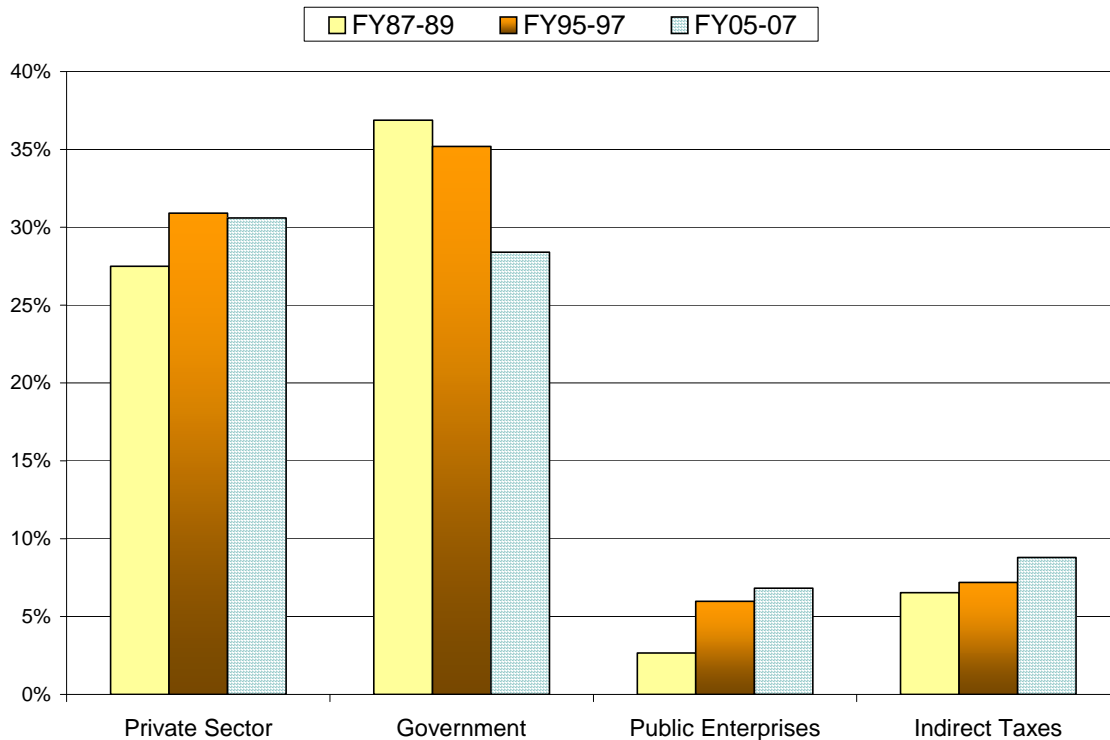


Figure 7 The institutional structure of the FSM Economy (percent)

decline reflects the creation of PSEs to provide the utility services of power and telecommunications, which had formally been government departments. However, not all of the 3.3 percent increase in the share of PSEs in the early period was in the creation of public utilities; a significant portion of the growth was in the creation of fishing enterprises, a largely misdirected and costly venture into an area for which the public sector is wholly unsuited. While it had been anticipated that the creation of PSEs had run its course, the sector has apparently increased in significance, increasing its share by a further 0.8 percent since the mid-1990s. Overall, combining government and the PSEs, the contribution of the public sector at large has fallen by 4.3 percent since the beginning of the Compact.

25. In addition to the private and public sectors, households and indirect taxes form a significant proportion of economic activity. The household sector represents the production of non-marked goods and home ownership. The share of households declined during the early period as is to be expected in a growing economy, but has subsequently grown in importance suggesting greater production for own consumption. While subsistence production is not directly measured, the result is highly plausible and consistent with the lack of economic growth during the last 10 years. The share of indirect taxes increased throughout the Compact from 6.5 percent of GDP during the FY1987-FY1989 period to 8.8 percent during the last three years. This development reflects two trends. First, reform of the national customs tax regime under the PSRP broadened the tax base, through sub-

jecting all sectors in the economy to the same tax rates, and changed the basis of evaluation of duties from an f.o.b. to c.i.f. basis. Second, indirect tax rates at the state and national levels rose through the period to offset declining Compact revenues.

4. SECTORAL DEVELOPMENTS

26. Data on the primary economic sectors of the FSM are weak: there are no indicators on agricultural production, limited information on agricultural exports, and fisheries information is poor. In agriculture subsistence activities make a substantial contribution to GDP, while production for either the domestic or export market is surprisingly small. The perception persists among local growers that returns from agriculture are low and slow to materialize compared with other activities such as fishing, tourism, non-traded services, and government employment. Compact assistance has exerted upward pressure on wages, turning the terms of trade against agriculture, and making agricultural production unattractive. Copra production, as in many other Pacific Island nations, has all but disappeared due to inefficiencies and low prices, but profitable export opportunities exist in other niche agricultural products.

27. With the vast marine resource falling under FSM jurisdiction it might be anticipated that fisheries would be a well-developed sector making a significant contribution to GDP. However, the sector has failed to achieve the growth anticipated. In the early 1990s, in an attempt to develop the economy, the FSM embarked on a strategy of substantial public sector investment in fisheries facilities and enterprises. Joint ventures with foreign partners in purse seine fishing operations were initiated in Chuuk, while similar but direct public sector investment in Pohnpei and Yap was undertaken. Investment in freezing, storage, and transshipment plants was undertaken in all four states, coupled with air shipment of sashimi-grade tuna to Japan by the national government. A long-line fishing company, the Micronesia Long-line Fishing Corporation, was set up with ADB loan finance for eventual sale to the private sector, but has subsequently filed for bankruptcy and liquidation.

28. However, none of the fisheries enterprises remaining in the public sector has achieved profitability. In most cases the operations are either defunct or operating with continuing losses. While there is awareness that the public sector should not be involved in the productive sectors of the economy, only recently have two public sector enterprises in the fisheries sector been transformed. The national government divested its ownership shares in the Caroline Fisheries Corporation, and 60 percent of the enterprise is now owned by a private foreign investor. The Pohnpei Fisheries Corporation has also been leased to a private foreign investor although the assets remain under public ownership. Divestment and establishment of an improved enabling environment, which is a key component of the Private Sector Development Program (PSDP), will help in development of the sector. It has yet to be proved, however, with the many existing structural impediments and high cost factors, whether the FSM has a long-term comparative advantage in fishing. The main benefit of the resource has been the annual rents earned from fishing access fees that make a substantial contribution to national government revenues. From

the high levels received during FY1994–FY1996, when fishing royalties averaged \$21 million per annum, receipts have fallen to an averaged \$12.9 million during FY2004–FY2006.

29. Figure 8 indicates recent trends in the FSM tourism industry (see Tables 2 in the statistical appendix for detail on visitor arrivals for the FSM and by state.) As with neighboring tourist destination economies the Asian crisis had a significant negative impact on FSM tourism. From a level of 18,305 arrivals in FY1996 visitor arrivals slumped in FY1998 to 14,526, reflecting a downturn in Japanese and Asian tourists. The tourism industry began a slow recovery in the subsequent years, and after a boom year in FY2000 the industry maintained a steady level of around 18,000 visitors from FY2002 onwards. Surprisingly, the events of September 11 did not adversely affect FSM tourism and numbers actually increased in FY2002. The tourism and visitor statistics reveal variance from year to year, but it is difficult to attribute the change to any specific factors. During the period for which information is available, tourism in the FSM has been largely static apart from a downturn in the late 1990s, and demand remains only 5 percent higher in FY2006 from what it was in FY1996.

30. While tourism represents the major potential growth sector of the economy, many factors currently hinder development of a vibrant visitor industry. The climate for foreign

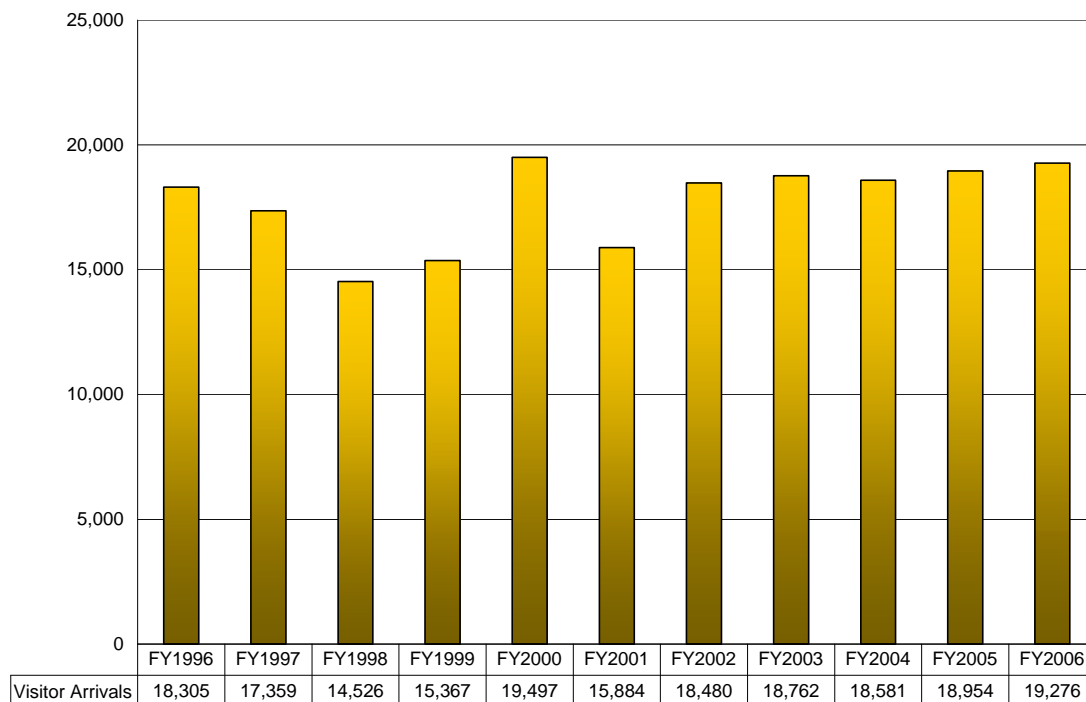


Figure 8 Visitor arrivals to the FSM, FY1996–FY2006, '000s

direct investment, was streamlined during the Public Sector Reform Program (PSRP), but requires work before it succeeds in providing an attractive climate for private sector investment (see section entitled Private Sector Development, p 47). Recent moves by Pohnpei state to prohibit reserve investment in tourism for Pohnpeians will inevitably result in stagnation in the state. Difficulties in obtaining secure long-term land leases are also an impediment. Hotels currently operate at low capacity levels, but many of the facilities offer a standard of accommodation that is unattractive to international travelers. Reliance on a single carrier operating high-priced flights in a remote geographical location has repressed growth in demand. While these factors have all impeded tourist development, the FSM has much potential particularly as a niche market in the eco-tourism and dive areas.

5. INCOMES, DISTRIBUTION, AND POVERTY

31. While economic growth during Compact I was lackluster most of the gains were eroded by population growth. At the beginning of the Compact population growth as recorded between the 1986 census and 1989 was at the rapid rate of 3.0 percent per annum. Between 1989 and the next count in 1994 the rate fell to 1.9, reflecting lower fertility rates and modest rates of emigration. However, between 1994 and the most recent census in 2000, population growth fell to the low growth rate of 0.2 percent (see Table 2). While fertility rates fell, the majority of the decline reflected outward migration to neighboring U.S. territories, Hawaii, and the U.S mainland under the migration provisions of the Compact. Clearly, the negative rates of economic growth experienced in the FSM after the second step-down resulted in large-scale migration to seek employment opportunities and better rates of remuneration in the U.S. In the long-run migration plays an equilibrating role: as incomes decline outward migration compensates, improving average income levels for those remaining. Outward migration will have a distorting impact on the local economy, however, if it is achieved through a loss of the economically active and skilled. The loss of human capital will reduce the long-run productive potential of the economy.

32. The relationship between real incomes and migration is further illustrated by FSM state in Figure 9. In all states except Yap real incomes are indicated to have fallen, reflecting poor economic performance during the last 10 years. As a result of the decline in

Table 2 Population by state and annual average growth rates

	Population numbers				Annual average growth		
	1980	1989	1994	2000	1980-89	1989-94	1994-00
Chuuk	37,488	47,871	53,319	53,595	2.7%	2.2%	0.1%
Kosrae	5,491	6,835	7,317	7,686	2.4%	1.4%	0.8%
Pohnpei	22,080	30,669	33,692	34,486	3.7%	1.9%	0.4%
Yap	8,100	10,365	11,178	11,241	2.7%	1.5%	0.1%
FSM	73,159	95,740	105,506	107,008	3.0%	1.9%	0.2%

Source National Census Report May 2002

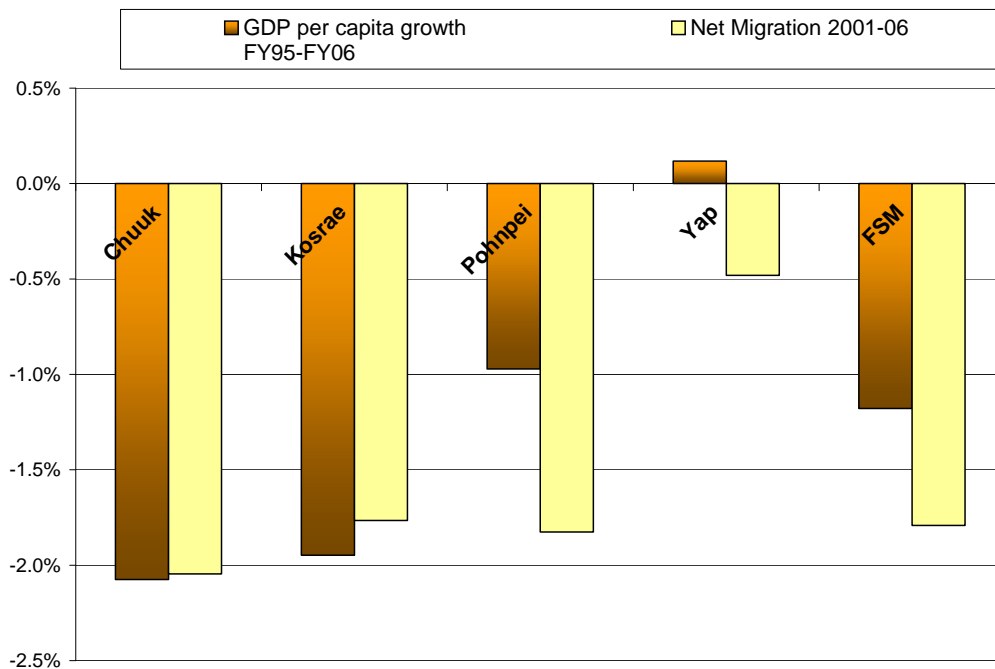


Figure 9 GDP per capita, migration, and population growth (annual averages)

incomes, outmigration as measured by net movements of air passengers leaving the FSM during 2001-06 has also been large. Clearly, there is a strong association between economic performance and outmigration. However, even in Yap where real income rose during the period, outmigration was significant. Table 3 indicates the relative level of GDP per capita in each state and compares the levels in FY1995 to that of FY2006. While some of the differences in GDP per capita between states reflect the structure of the Compact and that the smaller states receive a larger per capita share, the relative levels also reflect differential rates of economic performance. To illustrate the point, in FY1995 per capita income in Yap was more than double that of Chuuk, but similar to that of Pohnpei and Kosrae. By FY2006, per capita income in Yap was three times that of the level of Chuuk, 55 percent greater than that of Kosrae, and exceeded that in Pohnpei.

33. Generally speaking poverty has not been recognized as a major problem facing the FSM economy. However, a recent ADB assessment of hardship and poverty in the FSM (*The Federated States of Micronesia: Hardship and Poverty Status Discussion Paper*, The Pacific Department ADB, 2004) suggests that significant hardship exists. The discussion paper based on the 1998 Household Income and Expenditure Survey (HIES) indicates that approximately 28 percent of households reported incomes below the estimated basic needs poverty line of US\$768 per capita per annum (US\$5,693 per household per annum). The highest level of hardship and income poverty is 33 percent recorded in Chuuk, and 30 percent in Pohnpei, while Yap and Kosrae recorded 14 and 12 percent, respectively. Households with incomes (cash and non-cash own production) be-

Table 3 Real GDP per capita (US\$ 1998 constant prices)

	FY95	FY07	Percent growth FY95-FY07	Annual average percent growth FY95-FY07
Chuuk	1,293	1,005	-22.2%	-2.1%
Kosrae	2,475	1,955	-21.0%	-1.9%
Pohnpei*	3,019	2,685	-11.1%	-1.0%
Yap	2,996	3,038	1.4%	0.1%
FSM	2,107	1,828	-13.3%	-1.2%

low this level would be likely to experience some degree of financial hardship on a daily or weekly basis. For the 16 percent of households in Chuuk and 11 percent in Pohnpei that reported per capita annual incomes below the food poverty line of US\$437 per capita per annum, the extent of hardship being experienced would be quite acute. In Yap only 3 percent of households fell below the food poverty line while none were recorded in Kosrae.

34. Analysis of the HIES also indicates that the twenty percent (quintile) of households with the lowest incomes receive only 4 percent of total income. In comparison, the highest quintile received 60 percent of income, a ratio of 15:1. These figures, together with the corresponding Gini coefficient of income inequality, 0.51, suggest that income distribution in FSM is more unequal than in many other countries of the region. The foregoing statistics were based on the 1998 HIES, which was known to have been weakly administered in the outer islands where incomes are lowest. The recently completed HIES in FY2005 will significantly help improve understanding of this important issue once the figures are released.

6. EMPLOYMENT

35. Table 4 indicates that over the period FY1995–FY2007, formal sector employment based on Social Security Administration data contracted by an annual average rate of 0.7 or 8 percent over the whole period, and was unable to provide enough jobs for new job seekers. Over the period some 1,400 jobs were lost, nearly all in Chuuk. While employment in the public sector contracted overall as anticipated with the reforms in the public sector, private sector employment generation was either stagnant or declined in all states with the exception of Kosrae, which managed an annual average private sector growth of 2.4 percent although from a low base. This result is very disappointing and the lack of job creation clearly reinforces the strong incentive to migrate from falling real income levels, and seek employment opportunities in the United States.

Table 4 Employment Growth Rates by Sector and State (annual averages)

	FY1995-FY2007			2nd Step-Down FY1995-FY1999			Final Phase Compact I FY1999-FY2003			Compact II FY2003-FY2007		
	Total	Gov	Private	Total	Gov	Private	Total	Gov	Private	Total	Gov	Private
Chuuk	-2.5%	-3.7%	-0.8%	-4.9%	-6.7%	-3.7%	0.6%	0.4%	1.8%	-3.0%	-4.6%	-0.5%
Kosrae	-0.1%	-1.2%	2.4%	-0.1%	-3.7%	4.5%	1.7%	1.2%	4.7%	-1.8%	-1.1%	-1.8%
Pohnpei	0.3%	1.2%	0.8%	-1.2%	0.5%	-2.0%	-0.2%	1.7%	-1.1%	2.4%	1.3%	5.5%
Yap	-0.2%	-0.8%	0.2%	1.5%	-3.9%	5.5%	1.3%	0.1%	2.6%	-3.4%	1.6%	-7.1%
FSM	-0.7%	-1.3%	0.4%	-2.0%	-3.7%	-0.4%	0.5%	0.9%	1.0%	-0.6%	-1.1%	0.5%

Source FSM Social Security Administration Data

36. Figure 10 indicates recent trends in private and public sector employment since FY1995. Employment in the public sector contracted severely after the second step-down in Compact funding, reflecting a major fiscal adjustment. The ADB-financed PSRP enabled implementation of an ERP that facilitated the needed compression to restore fiscal balance. By FY2000 employment in the public sector had fallen from approximately 8,800 in 1995 to 7,400, a 17 percent reduction. However, in the following period up to FY2007 public sector employment has shown an oscillating trend reflecting the fiscal stance adopted in Chuuk state. A lack of discipline in Chuuk in FY2002 and FY2006 is reflected in peaks in total FSM public sector employment levels. However, with the impact of the need to compress expenditures with the phase out of the use of the capacity building grant to fund government operations in both Chuuk and Kosrae, public employment is projected to have fallen to a level in FY2007 just 3 percent above the level achieved at the height of public sector reforms in FY2000.

37. Private sector employment contracted between FY1995 and FY1997 reflecting the contraction in the economy, but rose again between FY1997 and FY2000 with the gradual improvement in the economy after adjustment to the second step-down was completed and the earlier financial crisis in Chuuk had been resolved. Since that time, however, and from FY2000 onwards, private sector employment has stagnated and declined by 3 percent.

7. WAGES

38. The labor market in the FSM is relatively free from regulatory distortions and institutional rigidities. Pohnpei is the only state to impose a minimum hourly wage for the private sector; that is set at \$1.35. While this wage may leave unaffected the demand for skilled workers, it may be an active constraint in labor-intensive activities, although private sector operators are not vocal. All the FSM governments have set minimum hourly wages for government employment (\$2.00 for Pohnpei, \$1.25 for Chuuk; \$1.35 for Kosrae; and \$0.80 for Yap), but these levels coincide with the lowest step on the public servant pay scale and are thus redundant. There are currently no unions in the FSM and there is no indexation of wage rates.

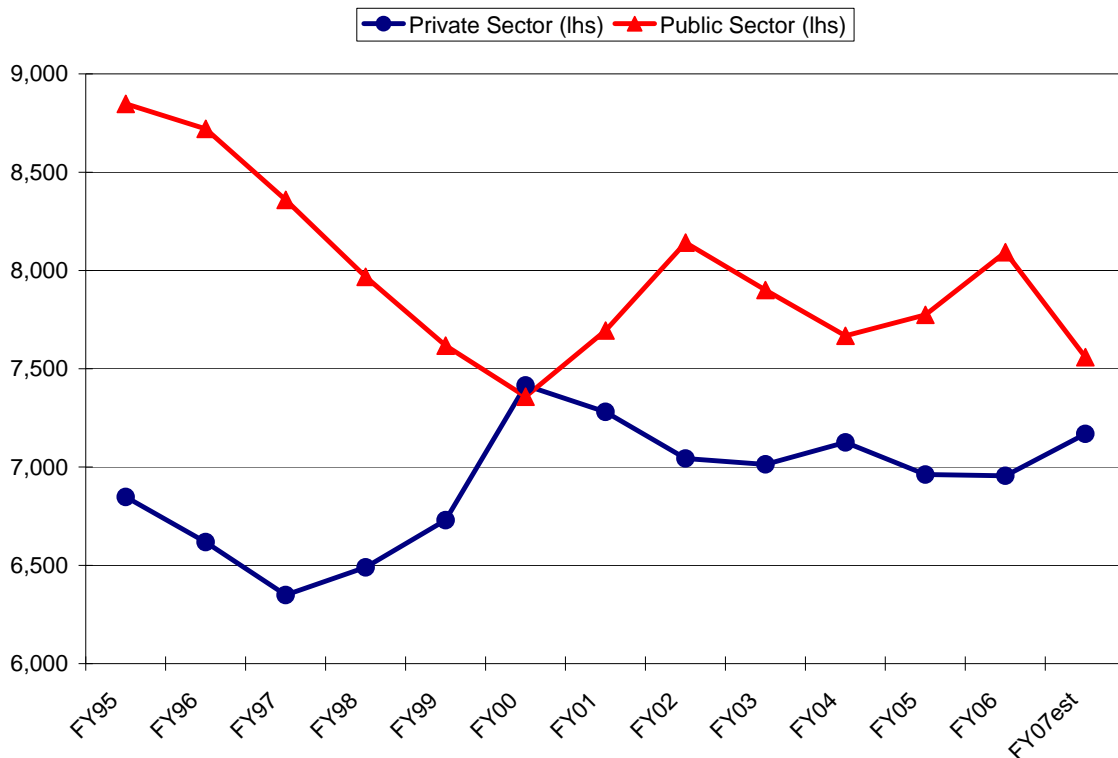


Figure 10 Employment by sector, FY1995–FY2007

39. However, while the labor market is relatively free from market rigidities, it is distorted by high public sector wage rates, the ease of migration and higher comparative wages in Guam and other U.S. labor markets, and the opportunity cost of labor in the subsistence sector. Table 5 indicates the level of real wages by state and between the private and government sectors. For the FSM as a whole, government wages were 78 percent higher in the FY2005-FY2007 period than those of the private sector. While the skill mix of the two activities affects the differential, the public sector clearly asserts an upward pressure on wages and influences the allocation of labor between the sectors.

40. Unfortunately, policy is constrained in its ability to influence distortions in the labor market. The effect of unrestricted external migration is part of the basic rights of FSM citizens under Title III of the Compact. However, during the Second FSM Economic Summit the FSM adopted a policy to reduce the differential between the private and public sectors. Data in Table 5 indicate that this policy objective has been achieved in Pohnpei and Yap, but in Chuuk and Kosrae there has been a significant increase in the disparity. Table 5 also indicates that real wages fell significantly in the FSM during the period FY1995–FY2007, by a total of 14 percent in the public sector, and 7 percent in the private sector. The most notable exceptions to this outcome were in Chuuk and Kosrae, where real public sector wages either rose marginally or fell by just 6 percent, respectively, and in the private sector in Kosrae where real wages fell by a substantial 20 percent.

Table 5 Real wages and differentials by sector and state

	Real Public Sector Wages (1998 US\$)		Real Private Sector Wages (1998 US\$)		Differentials	
	Average FY95-FY97	Average FY04-FY07	Average FY95-FY97	Average FY04-FY07	Average FY95-FY97	Average FY04-FY07
Chuuk	5,365	5,413	3,020	2,815	178%	192%
Kosrae	7,312	6,881	3,397	2,705	215%	254%
Pohnpei*	8,951	6,203	4,533	4,087	197%	152%
Yap	6,483	5,410	3,574	3,729	181%	145%
FSM	6,855	5,867	3,847	3,575	178%	164%

Source FSM Social Security Administration Data

Notes * includes national government

B. Monetary Developments and Prices

1. PRICES

41. The FSM commenced price collection and established a Consumer Price Index (CPI) for each state and the nation from 1999 onwards. Tables 5a-g in the Statistical Appendix provide CPI data for the FSM and each state. A general deflator based on the U.S. CPI through 1998, but chained to the FSM thereafter, has been used in the various statistical series, including the real GDP included in this review. While the use of the chained CPI index has proved satisfactory through most of the period, recent large increases in inflation, due to increases in food prices, discretionary tax changes, and fuel prices raise the question as to whether it is the most appropriate deflator. For example, inflation in the CPI recorded 8.1 percent in Kosrae during FY2005. While deflation of nominal GDP by the CPI certainly provides an appropriate indicator of changes in real incomes, it probably overstates the reduction in real production levels. Future efforts to improve the GDP series need to establish a more appropriate deflator, but in the meantime analysis needs to recognize the deficiencies.

42. Figure 11 provides information on the rate of annual change (quarter on the same quarter of the previous year) in the FSM CPI. To narrow the focus this analysis will pick up the story from FY2003 onwards. From the first quarter of FY2003 inflation started to rise. There are four general causes of the acceleration in inflation: (1) a period of increasing imported inflation in food prices, (2) discretionary increases in import taxes levied by the national government on beer and tobacco, (3) increases in utility tariffs in Kosrae and Chuuk to compensate for the loss of the Compact I energy grant, and (4) the general worldwide increase in energy prices. In most states prices of imported cereals, meat, and poultry increased significantly in FY2004, but since then the rate of increase has fallen back. The national government increased the tax on beer and tobacco in the first quarter of 2005 to compensate for a lack of revenues. This resulted in an approximate 10 percent

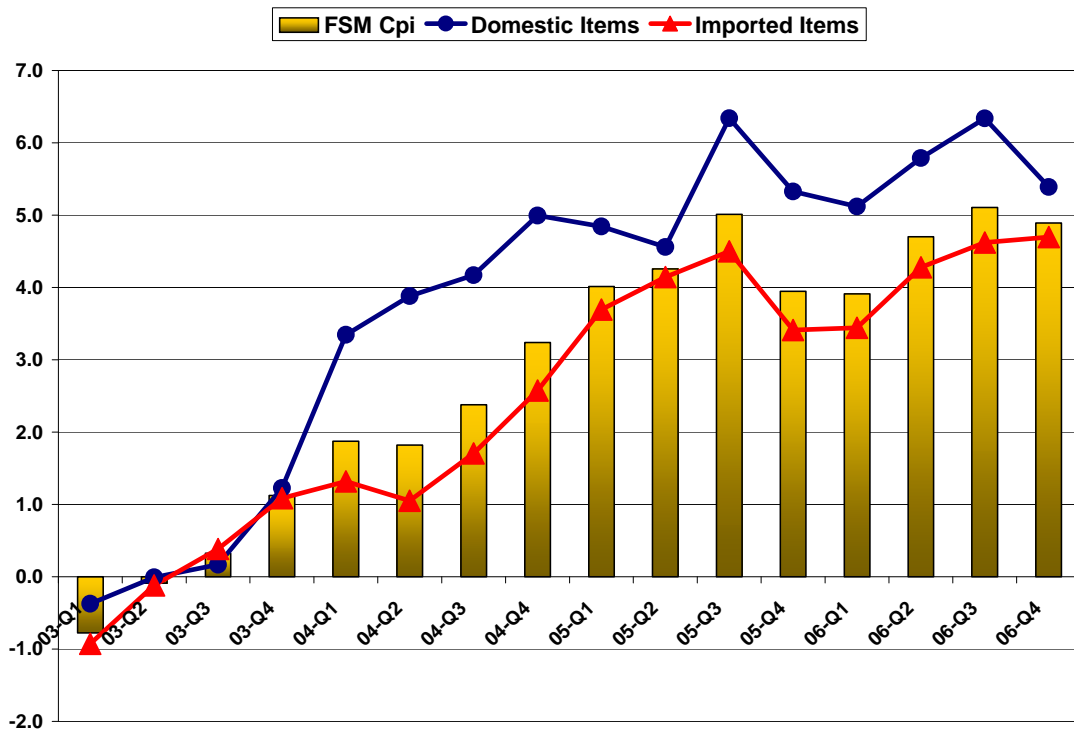


Figure 11 Change in Consumer Price Index - Domestic and Imported Items (year on year percent change)

hike in the prices of these items, which was reflected in the CPI in all states with the exception of Chuuk, where the increased tax rates appear to have made no difference to prices. This implies an under-collection of duties in that state, a widely suspected phenomena. The Compact I energy grant was used in Chuuk and Kosrae to subsidize energy prices, and its loss resulted in both states needing to raise electricity tariffs. In Pohnpei and Yap the state governments had adopted a cost recovery price basis of production and had ceased to use the energy grant to subsidize prices in the mid-1990s. Finally, the general increase in world fuel prices also imparted significant inflationary pressure pushing up both prices of gasoline at the pump and requiring increases in utility tariffs.

43. There has been some discussion in the FSM that the CPI understates the impact of inflation and in consequence the implied loss of purchasing power and real incomes is understated. Imports of fuel have increased as a percentage of total imports from 14 percent in FY03 to 21 percent in FY06, and as a percent of GDP from 7 to 12 percent. With world crude prices having doubled during the same period, a first approximation might suggest that real incomes would have fallen by about 7 percent, assuming limited substitution possibilities away from imported oil; a known characteristic of small dependent island economies. The import statistics do in fact suggest that there has been some substitution as the percentage of fuel imports to GDP rose by only 5 percent. This figure accords closely with the actual increase in the FSM CPI. Given the depressed nature of the

economy and approximately zero rate of inflation prevailing in the FY2001 through FY2003 period, the total increase in CPI during FY2005 and FY2006 seems consistent with the underlying economics.

2. MONEY AND BANKING

44. With the adoption of U.S. currency in the FSM, macroeconomic policy and adjustment has been limited to the use of fiscal policy. The use of a foreign currency is practiced in many other small island economies of the Pacific and has served the FSM well. While the range of macroeconomic policy options is limited, it has removed the potential to use inflationary monetary policy to adjust to changes and reductions in Compact funding. Of course, this has left the FSM with no other means of adjustment to reduced levels of resource transfers other than through the more politically painful means of directly cutting government expenditures, reducing public sector employment and wages, and increasing domestic revenues. The use of a foreign currency has removed exchange rate realignment and devaluation to encourage the export and traded goods sectors of the economy. At this stage of the FSM economic development, with many underlying structural impediments, exchange rate adjustment without accompanying supporting policies would be unlikely to encourage a favorable supply response in traded goods production.

45. The lack of an independent monetary policy results in domestic interest rates being closely aligned with U.S. rates. Deposit interest rates observed in the market are broadly similar to those throughout the United States, while lending rates are generally higher, reflecting the additional risk and costs of doing business in the FSM. Initially, the higher rates charged on loans resulted in regulation and limits were placed on both consumer and commercial loan interest rates. As part of the Public Sector Reform Program, removal of regulation was recommended and was a loan condition. The interest rate limits were effectively removed (leaving only a non-binding usury limit at 24 percent) in 1998 and there was no adverse change in the local interest rate structure as the financial system was allowed to adjust to market forces.

46. The FSM banking system benefits from the Federal Deposit Insurance Corporation (FDIC) as part of the provisions of the Compact. The FDIC has played a critical role in supervising the banking system and ensuring a sound and stable financial system. Under the amended Compact FDIC support remains effective, and will help maintain financial stability in the economy, and avoid the adverse consequences of banking system failures experienced in many other Pacific Island economies. The banking system is also regulated by the FSM Banking Board, which is developing a capacity for banking supervision. The role of the board includes licensing of domestic and foreign banks, on-site and off-site supervision of all banks, consumer protection, and consultation with the FDIC. Until December 2002, when the Bank of Hawaii withdrew from the market, there were two U.S. banks operating in the FSM. There is one locally owned bank, Bank of the Federated States of Micronesia. The remaining U.S. bank, Bank of Guam, is a branch of its parent, and thus also comes under U.S. federal supervisory requirements. The present system is thus well supervised and provides a secure basis for financial intermediation.

47. Early in 2002, Bank of Hawaii announced its intention to withdraw from the FSM and sell its local operations. Being the largest and most profitable bank in the economy, this decision was an unwelcome development. The decision apparently was motivated in large part by broader corporate restructuring concerns as opposed to an isolated analysis of the FSM-based operations. The same bank had also recently completed divestiture of its South Pacific operations. In the depressed state of the FSM market Bank of Hawaii was unable to find an interested buyer, and was left with little alternative but to run down its operations. The closure of the bank, effective from November 30, 2002, appears to have occurred in an orderly fashion, but not without major macroeconomic disruption to the economy. The departure of a major player has reduced competition in the financial sector and entailed a loss of institutional knowledge that will take time to rebuild.

48. Statistics on the FSM banking sector commenced in 1990, but analysis commences in 1995 (see Figure 12.) With regard to deposits, the most striking feature is the lack of any growth in the deposit base since September 1995. At the end of March 2007 the deposit base was only \$1 million higher or 1 percent above the level at the end of September 1995. While there was a dip in the series in 1996 and 1997, reflecting the Chuuk financial crisis, and some slight deviations from year to year, the level of deposits has remained remarkable constant. The lack of financial deepening during the period is consistent with the lack of growth in the economy.

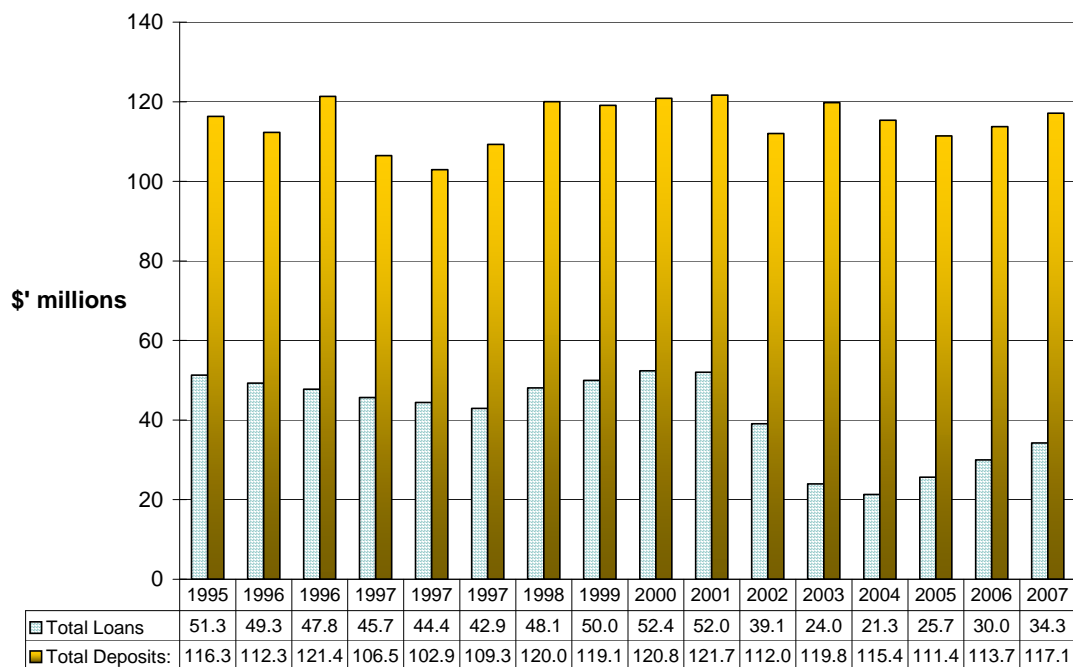


Figure 12 Commercial bank loans and deposits (end of period)

49. Regarding lending, developments reveal a similar pattern through the end of 2001. The period starts with a cutback in lending as the banks progressively reduced their portfolio to \$46 million through the third quarter of 1997, reflecting the second step-down and Chuuk financial crisis. By 1998, matters began to improve and the banks began extending credit once more, reaching a peak at the end of September 2001 of \$52 million. In 2002 the Bank of Hawaii began implementing its plans to withdraw from the market. Outstanding bank credit fell precipitously in each consecutive quarter, declining to a level of \$21 million at the end of September 2004. While the departure of Bank of Hawaii was implemented quietly without incurring adverse publicity, the bank failed to sell its assets to the two remaining banks. Neither Bank of Guam nor Bank of the FSM tried to capture the available business, preferring to leave the problem to the departing bank. While the Bank of the FSM was restructuring its portfolio at the time, the bank has since taken a more proactive stance and the level of outstanding credit in the system has grown by \$13 million since September 2004 and stood at \$34.3 million at March 2007.

50. The difference between loans and deposits indicates the large level of liquidity in the FSM banking system, and reinforces the widely observed phenomena in the Pacific Islands region that capital is not a factor of production in short-supply. Reflecting the trends described above, the loans to deposit ratio remained relatively constant, hovering around 39 to 44 percent until the departure of Bank of Hawaii. By the time of Bank of Hawaii's complete withdrawal from the market at the end of September 2004 the loans-to-deposits ratio had fallen to 18 percent. Since that time there has been some improvement in the situation and the loans-to-deposit ratio rose to 23 percent by the end of March 2006.

51. The large difference between the level of deposits and loans is invested offshore, and mirroring the reduction in credit following the departure of the Bank of Hawaii the level of foreign assets rose by approximately \$26 million or 34 percent between September 2002 and September 2003. The rise in foreign assets and associated reduction in credit should imply that the FSM economy experienced a large macroeconomic shock during FY2003 as the extra liquidity was invested offshore. Surprisingly, the figures for FY2003 indicate that economy actually grew by 2.9 percent and do not indicate the impact of any adverse shock. The reduction in credit would have been offset to some extent by the infusion of funds from FEMA for typhoon rehabilitation in Chuuk, but a significant reduction in GDP would have been expected.

52. Reflecting a lack of "bankable projects" the commercial banks have generally preferred to extend credit to consumers with secure public sector jobs and an identified repayment stream. Lending to consumers has traditionally represented about 60 percent of domestic credit creation. Consumer credit dropped off rapidly as the Chuuk crisis set in and with the second step in funding (see Figure 13.) With a return of more prudent fiscal policies in the state, consumer credit once again expanded. The impact of the departure of Bank of Hawaii was initially more adverse on the consumer market than on the business sector, although runoff of commercial loans followed suit shortly thereafter. The

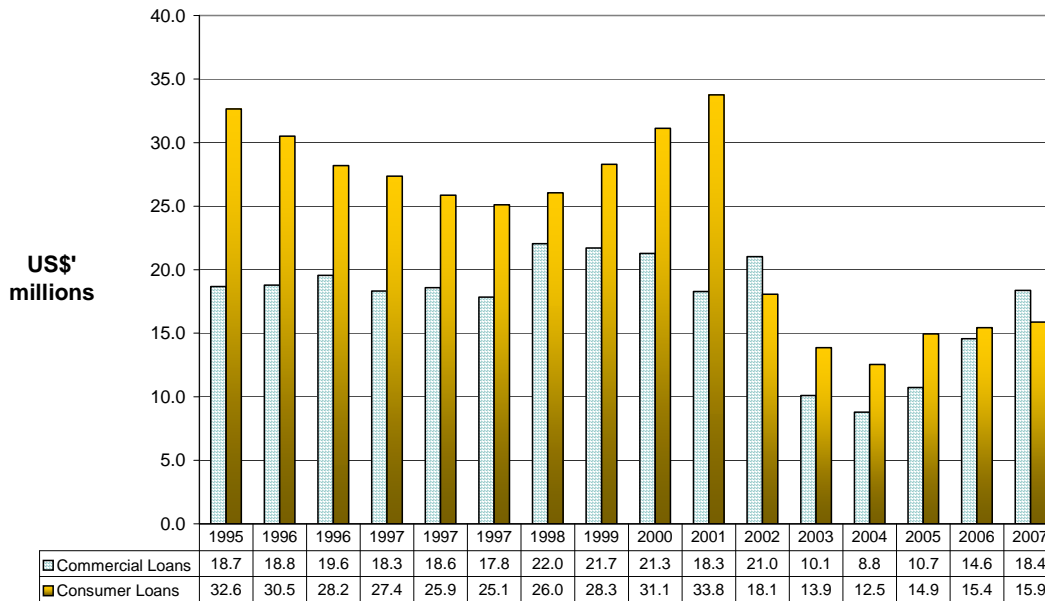


Figure 13 Commercial bank credit by sector

figures indicate that there has been extension in both consumer and commercial credit since the departure of Bank of Hawaii, but that commercial lending primarily by the Bank of the FSM has been the active element of the market.

C. Balance of Payments and External Debt

1. BALANCE OF PAYMENTS

53. The trade account of the balance of payments runs a significant deficit reflecting the excess of imports over exports (see Table 6.) Exports currently include a small quantity of agricultural produce and fish. While small volumes of inshore reef fish are exported to neighboring islands, the majority of fish exports are tuna caught by local purse seine and longline vessels operated by public enterprises. The FSM has yet to establish a sustainable fishing industry and the sector is fragile and financially vulnerable. The majority of the fish caught in FSM waters are caught by foreign vessels under license and the associated fishing access fees are treated as a factor income in the balance of payments. Imports dominate the trade account and normally reflect the level of activity in the economy. Up till FY1999 import estimates were derived from customs revenue data, but have subsequently been based on actual imports entering the FSM. In most years the direction of change in imports agrees with that of GDP. However, the magnitude of the changes is far from similar. In FY2002 imports declined despite the additional influx of resources received from the bump-up funds. In FY2003 imports rose rapidly although a

Table 6 Balance of payments (FY2004–FY2005, US\$ millions)

	FY97	FY98	FY99	FY00	FY01	FY02	FY03	FY04	FY05	FY06 est
Current Account Balance	-20.1	-19.6	-9.5	-17.0	-29.6	-9.1	-0.4	-44.7	-29.1	-38.4
<i>Trade balance</i>	-83.1	-77.1	-79.5	-88.9	-98.3	-87.7	-96.2	-120.3	-122.2	-128.9
Exports, f.o.b.	16.8	23.5	18.0	20.0	23.0	23.8	24.0	17.0	18.5	17.0
Imports, f.o.b. 1/	-100.0	-100.6	-97.5	-108.9	-121.3	-111.5	-120.2	-137.3	-140.7	-145.9
<i>Services account</i>	-34.0	-44.0	-34.9	-33.4	-35.0	-36.1	-36.0	-37.3	-38.2	-37.3
Receipts	17.7	14.4	15.3	18.6	16.8	18.9	18.6	18.2	18.5	20.1
Travel	15.8	13.2	13.9	17.0	14.7	16.8	16.7	16.5	17.1	18.3
Payments	-51.7	-58.4	-50.2	-52.0	-51.8	-55.0	-54.7	-55.5	-56.7	-57.5
Freight and insurance	-17.6	-17.7	-17.2	-19.2	-21.4	-19.7	-21.2	-24.2	-24.8	-25.8
<i>Income, net</i>	15.9	14.5	18.2	15.1	11.8	10.4	8.9	13.7	16.2	15.2
Receipts	26.0	25.5	27.2	22.9	18.1	16.4	15.6	20.1	21.5	20.5
Fishing rights fees	14.4	13.5	16.0	14.1	11.3	10.6	11.8	12.1	13.3	13.3
Interest dividend income	11.7	12.0	11.2	8.8	6.8	5.8	3.8	8.1	8.2	7.2
Payments	-10.1	-11.0	-9.0	-7.8	-6.3	-6.0	-6.7	-6.4	-5.3	-5.3
Foreign workers earnings	-1.9	-4.0	-2.9	-2.9	-3.0	-3.0	-3.5	-3.3	-2.3	-2.3
Interest payments	-6.7	-5.5	-4.6	-3.7	-2.0	-1.7	-1.8	-1.8	-1.6	-1.6
Dividends	-1.5	-1.4	-1.5	-1.3	-1.3	-1.3	-1.4	-1.3	-1.4	-1.4
<i>Unrequited transfers</i>	81.0	86.9	86.6	90.2	91.9	104.3	123.0	99.1	115.2	112.7
Private	1.8	1.9	2.1	2.2	2.3	2.3	2.3	2.5	3.4	5.3
Official	79.2	85.0	84.5	88.0	89.6	101.9	120.6	96.6	111.8	107.3
Compact funds	53.6	54.4	54.4	54.7	55.3	65.9	66.6	52.1	56.0	60.1
Other	25.6	30.6	30.1	33.3	34.4	36.0	54.0	44.5	55.9	47.3
Capital and financial account	29.0	24.1	19.0	14.0	23.0	38.4	17.0	-13.9	20.1	14.7
<i>Capital Transfers</i>	30.3	28.8	29.7	30.8	32.1	39.1	39.8	-21.6	7.1	12.0
Short term, net	2.9	-1.3	0.2	0.1	-2.1	-0.8	-25.0	7.5	12.0	0.8
Medium term, net	-4.2	-3.4	-10.9	-16.9	-6.9	0.1	2.2	0.3	1.1	1.9
Inflows	11.7	11.8	3.8	2.2	1.8	0.7	2.9	1.1	1.9	3.7
Outflows	-15.9	-15.2	-14.7	-19.1	-8.8	-0.6	-0.6	-0.8	-0.9	-1.8
MTN amortization	-8.3	-11.3	-11.0	-18.5	-8.2	0.0	0.0	0.0	0.0	0.0
Overall balance 2/	8.8	4.4	9.4	-3.0	-6.6	29.3	16.6	-58.6	-8.9	-23.6

Notes: 1/ Based on import tax collections FY1994–FY1999, thereafter actual imports

2/ Includes changes in FSM reserves, valuation changes, errors, and omissions

greater proportion of the additional funds were set aside. However, the expansionary impact of FEMA grants to compensate households for the destruction caused by Typhoon Chata'an would have boosted demand for imports. In FY2004 imports continued to rise despite the substantial reduction in Compact funding. Similar to the experience in Chuuk the previous year, Yap state suffered the destructive impact of Typhoon Sudal, which was also accompanied by the receipt of FEMA grants to assist with reconstruction. While some of these funds would have been received in FY2004 the majority would have been received in FY2005. Imports continued to rise in FY2006 reflecting increased costs of fuel.

54. The service account is dominated by two main factors: tourism and the cost of freight to transport imports to the FSM. The demand for tourism has remained relatively stagnant in recent years, but picked up in FY2000 with the recovery from the Asian crisis, although the drop-back in FY2001 was disappointing. Surprisingly demand for tourism was strong in FY2002 despite the impact of the September 11 terrorist attacks. The factor account of the balance of payments is comprised of fishing access fees, earnings of dividends and interest on overseas investments, and payment of interest on debt. Fishing fee earnings have remained relatively constant through the period although falling substantially from a high of \$21.5 million in FY1995. The FSM governments maintain a sizeable level of foreign investments, which has provided a significant source of interest and dividend earnings. However, earnings declined in FY2002 and FY2003 reflecting

both a reduction in the level of investments and the sizeable downturn in U.S. equity markets in which much of the reserves are invested. In FY2004-FY2006 equity markets improved and investment earnings firmed. From a level of \$12 million in FY1997 interest and dividend earnings dropped to \$3.8 million in FY2003, but have subsequently improved and are currently projected at \$7.2 million in FY2006. The repayment of the Yap Medium Term Note scheme, transfer of \$30 million of the bump-up funds to the amended Compact Trust Fund at the end of FY2004, greater use of unspent Capital Improvement Project (CIP) funds, together with use of past savings to fund deficits by the National Government have all led to a reduction in the level of reserves.

55. The most significant component of the balance of payments is the transfers account, which includes Compact funds and other aid flows. Private remittances appear to be relatively small in the FSM compared with other Pacific Islands, which have large migrant communities living in neighboring metropolitan nations. The 2000 population census indicates that migration has increased significantly, and suggests that remittances may well be underestimated and likely to rise in the future. Current account official transfers including Compact flows and federal and special programs (including FEMA in FY2002–FY2005) represent about two thirds of current account receipts. In total, the balance on the transfers account approximately matches the trade account deficit, and indicates the dependent nature of the FSM economy.

56. The major items on the capital account include capital transfers, changes in commercial bank foreign assets, external borrowing, and repayment of debt including the MTNs. Capital transfers include Compact funding of CIPs and projects delivered in kind by other donors, mainly from Japan. In FY2004 the level of capital transfers fell by \$60.8 million, reflecting the failure of the FSM to meet the drawdown conditions of the infrastructure sector grant and the FSM contribution to the amended Compact Trust Fund of \$30 million. This failure to meet the drawdown conditions of the infrastructure sector grant has prevailed throughout FY2006 and capital transfers remain low. These have been temporarily parked and will become available once the FSM meets the requirements. Short-term flows are not normally a significant feature of the balance of payments, but in FY2003 a sizeable flow was recorded reflecting the withdrawal of Bank of Hawaii from the FSM, the contraction in credit, and compensating buildup in foreign assets of the remaining commercial banks. Taken together current and capital account official transfers accounted for an average of 79 percent of total current account payments during the “non-bump-up” period FY1997–FY2001 of Compact I. In the first two years of the amended Compact period this percentage fell to an average of 60 percent due to the inability to absorb a significant proportion of Compact receipts. Clearly, the attainment of economic self-sufficiency, and progress toward replacing transfers through other foreign exchange earning sources, will be a long-term process and presents perhaps the major and most difficult challenge facing the FSM economy.

57. The FSM has adopted a prudent external debt management strategy and external borrowing has been modest (see External Debt section, below). In FY1997 and FY1998

drawdown of the ADB Public Sector Reform Program (PSRP) loan provided a major source of funds to finance the Early Retirement Program (ERP). The FSM drew down on further concessional funds from the ADB in FY1999 and FY2000, but the order of magnitude was small. There were no further drawdowns until the loan effectivity of the Private Sector Development Program (PSDP) loan in FY2003 and Basic Social Services Program in FY2004, although draw downs under both programs were not extensive. With most of the FSM's external debt financed from concessional sources with amortization not due for several years, the major component of debt service has been MTN repayment. This was paid in full by the end of October 2001 and is no longer an item in the balance of payments.

58. The balance of payments account is under ongoing development and the figures currently presented do not adequately specify the level of foreign assets, valuation adjustments, or overall balance. In FY2002 and FY2003 the FSM built up substantial foreign assets setting aside the bump-up funds for contribution to the Compact Trust Fund, which were transferred in FY2004. The overall balance thus accumulated large surpluses in FY2002 and FY2003, with a compensating deficit in FY2004. The weak absorptive capacity of the FSM to effectively utilize official transfers during Compact I, resulted in the accumulation of surpluses. In FY2004 the new fiscal regime of the amended Compact changed the rules and the FSM only receives those funds that it is capable of expending and absorbing. The tendency to surplus thus no longer prevails, and the balance of payments is likely to generate a deficit in the medium term as the five governments in the Federation run down the accumulated savings. This is reflected in the overall deficit of \$9 million in FY2005, and \$24 million projected for FY2006.

2. EXTERNAL DEBT

59. Prior to FY1990 the FSM had no official public sector debts to offshore lenders. During the period FY1990 to FY1993 the nation underwent a rapid increase in external public borrowing. This borrowing included MTN bonds issued for \$71 million to finance portfolio investments by Yap State, and \$42.9 million for fisheries-related investments in Pohnpei, Chuuk, Kosrae and for the National Fisheries Corporation. Public guaranteed borrowing also included \$41 million from the US Rural Electrification Administration by the FSM Telecommunications Corporation and \$9 million by the Yap Fishing Corporation.

60. Figure 14 shows that the heavy borrowing by FSM governments brought the nation's total official external debt to a level of \$118 million at the end of FY1995, representing 57 percent of GDP in that year. The only significant borrowing that has been undertaken since FY1994 has been through the concessional lending facility of the Asian Development Bank. The FSM external debt level has shifted from a position that was, in the early 1990s, quite adverse, to one that is now favorable. The completion of the Medium Term Note program with final repayments taken from Compact revenues in FY2001 has resulted in this desirable outcome. With a debt-to-GDP ratio of just 28 percent in FY2006, the FSM's debt level is low by Pacific Island standards (see Figure 15

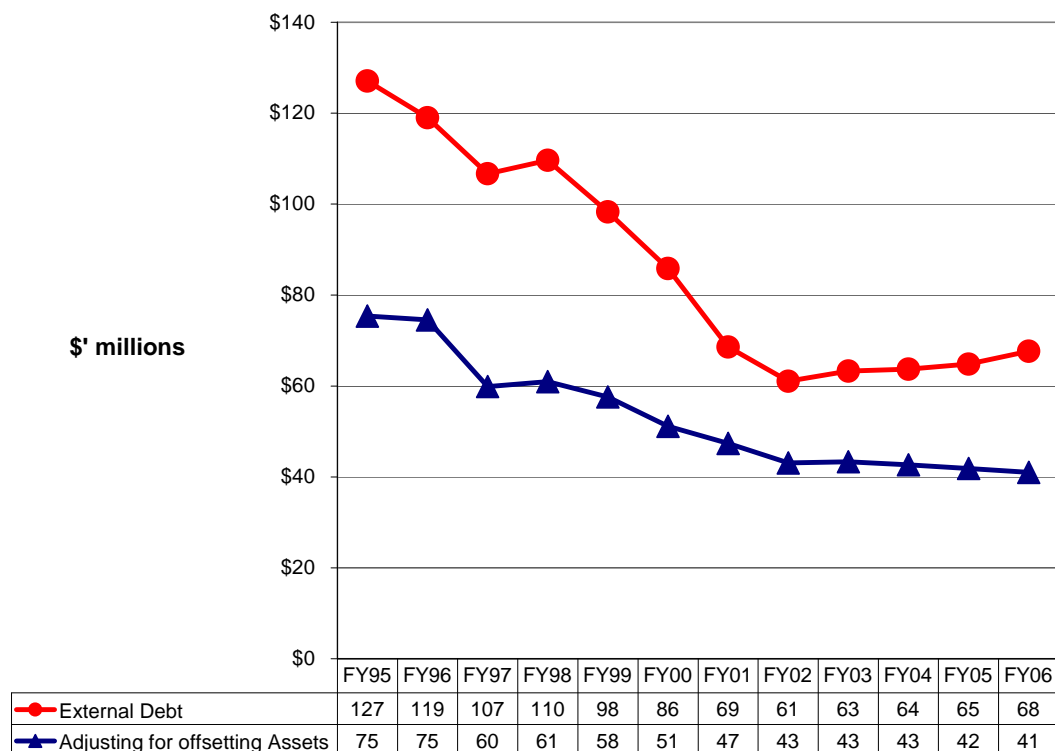


Figure 14 FSM External Debt (US\$ millions)

and Table 6b in the Statistical Appendix). Furthermore, with the remaining debt on concessional terms, the debt service ratio in FY2006 is projected at the low level of 9 percent of exports of goods and services. Each of these ratios is somewhat overstated in light of the fact that the FSM holds a sinking fund equal in value to the amount outstanding for the PSRP loan from the ADB. Adjusting for this asset held against external debt, the debt-to-GDP ratio in FY2006 would be 17 percent, and the debt service ratio 8 percent of exports of goods and services.

D. Fiscal Developments

1. FISCAL POLICY FRAMEWORK

61. The original Compact which became effective in FY1987 provided for the transfer of resources in three essential areas: funds to support general government, which were largely unrestricted, special grants tied to specific sectors, and access to U.S. special and federal programs. The flow of resources entailed two step-downs in five yearly intervals in FY1992 and FY1997, and an increase in funding in FY2002–FY2003 at the average levels of the first 15 years. Of the different grants some were inflation indexed at two-thirds of the U.S. GDP deflator and some were not indexed. The structure of the original Compact, due to the fungibility of the resources, placed no effective constraints as to

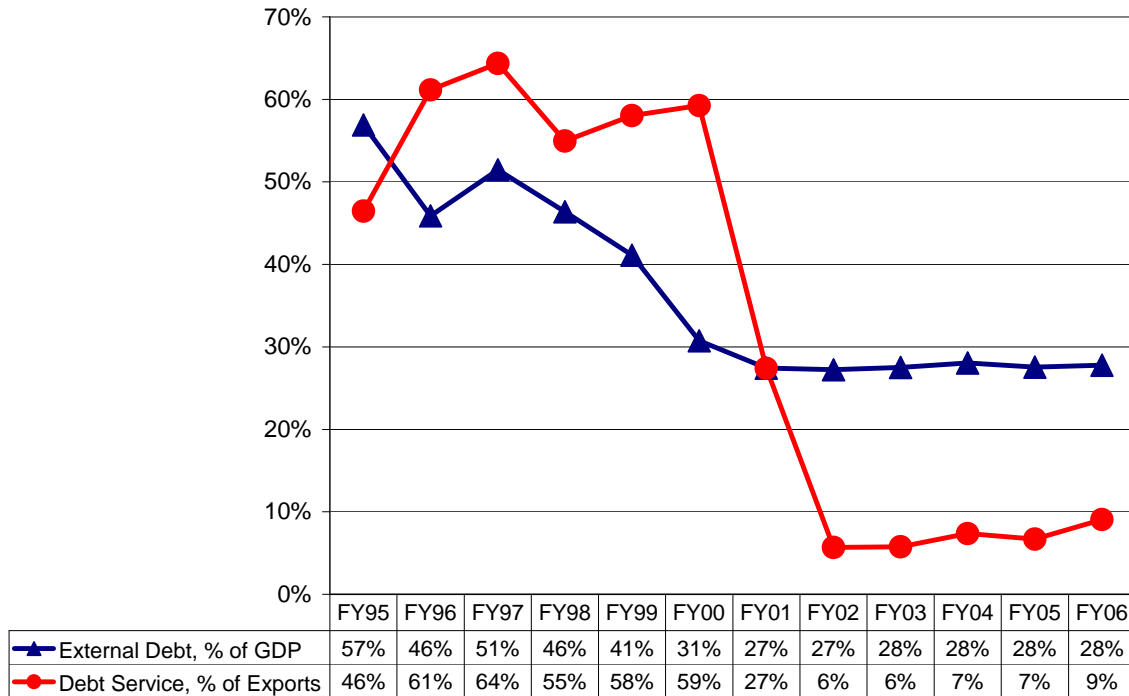


Figure 15 FSM external debt ratios

which sectors the resources were directed. However, the original Compact entailed the need for two large fiscal adjustments coinciding with the two step-downs and the challenge of how to “sterilize” the bump-up in resources in the final two years in FY2002 and FY2003.

62. The agreement and adoption of the amended Compact by the FSM and U.S. governments became effective in FY2004 and initiated a wholly new fiscal framework on the FSM. The structure entailed a series of sector grants earmarked for education, health, environment, private sector development, capacity building, and infrastructure. The innovative nature of the amended Compact was the introduction of a trust fund, which was designed to provide a yield sufficient to replace the annual grants after 20 years. Table 7 indicates the aggregate structure of the annual Compact grants and the contribution to the Compact Trust Fund. Each year over a 20-year period the United States will contribute to the FSM \$92 million partially adjusted for inflation. The inflation adjustment factor remains as in the original Compact. The annual sector grants start a level of \$76 million in FY2004, but are to be annually reduced by a \$0.8 million decrement from FY2007 onward. The difference between the total contribution and the annual sector grant levels will be deposited in a trust fund to accumulate over the 20-year Compact period.

Table 7 U.S. annual Compact grants and contributions to the Trust Fund

	Annual Grants	Trust Fund Contribution	Total Contribution
FY04	76.0	16.0	92.0
FY05	76.0	16.0	92.0
FY06	76.0	16.0	92.0
FY07	75.2	16.8	92.0
FY08	74.4	17.6	92.0
FY09	73.6	18.4	92.0
FY10	72.8	19.2	92.0
FY11	72.0	20.0	92.0
FY12	71.2	20.8	92.0
FY13	70.4	21.6	92.0
FY14	69.6	22.4	92.0
FY15	68.8	23.2	92.0
FY16	68.0	24.0	92.0
FY17	67.2	24.8	92.0
FY18	66.4	25.6	92.0
FY19	65.6	26.4	92.0
FY20	64.8	27.2	92.0
FY21	64.0	28.0	92.0
FY22	63.2	28.8	92.0
FY23	62.4	29.6	92.0

63. In comparison with the original Compact the new regime avoids the need for large fiscal adjustments every five years. However, in order to establish the viability of the trust fund, the United States instigated the annual decrement. While avoiding large shocks to the system, the decrement will still require an annual compression of expenditures once it kicks in from FY2007 onward. Coupled with the lack of full inflation adjustment, the annual reduction in real resources, estimated to be approximately 2 percent per annum, will require active fiscal policy adjustments unless a policy regime can be developed sufficiently attractive to encourage private sector investment and economic growth great enough to offset the decline. The sectoral structure of the Compact also presents special problems. In the FY2004 budgets the altered fiscal framework resulted in funding shortages for the operations of government not covered under the sector grants. In order to address the shortfall, the United States permitted the FSM to utilize the capacity building sector grant for this purpose, provided the FSM agreed to transition out the use of the grant for “non-conforming” purposes over a five-year period. Under duress the FSM had no alternative but to concede. While the operation of the FY2004 budgets were not affected, the transition requirements will become binding in FY2007 and require a painful adjustment of expenditure cuts or increased revenue effort.

64. At the FY2005 Joint Economic Management Committee (JEMCO) meeting in August 2004, it was resolved that the FSM must allocate at least 30 percent of Compact sector grants to the infrastructure grant effective from FY2006. The FY2005 infrastructure requests were considered below desired levels, and JEMCO felt a floor should be

established to ensure that public investment was maintained at sufficient levels to support the development of the economy as aggregate Compact resources were projected to decline. This requirement induced substantial reprogramming in Pohnpei and Yap states in their FY2006 budget submissions. Access to federal programs is to continue during the amended Compact with the exception of certain education programs, which were “cashed out” and have been replaced through the Supplemental Education Grant (SEG). Finally, implementation of the amended Compact entails a whole new accountability regime that is specified in the Fiscal Procedures Agreement (FPA). Taken as a whole the new fiscal arrangements of the amended Compact will have a wide-ranging impact on the conduct of fiscal policy and management in the FSM.

65. Fiscal policy has been formulated in each of the national and four state governments with separate expenditure and revenue policies in the absence of significant coordination. With respect to revenue policy, the national government has the power under the constitution to collect import and income taxes, and all remaining taxes are reserved for the states. Through its taxing powers the national government collects about three-fourths of all domestic taxes. In FY2005 national taxes amounted to \$22.4 million, while the four states collected an additional \$6.7 million. The states, with widely varying levels of tax effort, collect the remaining one-fourth of domestic taxes, primarily through general sales taxes and excise taxes on alcohol, tobacco, and other goods.

66. By constitutional mandate at least 50 percent of the nationally imposed taxes (and 80 percent of the fuel import tax) must be shared with the state in which the taxes were collected. At the start of FY1999, the national government shared a further 20 percent with the states, although the use of these extra transfers, amounting to about \$4.3 million annually, was restricted to health and education capital projects. In FY2004, as the fiscal position tightened with the implementation of the amended Compact, the national government legislated the return of the 20 percent. While overall tax effort remains low relative to other Pacific Islands, there has been some gradual increase over time. In FY2006 tax revenues equate to 12.6 percent of GDP as compared to roughly 10.8 percent, the level that prevailed throughout most of the Compact I period from FY1987–2003. The increase reflects primarily a policy change to the import tax that shifted the base from f.o.b. to c.i.f. and eliminated most personal (non-commercial) imports and increases on beer and tobacco effective FY2005. While it is likely that there has been a modest improvement in collection performance, tax administration and, in particular, compliance and audit functions remain in need of rigorous reform.

67. With respect to non-tax revenues, these continue to be dominated by fishing access fees, which recently have represented nearly one-quarter of all domestic revenues. The national government manages the tuna resources and keeps all revenues from the licensing fees. Revenue from penalties and fines is shared with specific states and, in some cases, local governments. The fishing access fee source of revenue grew rapidly from less than \$4 million in FY1987 to a peak of over \$21 million in FY1995, but has subsequently dropped back and averaged \$12.9 million during the amended Compact period. The de-

clining trend in this revenue source is the leading cause of the deterioration in the national government's fiscal position.

68. During Compact I the national government acted as an agent in distributing to each government, according to mutually agreed formulas, the grant funding received from the United States under the Compact. The national government received just less than 15 percent of current grants and 10 percent of capital grants. The remainder was distributed to the states based roughly on a formula that split 30 percent of funding evenly among the four states and 70 percent of the funds according to population. The formula shares were developed prior to the start of the Compact assistance and remained unchanged throughout the 17 years of Compact I assistance. With the advent of the amended Compact there was a general consensus that the formula should be revised to provide a greater share to the states where fiscal pressure was greatest. At a meeting of the Economic Policy Implementation Council (EPIC) in October 2003 the formula was revised, reducing the share of the national government to 8.65 percent and distributing the remainder in a similar proportion to original distribution amongst the states. However, with mounting fiscal pressure on the national government, the Congress of the FSM legislated in 2005 that no less than 10 percent would be allocated to the national government effective from FY2007.

69. On the expenditure side of fiscal policy, the five governments all operate within "balanced budget" requirements based on either constitutional or statutory provisions. However, the definition of a balanced budget is not restricted to the operations of a single budget year. Funds unexpended in one year are reported as revenues in the following year. The use of this so-called "carry-over" component in revenue projections tends to cloud fiscal management and can mask the onset of significant structural imbalances. The vulnerability to fiscal imbalance is compounded by delays in financial reporting and expenditure controls that result in legislative bodies taking appropriation actions without an accurate appraisal of each government's true fiscal position being readily available.

70. The national and state governments conduct budgetary operations through a series of separate funds, the most important being the general fund, special fund, and capital fund. Expenditures from the general fund are largely unrestricted in nature, but there is limited flexibility or authority to use funds from the special and capital funds. Under Compact I a major part of the external assistance provided revenue to the general fund. Under the amended Compact all such receipts are recorded as either special or capital funds. Thus, standard Government Financial Statistics (GFS) reporting, aggregating across funds and accurately distinguishing between "above-the-line" revenues and expenditures and "below-the-line" financing operations do not always highlight some of the additional constraints faced by fiscal policy makers. The best example of this was in Chuuk, which experienced severe financial crises in the mid-1990s and again in the early 2000s. The crisis was one affecting the general fund in particular, despite the fact that the state was running large surpluses on the capital fund and an overall fiscal surplus.

71. Fiscal analysis in the FSM has been hampered by the lack of timely and comprehensive financial reporting by the five governments. It was standard practice for audited information not to be available until 2 years after the closeout date. However, in the August 2005 JEMCO meeting a deadline was set that final audits should be available by June of the following year. At the end of July 2007 final audits for FY2006 were complete for Kosrae, Pohnpei and Yap, while completed audits were available for all prior years. The presentation of the fiscal outturn in this review is thus based on audited data where it is available, draft audits for Chuuk and unaudited financial statement for the national government for FY2006.

72. Tables 7a-f in the Statistical Appendix show the fiscal performance on a consolidated basis and for each of the five governments. The presentation follows the standard Government Financial Statistics (GFS) format. Tables 8a-e show fiscal performance of each of the five governments in the audit format. This latter format provides fund balances for each of the three main funds and, as noted above, does not report financing items below the line.

2. RECENT FISCAL PERFORMANCE

73. Figure 16 indicates the major trends in fiscal performance for the FSM (consolidating the five government accounts) since FY1995. At the start of the period before the second step-down, revenues and expenditures were largely in balance and the economy achieved fiscal balance. However, from FY1998 through FY2001, after the second step-down the fiscal account came under severe pressure as the nation was forced to adjust to a significant loss in revenues; the overall fiscal balance recorded an average deficit of 8 percent of GDP. The fiscal deterioration was compounded by a loss in fishing fee revenues that fell from an average of \$21 million per annum between FY1995–FY1996, to \$14 million between FY1997–FY2001. The large recorded deficits were financed through draw down of savings accumulated during the early phase of the Compact.

74. The second step-down in funding precipitated the need for a public sector reform program whose primary objective was fiscal stabilization. Fiscal stabilization was achieved through two major means: reductions in expenditures through an Early Retirement Program (ERP) and revenue reform. While the major element of adjustment (85 percent) was achieved through expenditure reduction, changes to the customs regime making all importers subject to the tax and switching the basis of collection from an f.o.b. to c.i.f. basis made a significant contribution. However, despite restoration of fiscal balance in Kosrae, Pohnpei, and Yap states, Chuuk and the national government recorded significant deficits between FY1997 and FY2001. In the case of the national government continued non-recurrent expenditures on constituency based projects were funded through draw down of past savings. While similar trends were evident in Chuuk, the primary cause was financial mismanagement and a large accumulation of arrears to vendors.

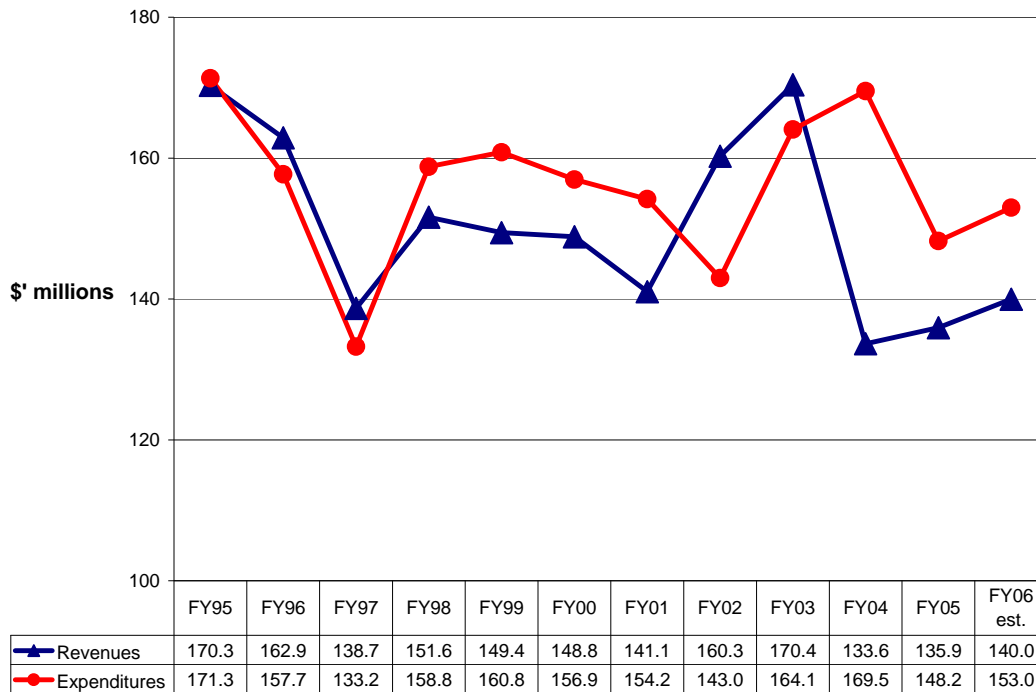


Figure 16 FSM consolidated revenues and expenditures

75. Returning to Figure 16, the FSM fiscal accounts recorded overall surpluses during the two bump-up years in FY2002 and FY2003, as the nation was required to save the excess funds to contribute to the amended Compact Trust Fund. However, in FY2004, at the start of the amended Compact period, the nation appeared once again to shift back into deficit as funding returned to levels below those prevailing before the pre-bump-up period. The large reduction in funding in FY04 onwards represents not only the lower aggregate level of Compact funds, but also capacity constraints with implementation, both relating to the recurrent sector grants and failure to establish compliant procedures for the draw down of the infrastructure grant. In FY2004 all governments were required to make payments to the amended Compact Trust Fund equivalent to \$28.3 million. After deduction of the Trust Fund contributions from the overall deficit of \$36 million, an underlying deficit of \$7 million more accurately reflects the fiscal position in that year. In FY2005 and FY2006 the FSM recorded deficits of \$12 and \$13 million, respectively representing 5 percent of GDP, and indicates the difficulties in adjustment.

76. Reviewing the structure of the fiscal accounts on a consolidated basis one can see the extensive dependence on external grants as well as the trend toward reducing that dependence. As shown in Table 8 grants represented 54 percent of GDP in FY1995, equated to 44 percent in FY2000 near the end of Compact I, and are estimated at 36 percent in FY2006. However, the figures for FY2008 and in future years will revert to

Table 8 Comparative analysis of fiscal structure FY1995, FY2000, and FY2005

FY95	Chuuk	Kosrae	Pohnpei	Yap	National	FSM
Grants as % of GDP	56%	75%	29%	55%	10%	54%
Grants as % of Total Revenue	84%	84%	79%	68%	38%	66%
Tax Revenue as % of GDP	9%	10%	10%	12%	8%	10%
Total Expenditure as % of GDP	66%	80%	42%	82%	25%	-82%
Overall Balance as % of GDP	52%	9%	-5%	0%	21%	-67%
FY00						
Grants as % of GDP	48%	64%	23%	48%	9%	44%
Grants as % of Total Revenue	76%	78%	68%	69%	47%	65%
Tax Revenue as % of GDP	14%	12%	12%	16%	8%	13%
Total Expenditure as % of GDP	73%	77%	31%	55%	24%	-72%
Overall Balance as % of GDP	53%	48%	4%	14%	22%	-58%
FY06						
Grants as % of GDP	35%	52%	17%	34%	8%	36%
Grants as % of Total Revenue	78%	82%	59%	71%	42%	61%
Tax Revenue as % of GDP	9%	10%	10%	12%	16%	13%
Total Expenditure as % of GDP	55%	72%	28%	53%	21%	-65%
Overall Balance as % of GDP	55%	-8%	1%	-5%	20%	-62%

- Notes
- 1 State GDP is used as the divisor for each of the four states, and FSM GDP is used as the divisor for the national government and consolidated account
 - 2 Taxes include all taxes collected in each state irrespective of the revenue sharing arrangements.

higher levels as the nation overcomes capacity bottlenecks and draws down on the infrastructure grant. Government expenditures have also declined as a share of GDP from a level of 82 percent in FY1995 to an estimated level of 72 percent of GDP in FY2000, and are projected at 65 percent for FY2006. While expenditures will rise for the reasons just outlined, the dominance of government in the economy has been reduced. On the revenue side the change in structure has been less dramatic and the relative importance of grants and domestic revenues has changed little. Grants made up some 61 percent of government revenues in FY2006, down slightly from the level of 66 percent in FY1995. Tax effort as a share of GDP has grown from 10 percent in FY1995 to 13 percent in FY2006. The most prominent change in the structure of revenues has been the reduction in fishing access fees, which reached a peak of \$21.5 million in FY1995 and averaged \$12.9 million annually in the FY2004–FY2006 period.

i National Government

77. At the beginning of the period in FY1995 and FY1996 the national government was running a fiscal surplus. The impact of the second step-down in FY1997 altered this situation. Coupled with a large reduction in fishing access fees, which was to become the norm in subsequent years, the fiscal position of the national government deteriorated significantly. The combined revenue losses, together with a failure to reduce current expenditures, created an overall deficit of 5 percent of GDP in FY1997.

78. The fiscal performance of the national government was a serious concern during the FY1997–FY2001 period as it ran large overall deficits in the range of 4 to 6 percent

of GDP or an average annual level of \$10 million. These deficits were largely funded from surplus balances accumulated in prior years—in effect by drawing down portfolio assets from abroad. Through the ERP the national government reduced payroll costs by about \$1 million, and achieved about 50 percent of the intended target reduction. However, these cost-saving measures were clearly minor in terms of the magnitude of the problem. In FY1999 the national government conceded to increase the share of revenues allocated to the states from 50 to 70 percent after the state governments had unsuccessfully managed through legal action to attain any share of the fishing fees. This loss of revenue amounted to about \$4 million annually or 2 percent of GDP.

79. During FY2002 and FY2003, it became increasingly apparent that such deficits were no longer sustainable and expenditures on public projects had to be severely curtailed. However, the adjustment was insufficient and the national government continued to run deficits of 1 percent of GDP during each of the two years. At a meeting of the EPIC in FY2003 the states had pressed for a greater share of Compact revenues and the share of the national government was reduced from 13.3 to 8.65 percent, effective in FY2004. With lost revenue on several fronts the Congress of the FSM legislated to restore the lost 20 percent revenue share in FY2004, and at the beginning of FY2005 further legislated to set a national government minimum share of Compact resources of 10 percent to be effective from FY2007. Coupled with tax measures to increase revenues on beer and tobacco in early 2005 the fiscal position of the national government strengthened. In FY2004 an underlying surplus (removing the \$8 million contribution to the Compact Trust Fund) of 0.7 percent of GDP was recorded. In FY2005 and FY2006 the national government again moved into deficit and recorded deficits of \$1.6 and \$3.5 million, respectively.

ii Chuuk State

80. Financially, Chuuk State has been the least well-managed of the five FSM governments. The impact of the reduction in Compact grants in FY1997 required a particularly difficult adjustment, and expenditures were cut in FY1997 to just \$25.8 million from a level of \$42.4 million in FY1995. Cuts in staffing and working hours (from 80 to 64 hours per pay period) achieved through the ERP resulted in reductions in payroll expenditures from a peak of \$21.9 million in FY1995 to \$12.8 million in FY1998, and reflected a 42 percent cut. The return to fiscal discipline in Chuuk from FY1997–1999 was a significant achievement and sufficient to repay arrears and to support a substantial economic recovery.

81. However, immediately upon achieving recovery, the state returned to many of the same poor fiscal practices that led to the original financial crisis. The state restored half of the working hour cut, up from 64 to 72 hours bi-weekly at the start of FY2000 and the remaining 8-hour increase in FY2001. The impact of this return to full hours, combined with new hiring, contributed to an increase in payroll costs to a level of \$19.5 million in FY2002. Yet even with the upward adjustment in payroll, much of the return to fiscal crisis in FY2000 and FY2001 can be attributed to an increase in other discretionary spend-

ing for constituency-based projects and increases in legislative allowances and expenses coupled with similar indiscipline in executive branch discretionary spending. While the overall deficit in FY1999 was primarily a result of a doubling of capital expenditures to finance the renovation of the state airport, subsequent deficits in FY2000 and FY2001 resulted directly from a lack of fiscal discipline.

82. During FY2002 and FY2003 the state recorded two years of fiscal surplus resulting from the receipt of bump-up funds and had to set aside the increase for the amended Compact Trust Fund. In FY2004 through FY2006 due to difficulties adjusting to the new regime of the amended Compact and lack of financial discipline the state once again moved back into deficit registering overall deficits of \$6.7, \$5.8 and \$7.0 million, respectively or about 10 percent of state GDP. With current accumulated debts said to be in excess of \$40 million the state is in effect insolvent. Unlike prior financial crises in which Compact funds could be set aside to repay creditors, the current structure prohibits the use of the new sector grants for reasons other than conforming to the purposes stated. Restoration of solvency can only be achieved through savings of local revenues, which are under considerable stress already to fund activities that are no longer eligible for Compact sector grants.

iii Kosrae State

83. Kosrae has maintained relatively consistent fiscal balance throughout the period FY1995–FY2003. The state had a current deficit of about 7 percent of state GDP in FY1997 as a result of the reduction in Compact grants and delay in implementing expenditure cuts. While current expenditures were subsequently reduced and current balance restored, the emerging deficit of 4 percent of GDP in FY2001 led to concern that further fiscal tightening was required. Payroll levels had not been reduced as significantly in Kosrae as in other states, despite implementation of a 56-hour pay period in FY1997. Payroll costs had been cut from a peak of \$5.8 million in FY1996 to a level of \$4.6 million in FY1999, a nominal cut of over 20 percent. However, a mandated annual step increase of 5 percent provided significant upward pressure on the state wage bill, and in FY2002 the state was able to accommodate a large increase in payroll expenditures and return to a 64 hour bi-weekly payroll as the state benefited from the large increase in revenues from the bump-up funds. The payroll for FY2003 stood at \$6.2 million, 8 percent above the pre-reform peak.

84. These developments left the state in an unenviable position at the start of the amended Compact. In effect the modest current surplus in FY2002–FY2003 was less than the bump-up, and provided a clear signal that, with respect to medium-term fiscal policy, the state had a structural deficit and would have to undergo another period of painful adjustment. The structure of Kosrae State's fiscal accounts have been transformed the least of any of the five FSM governments, tax effort is weak, and the local economy is the most dependent on Compact revenues. These features indicate a lack of flexibility in adjustment options to the new provisions of the amended Compact. In FY2004 the state experienced cash flow management problems, revealing an underlying stressed fiscal posi-

tion, and after adjusting for the contribution to the Compact Trust Fund a structural deficit of \$2 million or 11 percent of state GDP was recorded. Matters failed to improve in FY2005 and FY2006 and the state continued to experience overall deficits of \$1.2 and \$1.5 million or 7 and 8 percent of GDP, respectively. With the looming need to phase out \$0.9 million use of the capacity building grant from non conforming purposes in FY2008 and FY2009, the state was bracing itself for financial collapse as the new fiscal year loomed mid 2007.

iv Pohnpei State

85. Pohnpei State has shown considerable fiscal discipline from FY1996 to the present. As with Chuuk State, the GFS presentation masks some budgetary problems that were faced with respect to the general fund, but even with that the state appears to have adequately adjusted to current resources. Payroll costs were reduced from their peak of \$17.9 million in FY1996 to a low of \$13.6 million in FY2001. A return to the normal 80-hour working week was possible in FY2003 without threatening fiscal balance and the wage bill rose to \$15.2 million. More than any other state, Pohnpei responded significantly to the adjustment challenge by increasing state tax revenues. State taxes have nearly doubled from \$1.4 million in FY1997 to a level of \$2.7 million in FY2006, and total tax revenue as a share of state GDP has increased from 6 to 8 percent during this period despite a return of the 20 percent revenue share to the national government. In FY2004 a deficit of \$5.5 million or 5 percent of GDP was recorded. However this outturn hides the state's contribution of \$7.5 million to the Compact Trust Fund (CTF) and an unusual increase in non-tax revenues of about \$5 million. Adjusting for these non-recurring features suggests the state ran a deficit of \$2.9 million or 2.5 percent of GDP. In FY2005 a small deficit of \$0.1 million was recorded and a surplus of \$0.9 million or 1 percent of GDP was recorded in FY2006. Given that the state is not required to phase out any non-conforming use of the capacity building sector grant, it is much better placed to face the coming development challenges than either Chuuk or Kosrae. Unfortunately, the inward looking and weak policy environment will need rectification before the state can expect to experience a return of economy growth.

v Yap State

86. During Compact I and the FY1995–FY2003 period Yap State showed the most consistent fiscal performance within the FSM, and recorded an average surplus of 13 percent of GDP throughout the FY1997–FY2003 period. Adjustment to the second step-down in FY1997 was done in an impressive manner, and payroll costs were reduced from a peak of \$7.3 million in FY1996 to an estimated \$5.3 million in FY2003, a cut of 27 percent in nominal terms. Tax revenues as a percent of GDP have been variable, reflecting years of growth and stagnation. In FY2001 and FY2002 state taxes slumped, indicating declining capacity and the need for administrative strengthening; performance improved in the FY2003–FY2007 period. A key component of the state's fiscal situation has been the success of the state's monetization scheme. In FY1991 the state borrowed \$71 million through the issuance of MTN bonds secured by future Compact assistance flows under

full faith and credit provisions provided for in the Compact Treaty by the U.S. government. Having borrowed at a weighted average interest rate of 8.5 percent, the state has received investment earnings in excess of the cost of borrowing, which is reflected in investment balances in FY2006 of \$58 million.

87. In the amended Compact period FY2004–FY2006, under a new administration fiscal performance has deteriorated and after adjusting for the contribution to the Compact Trust Fund, the state recorded overall deficits of \$2.3, \$3.6 and \$1.9 million or 6, 9 and 5 percent of GDP in the three years, respectively. After many years of fiscal discipline, pressure to increase wages resulted in a significant increase in payroll costs. While some of this was due to rehabilitation after Typhoon Surdal with the infusion of FEMA funds, a significant component was represented by increases in operating expenditures. In FY2006 payroll costs reached a level of \$8.4 million significantly above the level of \$7.3 million recorded before the ERP and reforms in FY1996. In common with Chuuk and Kosrae, Yap state was required to phase out \$1.3 million of non-conforming use of the capacity building grant. The state has opted to fund this out of earnings and draw down from its investments. The state has also drawn on the corpus of its investments to maintain infrastructure investment, in particular the construction of the southern road system, while capacity problems continued in the use of the Compact infrastructure grant. The state has yet to design and implement an investment fund use strategy, outlining what are the economic and sustainable uses of its resources. Clearly, a sound policy is needed if the state wishes to avoid an undisciplined draw down of resources, which have been arduously built up to provide for the well being of future generations.

III. POLICY DEVELOPMENTS, PROSPECTS, AND ISSUES

A. *Public Expenditure Management*

1. PUBLIC SECTOR REFORM

88. A major objective of the Compact has been the attainment of economic self-reliance. However, at the beginning of the Compact I period the policy environment was hostile to the private sector, inward-oriented, and supported large government—a truly unfortunate policy mix for the support of economic development and attainment of the goals enshrined in the Compact. With the coming of the second step-down, the recognition emerged in 1995 that matters needed to change. The First FSM Economic Summit resulted in a consensus on policy reforms, and with the assistance of the ADB through the Public Sector Reform Program (PSRP), a series of reforms were implemented by the FSM states and national governments.

89. While a full review of the PSRP, which was evaluated by the ADB, is not called for, a brief assessment is warranted because the program attempted to reform many of the major policy areas which would be considered essential for an economy seeking to improve its economic performance. The goal of the PSRP was the transformation and development of a more efficient FSM economy. Its purpose had two dimensions: (1) reforming and reducing the size of the public sector to adjust to declining external resource transfers, and (2) shifting the balance of economic activity away from the public to the private sector. Five outputs were specified: (1) reduced size and operating cost of the civil service; (2) increased domestic revenue generation; (3) restructured government operations and public enterprises, with the divestiture of some of the latter; (4) successful mitigation of negative social and economic impacts of the adjustment in public expenditure; and (5) improved conditions for private sector development.

90. The achievement attained with reduction in workforce and payroll costs under the PSRP through April 2006 is indicated in Table 10. From an initial target to save 35 percent of payroll costs, the five governments of the FSM attained 25 percent by the time of the PSRP closeout in December 1999. By early 2007, more than six years later, there had been some slippage and the rate of cost savings had slid back from 25 to 20 percent. Compared with the original target set in 1996 current annual payroll savings is \$11.1, which remains a very substantial amount. Performance at the state level indicates marked differences. Yap State has been one of the best performers, which until the close of FY2004 had surpassed and maintained costs within target. However, with implementation of the amended Compact and a new administration, there has been some erosion of Yap's normal commitment to fiscal discipline and both payroll numbers and costs have risen. The implementation in Pohnpei has taken a somewhat similar track, which largely sustained the progress attained at PSRP closeout. With implementation of the amended Compact, however, significant additional recruitment has taken place in education. As a result the target, cost savings in Pohnpei is now approximately half the wage bill target.

Table 9 PSRP workforce and payroll reduction performance (progress at loan closing December 1999 and April 2006)

	Workforce Reduction Target	Workforce Reduction Dec-99	Workforce Reduction Apr-07	Wage Bill Reduction Target	Wage Bill Reduction Dec-99	Wage Bill Reduction Apr-07	Annual Payroll Savings (US\$)
Chuuk	-29% (2,784 ==> 1,963)	-24% (2,784 ==> 2,151)	-20% (2,784 ==> 2,234)	-44%	-31%	-25%	5.0 million
Kosrae	-14% (712 ==> 610)	-20% (712 ==> 628)	-24% (712 ==> 538)	-26%	-11%	-11%	0.6 million
Pohnpei	-28% (1,316 ==> 952)	-19% (1,316 ==> 1,069)	-3% (1,316 ==> 1,275)	-37%	-25%	-18%	2.8 million
Yap	-30% (940 ==> 661)	-33% (940 ==> 621)	-23% (940 ==> 719)	-29%	-34%	-27%	1.7 million
National	-21% (642 ==> 507)	-7% (642 ==> 600)	-7% (642 ==> 598)	-21%	-15%	-10%	1.0 million
FSM	-27% (6,394 ==> 4,693)	-22% (6,394 ==> 5,069)	-16% (6,394 ==> 5,363)	-35%	-25%	-20%	11.1 million

91. The national government, while performing poorly in terms of workforce numbers, achieved a significant reduction in cost savings, primarily through the near elimination of overtime payments. Chuuk achieved a high degree of success through the end of the PSRP program, but the fiscal crisis of the early 2000s undermined commitment and led to an increase in costs and hiring of contract workers. With the implementation of the amended Compact, a new administration, and after some backward movement payroll costs were forced more into line with fiscal realities—employment of contract workers was reduced and the 80-hour by-weekly pay period reverted to 72 hours. Despite the current problems, Chuuk's performance has made the largest contribution to the overall reduction in payroll costs. The result in Kosrae was the most disappointing. While exceeding the target reduction in workforce by a significant proportion, the state subsequently allowed the savings in payroll to be almost completely eroded. Annual increments and an increase in wage rates through a return to a 64-hour pay period were made possible through use of the bump-up funds. However, the onset of the amended Compact and need for the capacity building transition has significantly eroded the state's fiscal position and the former expansion in payroll is no longer sustainable and compression is unavoidable. There has thus been some improvement in Kosrae's position since FY2005 and both the workforce and payroll costs have been cut back. Overall at the FSM level, success in reducing payroll costs have been noteworthy and sustained although there have been some significant setbacks.

92. The major focus of the PSRP was the downsizing of the government sector through the ERP, but the program also emphasized other areas of public sector reform, restructuring, and private sector development. While there was an intentional emphasis on expenditure compression, important revenue reforms were achieved through shifting

the collection of import taxes from an f.o.b. to c.i.f. basis and broadening the system through levying import duties on all sectors of the economy, both private and public. Revenue targets were met or exceeded by the end of the program period, and consolidated tax revenue was 27 percent higher on average in the 4-year period FY1998–FY2001 than in the previous 4 years. Exports were exempt from gross revenue taxes consistent with adoption of an “outward”-looking development strategy. However, the revenue reforms were intentionally undertaken within the existing regime rather than through adoption of a modern administration and tax system such as required through the implementation of a VAT. Tax reform is currently an active area of policy reform and is discussed in the section on private sector development (see p.61).

93. The PSRP also addressed the need for restructuring of government operations and public enterprises, but progress has been slow and only recently has any significant transformations been undertaken. A subsequent attempt at Public Sector Enterprise (PSE) reform was initiated through an ADB Technical Assistance and agreed target transformations were specified in the Private Sector Development Program (PSDP). Finally, the other main component of the PSRP was reform of the regime for foreign direct investment (FDI) through establishment of a transparent and predictable system implemented at the state and national levels. As with measures to reform the public enterprise sector, efforts to further improve the environment for FDI were incorporated into the PSDP. These are discussed below.

2. PERFORMANCE MANAGEMENT AND INFORMATION SYSTEMS

i Financial Management Information Systems

94. This section of the report has been prepared with assistance from Steve Medlin. The Office of the Secretary of Finance and Administration in the Federated States of Micronesia (FSM) initiated the Uniform Financial Management Information System (FMIS) project several years ago to replace the existing diverse collection of FMIS systems in use at the State and National levels with the FundWare application. The objectives of the project are to:

- Analyze and improve the quality of the existing financial information within the State and National government finance offices,
- Replace defective, antiquated, and unsupported software and hardware with new equipment and software that is fully licensed and supported with maintenance agreements,
- Migrate high-quality financial information from each obsolete financial management information system into the new FundWare system, and
- Train and mentor finance office personnel in the proper use and maintenance of their new FMIS.

95. The ultimate goals of the project are to:

- Enable the States to accurately and consistently manage their financial information and report it to the National government and other stakeholder organizations,
- Enable the National government to integrate the State's financial information with its own and report it accurately and consistently to stakeholder and partner organizations,
- Increase the level of management control by the National government of financial information that is necessary for the purposes of fiscal accountability and reporting accuracy, and
- Improve the technical capabilities (hardware, software, and skills) in the financial offices at both the State and National level.

96. **Current Status:** Yap, Pohnpei, and Kosrae State finance offices (in that order) were successfully migrated to FundWare. The next state to be implemented is Chuuk, scheduled for October 2007. Lastly will be National government which is tentatively scheduled for February 2008. The Office of the Secretary of Finance and Administration, FSM, is in the final stages of a services contract modification with Kintera. The project experienced some cost overruns due to changes in the original implementation strategy. Thus additional funds needed to be secured and the contract modified to reflect this change. The project is now divided into two major activities:

- Core Implementation: this provides finance offices with all the financial management capabilities enjoyed prior to the conversion to FundWare. This has been implemented in Yap, Pohnpei, and Kosrae, and will be achieved in Chuuk and the National government after conversion.
- Post-Core Implementation: this provides additional, and in some cases optional, financial management capabilities. The most notable capabilities are Fixed Assets tracking and reporting, and Budget Preparation.

97. The project schedule currently calls for all Core and Post-Core activities to be completed by the summer of 2008. Sufficient funds to complete the project have been identified but are not yet formally approved and released to the project.

98. **Issues:** Several key issues must be resolved in order to keep to the current project schedule. Each of these is being worked on by the project team and the Secretary's office, with the assistance of the Grad School, USDA and the OIA, as appropriate.

- Funding: the original services and licenses contract with Kintera, the supplier of the FundWare application, was for \$2.8 million. However, the estimated cost to complete both core and non-core activities is now \$3.4 million. While the \$2.8 million is secured through an OIA grant, and a further \$0.2 million has been approved by JEMCO, funding for the remaining \$0.4 million is only tentative.
- Personnel: the most critical need facing the successful installation of the new FMIS is the establishing a central point of contact once the project is complete. At

- that time centralized control and communication must be coordinated by an FSM appointed full-time project/program manager. Uniformity of the Chart of Accounts and other financial and accounting practices is absolutely necessary for long-term success. This can only be assured through a centralized program management office run by a capable, full-time, manager.
- Logistics: availability of office, training space, and reliable electrical power is a critical issue facing the Chuuk implementation in October.
 - Contractual issues: the project has continually been hampered by inadequate contracting provisions. The services contract with Kintera is time and materials based, it precludes any effective means of enforcing a quality standard or ensuring that deadlines are met.

ii Performance Management Capacity Building (PMCB)

99. The FSM initiated a process of performance budgeting and management with assistance from the ADB in the late 1990s, and up to 2003 was the beneficiary of four TA efforts. The process of implementation has been long and drawn out, and has yet to produce tangible improvements in service delivery. In the initial phases the process was concerned with adoption of a performance or output orientation in budgeting. Over a period of time each of the FSM budgets were converted from a line item basis to a performance basis. However, the process more frequently than not largely involved a change in budget format rather than the introduction of any new processes. A software program referred to as the Budget Preparatory Software (BPS) was developed and is now used by all governments. While it has the benefit that budgets are stored electronically, and therefore the BPS produces consistent reports, the performance orientation has gone little further than allocation of existing inputs to outputs. This implies existing processes are made to “fit” the selected performance criteria rather than estimating the cost of inputs required generate each output.

100. With the implementation of the amended Compact, new fiscal procedures and need for strict accountability, the Office of Compact Management (OCM) initiated a PMCB project with OIA support to develop and refine uniform performance measures and data needed to track progress in achieving the goals and objectives of the FSM Strategic Development Plan and the Compact-funded sectors of education, health, public sector capacity building, private sector development, environment, and public sector infrastructure. The objectives of the project are to:

- Build capacity in national and state government departments in performance budgeting, management, and reporting,
- Develop performance measures and indicators linked to the FSM Strategic Development Plan and the specific purposes of Compact financial assistance,
- Improve performance budgeting and management throughout the FSM, and

- Develop a system of metrics for the display, monitoring, and reporting of performance indicators and measures.

101. The ultimate goals of the project are to:

- Improve the governments' responsiveness in achieving the nation's strategic goals and objectives,
- Improve operational performance effectiveness and efficiency,
- Provide the data needed to demonstrate progress (or lack thereof) to key stakeholders (the US Department of the Interior's Office of Insular Affairs, elected government officials, the FSM public, etc.),
- Provide the information needed for decision-making on budgets, program and departmental operations, and asset allocation, and
- Institutionalize the organizational processes and staff capabilities necessary for the FSM to maintain, manage and improve the performance management system independently.

102. **Current Status:** Performance measures have been developed by teams of FSM experts for the education and health sectors. These measurement structures are now being presented to, and discussed with, stakeholders in the health and education sectors. The measures and the data supporting the measures are also being assessed to determine: (1) whether they are currently being collected and reported, (2) who is collecting and reporting the data, (3) when and often the data are being collected and reported, and (4) the credibility of the data. These data will be used to improve the data collection and reporting systems in the health and education sectors. The remaining four sectors, environment, private sector development, infrastructure, and public sector capacity building, are tentatively scheduled to participate in workshops to develop performance measures in October.

103. **Issues:** The OCM has been directing the project to try to develop performance measures for all six sectors to be used in the formulation of the FY2009 budget. For this objective to be achieved, four components of the project must be coordinated and essentially completed by November 2007:

- Performance measures must be completed for all six sectors,
- Performance data for all six sectors must be assessed for their availability, credibility, and timeliness, and data collection and reporting systems must be installed to ensure the data being reported meet certain minimal levels of credibility,
- The Financial Management Information System (FMIS) must be modified to accommodate performance measurement data in both its financial and budget modules, and

- The Performance Reporting System must be re-designed, developed, and distributed (with training) so performance data can be collected, assimilated, and reported in an efficient, credible, and timely manner.

104. As of the beginning of August 2007, several factors put the project's ability to include performance data in the FY2009 budget formulation process at risk:

- The FSM has not yet approved and released the \$221,000 JEMCO approved to fund non-core FMIS modules. Without this funding being made available, the FMIS budget module will not be included as part of the FMIS implementation plans for 2007, and thus will not be available for FY2009 budget formulation.
- The FSM is considering an ADB project that would also develop performance measures and try to improve the FSM budget process. If the ADB project proceeds as currently designed, it will generate confusion and duplication of effort and would significantly impede the success and progress with the PMCB project. Clearly, the ADB project needs reprogramming so that it may augment and complement the existing effort to provide a positive rather than competing resource.
- OIA is considering an October planning session with several of the sectors the PMCB Project has scheduled for the October measurement development sessions. If the PMCB sessions were to be delayed to accommodate OIA's planning meetings, the PMCB project would not be able to re-schedule these sessions until January, causing a delay of three months.

105. Several significant risks also affect the FSM's ability to complete the PMCB Project successfully in the longer term:

- The FSM has essentially no staff assigned to participate in the project. Capacity building cannot be successful if there is no recipients in whom to build capacity.
- The FSM continues to view the project as primarily a budgetary exercise when it is in fact an executive/managerial level undertaking.
- The FSM has not yet defined the structure through which it will implement, monitor, and manage the measures once they are developed.

B. Private Sector Development

1. THE PRIVATE SECTOR DEVELOPMENT PROGRAM

106. With the closeout of the PSRP at the end of 1999, the intention was to maintain the reform effort through implementation of the Private Sector Development Program (PSDP) loan. The PSDP was designed to shift the focus to private sector development, but was also intended to secure the achievements made under the Private Sector Reform Program (PSRP). Particularly important was the intent to lock in the existing reforms before the release of the bump-up funds in FY2002 and FY2003. However, the program was delayed. A Basic Social Service (BSS) sector loan was accorded priority by the ADB

and resulted in confusion. Neither loan was approved by the FSM Congress until late in 2000. Subsequent approval and authorizing legislation at the state level was also slow in coming, and not attained until a further year later. While the intention had been to follow the PSRP with the PSDP during 2000, actually implementation did not start until 2003. By this time the FSM was into the bump-up period, the Compact renegotiations were well under way diverting attention from further reform, and momentum was lost. The loan program was finally closed-out by the ADB in February 2007.

107. The PSDP was structured in two parts: a project and a program loan. The project loan contained a series of activities designed to improve the environment and capacity for private sector development, including improvements to the legal and regulatory environment; increased access to, and security of, land for economic use; increased access to finance for small business; and improvements to business and entrepreneurial skills. The policy loan was tranching in two parts. Compliance with a series of policy reforms opened the door for the second tranche draw down. Only the national and Kosrae state governments were deemed compliant by the ADB and qualified for second tranche draw down. The policy measures required to be met in each state included:

- Maintenance of medium-term fiscal balance (maintaining current expenditures within pre-bump-up revenue levels),
- Maintenance of government payroll levels within specified targets,
- Sterilization of bump-up funds,
- Sound external debt management (national government only),
- Foreign investment laws amended and regulations improved,
- Long-term lease and mortgage legislation enacted (state governments only), and
- Public Sector Enterprise reform and at least one entity transformed.

108. While official review of the PSDP policy matrix indicates that all governments passed the requirement to maintain medium term fiscal balance in FY2003 and FY2004, only Yap achieved this requirement. All other governments either failed to maintain medium-term balance in one or both of FY2003 and FY2004. All governments, except Kosrae, were below their payroll targets as of April FY2006, and the bump-up funds were effectively sterilized in FY2002 and FY2003, fulfilling the U.S. requirement that the FSM contribute \$30 million to the Compact Trust Fund. The FSM has maintained a sound external debt profile. Discussion of the foreign investment regime, long-term leasing, and PSE reforms are based on a report prepared for the ADB by Rick Caldwell (“Legislation for Private Sector Development”, November 2005), and a loan close-out report prepared by the FSM.

109. ***Foreign Investment Reform:*** Until the late 1990s, control of foreign investment in the FSM was regulated by the national government and based on an outdated law enacted during the Trust Territory days. The states indicated concern about slow processing, insufficient sensitivity to local concerns, and usurpation of power by the national gov-

ernment. Except for a few sectors of undisputed national interest, there was general agreement at all levels in the FSM that decentralizing the control of foreign investment to the states was a good idea. While the states sought decentralization, development experts and foreign investors were concerned about the restrictiveness and lack of transparency in the existing law. The Foreign Investment Advisory Service (FIAS), a joint facility of the International Finance Corporation and the World Bank, was requested to do a review. FIAS proposed a “stoplight system” of red, amber, and green lists, which was incorporated as a loan covenant of the PSRP. The new foreign direct investment (FDI) regime was subsequently adopted by the national government in 1997 and three of the states followed soon after. Pohnpei already had a foreign investment regime of its own design and did not wish to adopt the same approach as the other FSM governments.

110. The new FDI regime had four goals: (1) decentralization, (2) uniformity of structure, (3) making the rules less restrictive, and (4) making the rules more transparent. The new regime achieved decentralization, but at the cost of the need to apply for more than one permit if an investor wished to operate in more than one state. With Pohnpei state maintaining a Foreign Investment Board approach to FDI, the objective of implementing a uniform structure to FDI was not achievable, although the structure of the laws in the other four governments remained similar. While there was some improvement in the areas of restrictiveness and transparency, these goals were mostly subverted by changes that each government made to the model FDI legislation.

111. At the request of the national government in September 1999, FIAS was requested to review the changes in the laws and regulations implemented by the five governments during the PSRP and propose changes that would help the FSM achieve the original objectives of the reforms. The recommendations proposed by FIAS became the requirements for each government to implement to qualify for second tranche release of the PSDP funds.

112. It is important to bear in mind that the new FDI regime in the FSM is highly dependant upon regulations. In each government, the statute sets forth a framework for regulation, leaving much of the detail to be fleshed out in regulations. Since regulations implement statutes, amendment of regulations is generally required after any significant statutory amendment, thus creating a two-step process with all its timing implications.

113. Reviewing the progress of each government in turn, the national government was required to make amendments to the existing statutes and implement regulations compliant with the FIAS review. The revised bills and regulations were signed into law by the end of 2005. In Chuuk revisions to the law were proposed and new regulations prepared. However, despite no apparent opposition to the proposals no progress was made. In Kosrae the proposed changes to the law and regulations were both enacted by the legislature and signed into law. In Pohnpei the general aversion to FDI resulted in the state remaining out of compliance with the PSDP matrix. In fact, recent legislation passed by the state legislator in December 2006 prohibits FDI in many service sectors which compete with

local interests. While tourist support services are reserved for local business, larger hotels greater than 12 rooms remain open to foreign investment. As a consequence of these changes one dive operation went out of business and currently Pohnpei state has no operators in this sub-sector. In Yap state the changes recommended were enacted by the end of 2005. Thus, of the five governments, national, Kosrae, and Yap implemented the necessary reforms, while Chuuk and Pohnpei remain non-compliant where the environment for foreign investment remains adverse.

114. ***Land Leasing and Mortgage Reform:*** The FSM constitution prohibits ownership of land by noncitizens. The constitutions of two states—Kosrae and Pohnpei—prohibit ownership even by citizens from other states in the FSM. The availability of land for development and as collateral for financing is critical if there is to be significant private sector development. With this background, the ADB sponsored TA in 1999 to develop the necessary legal framework for a system of long-term land leasing and mortgage reform. The result was a report prepared by Rick Caldwell entitled *Land Leasing in the FSM: A Report on Long-Term Land Leasing and Leasehold Mortgaging*. The report became the basis for the second tranche requirement that “the legislative branches of the States shall have passed legislation improving the legal environment for long term leasing of land and for encouraging mortgage-secured commercial lending.” Unlike the FDI case, the proposed reforms only required legislative action, avoiding the need for an accompanying set of regulations. Land issues clearly fall under the domain of the state governments, which implies that no action was required of the national government.

115. Before commencement of the PSDP Chuuk was the only state to have adopted legislation in the land area. However, there were numerous shortcomings of the legislation and, although there was no opposition to the proposed changes to bring the laws into compliance, these were not implemented. Like the proposed changes to the FDI regime, a lack of inertia was reported as being the major fault. In Kosrae the state adopted a proactive position and passed the required amendments bringing the state into compliance with the PSDP. In Pohnpei proposed changes to the existing land legislation were considered, but once it was apparent that the state would not qualify for the second tranche draw down, the state lost interest. In the case of Yap, while the state is generally reform-minded the interaction between land and culture comes to the forefront. While the Executive branch supported the land reform initiatives, the two bills have been held up at the legislature, resulting in the state failing to qualify for second tranche draw down.

116. ***Public Enterprise Reform:*** While the PSRP entailed reform and restructuring of the public sector, there was little emphasis on PSE transformation. Much of the groundwork for PSE reform in the FSM came from a subsequent ADB TA entitled *Privatization of Public Enterprises and Corporate Governance Reform*. The final report prepared in 2001—commonly called the “Aries Report”—identifies a variety of activities that can constitute PSE reform, including liquidation, divestiture, corporatization, commercialization, governance reform, and outsourcing of goods or services. However, while the Aries Report analyzed the FSM PSE sector, proposed an institutional structure for reform, and

identified suitable candidates for transformation, no reforms took place. The findings and recommendations of the TA were to form part of the PSD reform requirements, which included (1) preparation of master plans for public enterprise reform for submission to each government and (2) transformation of at least one enterprise.

117. Before discussing the progress attained during the PSDP, it is well to recap some of the important features of the PSE sector. The FSM Strategic Development Plan identifies 22 major PSEs operating in the financial sector, utilities, fisheries, and a miscellaneous category. In the FY1997–FY2001 period, the sector employed an average 990 people (6 percent of the labor force) and contributed \$14 million to GDP (7 percent.) Overall the sector made an annual net loss of \$0.9 million and required annual subsidies of \$4.9 million to support operations. Salaries are 2.5 times the private sector average. From FY1995 through FY2004 the capital base of the sector fell from \$222 million to \$186 million, almost of all it representing accumulated losses of the fisheries sector.

118. The first requirement of the PSDP was the transmission of PSE master plans to each government. However, while this objective was completed, not one master plan has been institutionalized or acts as an active framework guiding PSE management or transformation. Regarding actual PSE reform, a qualifying transformation was regarded as one that reduced government costs, improved service delivery, or avoided crowding out the private sector. In the case of the national government the capital water system was transferred from a national department to the Pohnpei Utilities Corporation. This was accepted as a qualifying transformation. In Chuuk no transformation took place that enabled the state to qualify. In Kosrae the state government outsourced the operation of the hospital food service, which was deemed as a qualifying transformation. In Pohnpei, due to financial considerations the state was forced to sell three fishing vessels to a private company. Although there was no evidence that the transformation was intended to satisfy the PSDP condition, it was accorded a compliant transformation. In Yap the state transferred the television service from a state owned department to FSM Telecom and was deemed compliant.

119. While in four out of five cases the governments of the FSM were deemed to be in compliance with the PSD requirements, two involved transference of an enterprise to a different level of government, one took place by default, and one was largely insignificant. Not one of the transformed enterprises was represented in the 22 major PSEs identified in the Strategic Development Plan. Clearly, while perhaps qualifying by the letter of the law, the PSDP transformations did not fulfill the spirit of reducing the size or role of government in the economy. On the positive side Pohnpei state has subsequently transformed two of its loss-making fisheries enterprises since the close-out of the PSDP. The Caroline Fisheries Corporation is now under 60 percent foreign ownership with the remaining 40 percent held by the state. While the assets of the Pohnpei Fisheries Corporation remain under state ownership, it has now been leased to a private foreign investor. Finally, the Micronesian Longline Fisheries Corporation, a national government enterprise, has now filed for bankruptcy and is under liquidation.

Table 10 Compliance with PSDP policy reform conditions and overall score (max. 6)

	Chuuk	Kosrae	Pohnpei	Yap	National
Medium term fiscal balance	0	0	0	1	0
Maintenance of government payroll	1	0	1	1	1
Sterilization of “bump-up” funds	1	1	1	1	1
Sound external debt management					1
Foreign investment regime	0	1	0	1	1
Long-term lease and mortgage legislation	0	1	0	0	
PSE reform	0	0	1	0	0
Score	2	3	3	4	4

120. Table 11 provides a summary table of the current position of each state in implementing the PSDP policy reforms (this does not equate with compliance with the ADB loan covenants). An average score, based on a possible score of 6, is provided on the basis of whether each currently government fulfills the respective policy reforms. The table indicates a mixed level of success and compliance. Yap and the national government scored the highest level, fulfilling a majority of the reforms. In the case of Yap the state failed to fulfill the land reform component and like most other states failed to complete any serious public enterprise transformation. The national government complied with four of the conditions, but during FY2002 and FY2003 ran medium term fiscal deficits and failed to achieve any substantial transformation of a public enterprise. Kosrae fulfilled three of the conditions, and was more favorable to enact policies that supported private sector initiative, but lacked fiscal discipline or made any serious efforts to reform its public enterprises. In fact through the creation of the Micronesian Petroleum Corporation, the state extended the boundaries of the public sector. While Pohnpei has generally maintained fiscal discipline, it surprisingly failed to meet the medium-term fiscal balance requirement, and the environment for private sector development is inward-looking. Only recently the reform of two of its PSEs has enabled the state to achieve a higher score. Chuuk produced the least satisfactory result reflecting weak fiscal management and a general lack of administrative capacity to enact any reforms rather than any policy decision not to encourage the private sector.

2. TAX REFORM

121. The need to reform the FSM tax regime has been long recognized. While the existing system served the needs of the nation reasonably well during the early days of nationhood, it does not provide a strong foundation for an elastic source of revenue without distorting economic incentives. While the design of the PSRP took into account the long-term need for tax-reform, it was felt in the short to medium term that efforts should be directed to improvements in administration and reform of known weaknesses of the existing system. It was understood that radical reform of the tax system should be deferred until after the PSRP was complete.

122. As the Compact renegotiations neared completion it became clear that the new structure of the amended Compact would entail significant adjustments, both in the short term and during the 20-year horizon. The new sector grant approach resulted in a system that provided sufficient funding to maintain the operations of education and health and selected sectors, but failed to support the ongoing needs of many government functions. In the near term, the United States permitted the FSM to utilize the capacity building sector grant for non-conforming purposes, provided it was agreed that these would be transitioned out over a five-year period. In the long term, a reduction in the resources of the amended Compact was programmed through an annual decrement of \$0.8 million, and lack of full indexation of the transfers. Thus both the short and long-term reduction in funding required that the FSM consider measures to increase revenue effort if the burden of adjustment was not to fall entirely on expenditure compression.

123. In 2002 a nationwide tax and revenue symposium was held to raise the awareness of the problems and encourage steps that would result in revenue and tax reform. The symposium passed two important resolutions. First, it recommended the introduction of a comprehensive tax reform program including the introduction of a broad based consumption tax (value-added tax plus excises) and, subsequently, a simple net profits tax. The consumption tax would be enacted at the state level, replacing the existing national gross revenue, and state sales taxes. Second, the symposium recommended the establishment of a unified tax administration to implement the new regime and collect taxes on behalf of both layers of government.

124. In March 2004 the FSM convened the Third FSM Economic Summit. Participants were presented with varying scenarios that ranged from a dismal one, where the FSM failed to generate economic growth and many Micronesians were forced to migrate due to lack of opportunities, to a Sustained Growth Strategy (SGS). It was recognized that attainment of the SGS would entail the need for additional domestic resource mobilization, not only for adjustment to the conditions of the amended Compact but also to support public investment in needed infrastructure. A modern tax regime was required that supported the adopted outward-orientated growth strategy and encouraged private sector investment.

125. During the remainder of 2004, with support from the ADB and Pacific Finance Technical Assistance Center (PFTAC), the design and structure of a modern tax regime appropriate to the FSM was fleshed out. In Chuuk in September 2004, a preliminary working group with delegates from both national and state governments met and organized a task force with representation from the various stakeholders, especially the private sector, to provide a comprehensive approach to the issue of tax reform. In January 2005, the Tax Reform Task Force (TRTF) was formally organized and created by the FSM president. The TRTF would be chaired by the vice-president, with the FSM Customs and Tax Administration forming the secretariat. Membership on the task force included the FSM secretary of finance, representatives from the private sector, one from each state, and two members from the FSM Congress. The objectives of the TRTF were:

- To examine different options for reform of the FSM tax system in order to meet expected reductions in revenues and to support the long-term sustained economic development of the nation.
- To prepare a tax reform proposal to present to the leadership of the FSM and the FSM Congress for consideration and enactment at the earliest possible time.
- To assist in education, holding of seminars and working groups to increase public awareness about the fiscal implications of the amended Compact, and the need to generate more local revenue, for tax reform, and to strengthen tax administration.

126. In June 2005 the TRTF submitted to the president its final recommendations, which the president approved in December. The key recommendations include:

- Tax reform and the introduction of a form of value-added tax (VAT).
- A tax package which includes the elimination of the current GRT and (state) sales tax and surtax.
- A form of Net Profit Tax (NPT) or business income tax to replace the GRT, allowing for deductions of business expenses from taxable revenues.
- The establishment of an independent tax collection authority with operations nationwide.

127. In September 2005 the reform proposal was put to the Economic Policy Implementation Council (EPIC) and was adopted by resolution (similar resolutions had been adopted on previous occasions.) Congress similarly adopted the reform proposal (for the first time) in September and requested the president to establish an executive steering committee (ESC). Laws were drafted with the support of the IMF for the creation of a Unified Revenue Authority, a Revenue Administration Act, and new VAT and NPT laws. In June of 2006 at the inauguration of the ESC a high level implementation plan or master plan was adopted by the Committee together with the creation of a Technical Working Group. Follow up progress with the reforms was delayed during the following year as the FSM prepared itself for the March 2007 national and state elections. In April of 2007 the ESC once again convened and endorsed the commitments already made. The technical working committee was tasked with preparing a detailed implementation plan, preparing a tax reform package for submission to each of the FSM states, and requesting the creation of state-level implementation teams. In July the first state level meetings were held and a tax reform symposium is currently planned for August. AusAid, the Australian aid agency, has committed to the provision of a full time project coordinator to drive the process. Given the low level of administrative capacity in the FSM, donor support is critical. It must be envisaged that a resident team of tax experts will be required for several years, if successful implementation is to be achieved.

128. Clearly progress with the tax reform initiative has been slow, and is only currently making headway. Unfortunately, implementation of the tax reform initiative will be too late to assist in transitioning out the use of the capacity building grant from non-

conforming purposes in Chuuk and Kosrae states. Adjustment will need to be made through painful expenditures cuts and reductions in payroll. However, the need for tax reform remains to assist with adjustment to the annual decrement over the remainder of the amended Compact period, and to support the private sector through the adoption of a broad based, modern, and non-distortionary tax system.

C. Outlook

1. ADJUSTMENT TO THE AMENDED COMPACT

130. After successfully completion of the Compact renegotiations with the United States, the FSM was left with a set of fiscal adjustments. First, the amended Compact entailed an 8 percent set down in funding from \$83 million to \$76 million. Second, the switch from a general to a sector grant approach meant that there was a shortage of domestic revenues to fund non-Compact sector operations, such as administration, law and order, public works, transportation, etc. In the interim the United States agreed that the FSM could use the capacity building sector grant to fund operational activities listed under the grant, provided that the FSM agreed to phase out these activities over a 5-year period. Third, those activities that were not listed under the capacity building grant required immediate adjustment. Fourth, the United States imposed the requirement that 30 percent of Compact resources be devoted to infrastructure. And finally, the loss of the Compact I energy grant meant that in certain states utility corporations were forced to raise prices to cover costs.

131. The first two years (FY2005 and FY2006) of the phase out of the use of the capacity building grant from non-conforming activities were met through switching the source of funding of national government operations to domestic revenues, and funding the College of Micronesia out of the education sector Compact grant. The four state governments were thus largely spared the need for adjustment, although the 30 percent infrastructure requirement, and lack of Compact funding for such activities as public works still required adjustment, particular in Kosrae. Table 11 indicates the required adjustments during the remaining three years of the capacity building adjustment period (FY2007 through FY2009), which fell entirely on the state governments. In Pohnpei the annual adjustment of 3 percent was quite small and has been easily absorbed. In Yap the adjustment has also been completed through funding the required activities out of the state's investment reserves. While Yap speedily resolved the problem, the long-run sustainability of the decision to draw down on reserves to fund operational activities is open to question, and certainly raises the issue of the optimal use of the state's hard earned savings. In Chuuk, the capacity building transition issue has not been resolved and the state met the FY2007 phase out requirement through deficit spending. In Kosrae, the state opted to defer transition until the last two years of the five-year period, and coupled with the failure to adjust to the other requirements of the amended Compact, placed the state in an unenviable position as the FY2008 budget neared. The next section discusses in more detail the situation in Kosrae and Chuuk and the adjustment plans proposed by the two states.

Table 11 Capacity building sector transition and Compact fiscal adjustment

	FY07	FY08	FY09	Domestic Revenues	Annual Compression Required ^{/1}	3 Year Compression Required
Chuuk	884	884	884	6,988	11.2%	27.5%
Kosrae	92	462	462	2,124	17.9%	32.3%
Pohnpei	329	329	329	12,806	2.5%	7.1%
Yap	449	449	449	5,672	7.3%	19.2%
National				27,112		
FSM	1,753	2,123	2,123	54,703	3.7%	9.9%

Note /1 For Kosrae compression ratio refers to FY08 and FY09 levels

2. ADJUSTMENTS IN KOSRAE AND CHUUK

132. The imminent and dire implications of a lack of response to the need for fiscal adjustment looming FY2008 compelled the Kosrae leadership to confront the problem. At a leadership conference in May 2007 an adjustment package was worked out not only in response to the capacity building transition, but also to rectify past deficit spending. The measures included \$1.9 million in savings through: (i) expenditure reduction, (ii) enhanced revenue effort, and (iii) measures to mitigate the impact of the adjustment. Expenditure compression focused on the elimination of 98 positions from the FY2008 budget—64 positions to be eliminated completely and the removal of 34 vacant positions, with a total cost savings of \$719,000. Expenditure compression included a further \$254,000 in a 5 percent across the board pay cut, and \$120,000 in non-payroll cost reductions. Revenue measures include hikes in rates to raise a total of \$511,000. The total impact of both the revenue and expenditure measures totals \$1,606,000 with \$293,000 remaining to be accomplished in FY2009. Measures to mitigate the impact of the RIF include a one year salary payout, with proposed U.S. support by way of Compact sector grant funding.

133. While Kosrae state appears to have responded positively to the challenge of the fiscal adjustment, Chuuk state has executed an MOU with the national government to achieve financial and structural reform. At the present time Chuuk has an accumulated debt in excess of \$46 million, a general fund deficit of \$2 million as recorded by the state, although projected at \$7 million on a GFS basis. In contrast to the measures proposed by Kosrae, those proposed in the Chuuk MOU lack credibility and do not appear to be sufficiently developed to seriously address the problems at hand. The need to phase out the capacity building sector grant is addressed through a commitment to eliminate 200 positions in March 2008 with a cost savings of \$1 million and a further elimination of 200 positions in March 2009. Although a reduction in force is needed prior to the start of the next fiscal year on October 1st 2007, the MOU proposals will not come into effect until 6 months after their budget deadline. The prognosis for the state is thus bleak, with continued deficit spending implied in the adjustment package and the likelihood of increasing instability and financial collapse imminent.

3. SHORT-TERM PROSPECTS

134. In the following discussion, estimates are provided on short-term prospects and the possible impact on the economy of the adjustment to the capacity building transition in Chuuk and Kosrae. In FY2007 estimates are based on data covering the first six months (see Appendix Tables 1a-e.) For FY2008 and FY2009 it is assumed that Kosrae implements the proposed adjustment package, and that Chuuk is also forced into a similar program. Pohnpei and Yap have already fulfilled the capacity building grant phase out, and thus are not required to adjust. However, both states are constrained by the lack of full indexation and annual decrement in funding. On the positive side, it is assumed after four years of lack of draw down of the infrastructure grant that the FSM is able to start utilizing the funds, albeit at a reduced rate. It is also assumed that private sector performance in each state is reflective of public sector demand, and that there is no new autonomous domestic or foreign investment.

135. In FY2007, the Chuuk State economy is projected to decline by 8 percent (based on first six months of data), and reflects the significant reduction in government payroll. In nominal terms value added contributed by the state government declines by 18 percent, and all other sectors remain largely unchanged. After deflation by the increase in state CPI of 3.4 percent, the impact on overall GDP is substantial. The outlook projected for FY2008 is similar. While the Chuuk state adjustment package fails to provide for any adjustment until March of 2008, it has been assumed that the state is forced into a RIF to phase out two years worth of capacity building grant in FY2008, and impose a 5 percent across the board pay cut. An additional tax effort of 25 percent has also been assumed although the capacity to introduce an increase of this magnitude must be questionable. On the positive side it is assumed that the state has been able to start spending the infrastructure grant. However, the infrastructure spending is insufficient to offset the impact of the adjustment and GDP is project to decline by 6.7 percent. In FY2009 the state is required to make a further adjustment to the capacity building phase. Infrastructure spending picks up , but with the lack of full indexation and decrement, state GDP is project to decline by a further 0.4 percent.

136. In Kosrae the economy is projected to grow by 1.0 percent in current prices in FY2007, reflecting slight increases in nominal levels of private and public sector activity. After deflation by the state CPI, real GDP is projected to have declined by 0.3 percent. The relative favorable outcome reflects the failure of the state to adjust to declining Compact resources and maintenance of an unsustainable fiscal deficit. In FY2008 the state real economy is projected to decline by 8.7 percent, reflecting the impact of the Kosrae adjustment program. The projections incorporate the reduction in force of the state payroll by 64 positions, imposition of a 5 percent wage cut, and enhanced revenue effort. Against these forces, infrastructure spending is set to increase as Compact funding becomes available for this purpose. In FY2009, the state economy is projected to decline by a further 1 percent as the remaining adjustment to the capacity building grant phase out is squeezed out of the system.

137. In Pohnpei the economy has been estimated to have declined by 0.7 percent in FY2007, reflecting the impact of a 2.3 percent increase in the CPI on slightly growing levels of nominal GDP. In FY2008 and FY2009, the state is able to draw increasingly on the infrastructure grant, but this is offset by declining levels of real Compact operational grants. State GDP is projected to fall by 1.9 percent in FY2008 and 0.4 percent in FY2009. In Yap a similar story is told with GDP projected to decline by 1.8 percent in FY2007, and to fall back by a further 2.0 percent in FY2008. In FY2009 the economy is projected to grow by a real 0.7 percent the only example over the three years of any state for a positive outcome.

138. For the FSM as a whole the economy is estimated to have fallen by 3.2 percent in FY2007, and projected to decline further by 3.8 and 0.2 percent in FY2008 and FY2009, respectively. The poor result for FY2008 reflects the need to transition out the use of the capacity building grant in Chuuk and Kosrae, but this is counterbalanced by increased private sector activity generated by access to the Compact infrastructure grant. In FY2009, the situation is less adverse with relatively small components of the fiscal adjustment still requiring implementation. Infrastructure spending accelerates as projects are implemented, but the impact of inflation on declining real levels of transfers results in a negative overall outcome.

4. LONG-TERM PERSPECTIVES

139. The 3rd FSM Economic Summit was held in Palikir, Pohnpei, from March 29-April 2, 2004. The Summit was presented with three economic scenarios that the FSM might experience over the next 20-year period of Compact support: a dismal scenario, a medium-growth scenario and a sustained growth scenario. While noting that the FSM might face a truly “dismal” scenario if the country's leadership failed to make needed economic adjustments to offset the drag on economic activity resulting from the structure of Compact assistance, the discussion focused primarily on “moderate growth” and the “sustained growth” scenario. The Summit adopted a six-part strategy for transition and accelerated growth:

- Macroeconomic Stability
- Good Governance: Improving Effectiveness and Efficiency of Government
- Developing an Outward-Oriented, Private Sector-Led Economy
- Investing in Human Resource Development
- Investing in Infrastructure
- Long-Term Sustainability

140. The FSM Strategic Development Plan (SDP) examines the three growth scenarios in detail and makes projections of the likely economic growth and development patterns (see Figure 17.) Under the sustained growth scenario economic growth is held back initially as the economy adjusts to the structure of the amended Compact. However, as the benefits of the sustained growth strategy take hold, the economy is projected to accelerate and attain an annual average rate of 2.6 percent over the whole period. On the other hand under the dismal scenario economic growth is weak and the economy is only projected to achieve 0.1 percent over the period.

141. Figure 18 makes a comparison of the projected dismal scenario with the actual performance since FY2003. While the model on which the projections of the SDP were based overestimated the impact of the amended Compact on the FSM economy in FY2004, the projection for the dismal scenario significantly out performs the actual growth attained. While previous policy recommendations have been aimed at how to accelerate growth and development, and to move the FSM off the dismal growth path, current initiative must now be focused on completing the fiscal adjustment to the amended Compact in an orderly fashion while minimizing the negative consequences for economic growth. Future initiatives may return to the objectives of the 3rd Economic Summit and national Strategic Development Plan, but current efforts must be directed towards implementing the tax reform agenda, completing the adjustment to the amended Compact,

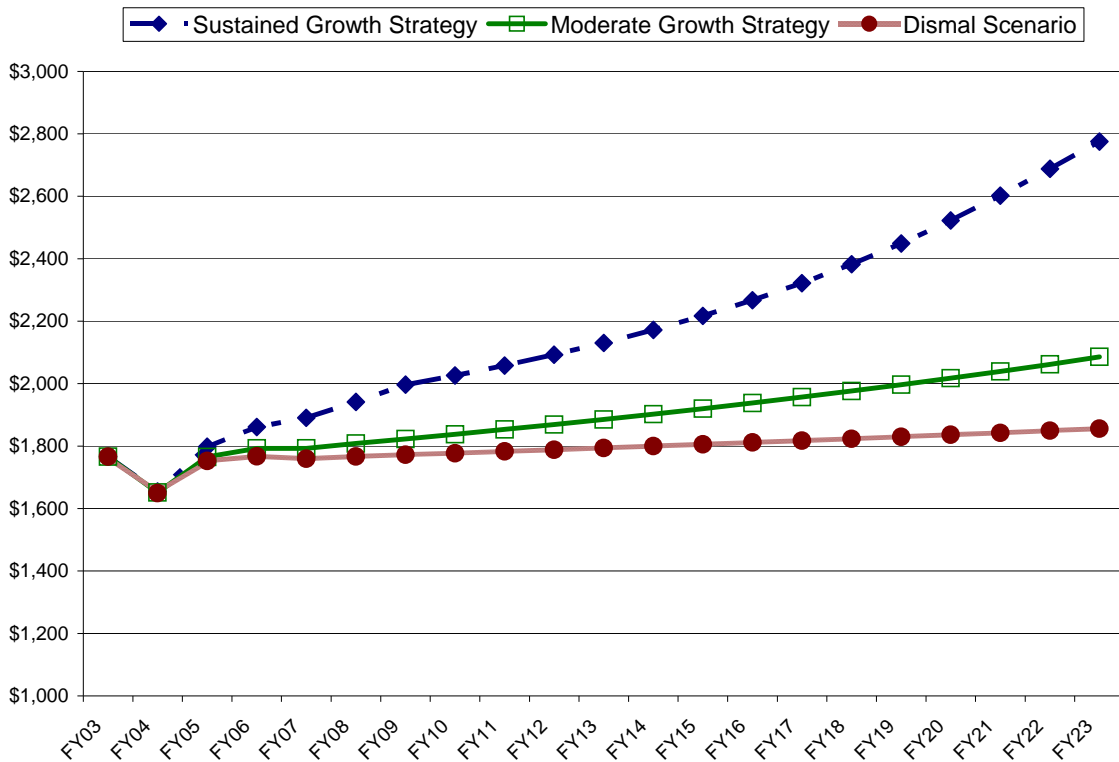


Figure 17 Alternative growth scenarios, GDP per capita, \$s 1998 prices

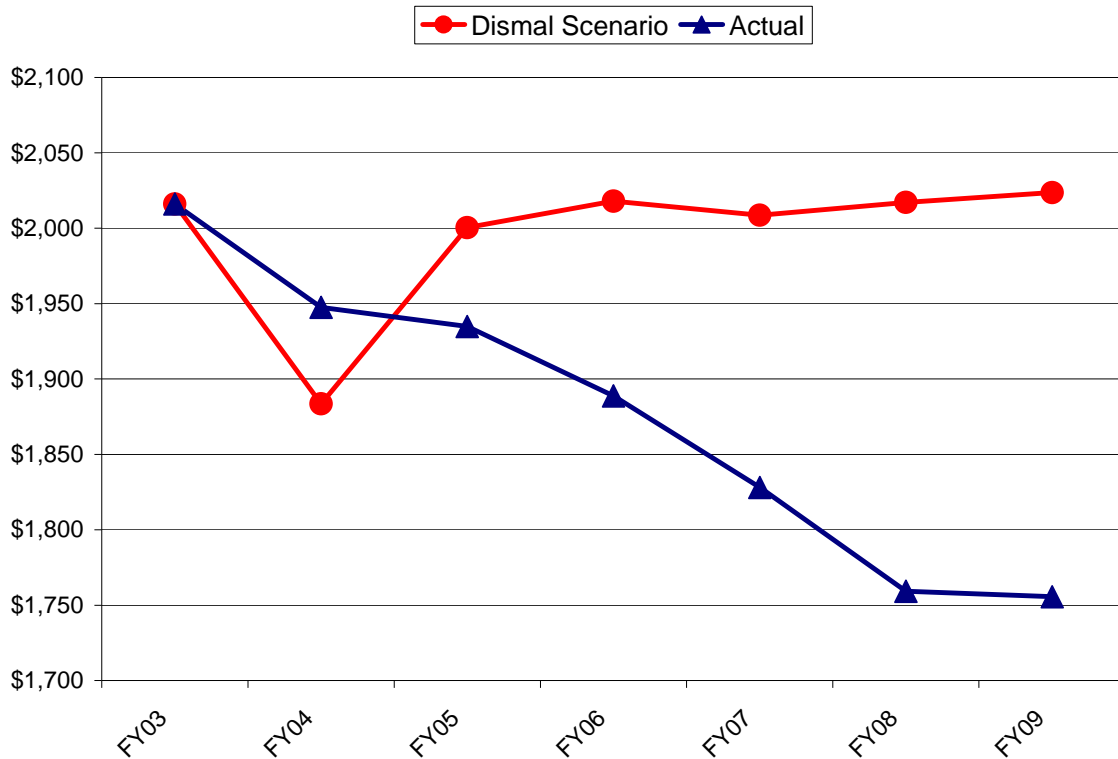


Figure 18 Comparison of the Third Summit dismal scenario with performance—GDP per capita, \$s 1998 prices

transitioning the capacity building sector grant, and preventing financial collapse in Chuuk state. With these objectives successfully completed, the FSM can once again return to the debate on how to achieve accelerated economic growth, and seek support from the donor community.