



Federated States  
of Micronesia

EconMAP  
Technical Note

June 3, 2020



*Assessing  
the Impact of  
COVID-19 on  
the Federated  
States of  
Micronesia  
Economy*



Economic Monitoring and Analysis Program (EconMAP) Technical Notes are intended to provide concise and timely analysis of important issues for decision-makers in the Federated States of Micronesia. Technical notes utilize currently available data sets and macroeconomic tools developed in close collaboration with the FSM government. The EconMAP program is managed by the Graduate School USA's Pacific and Virgin Islands Training Initiatives (PITI-VITI) with funding support from the Department of the Interior's Office of Insular Affairs. Comments, questions or requests for further detail may be directed to [info@econmap.org](mailto:info@econmap.org).



# *Assessing the Impact of COVID-19 on the Federated States of Micronesia Economy*

## ***Introduction***

The global emergence of novel coronavirus disease 2019 (COVID-19) continues to have an extraordinary impact on Pacific island economies and across the globe. The Federated States of Micronesia (FSM) has been spared any confirmed cases of COVID-19 and has taken strong proactive measures—among the strongest in the world—to protect the health of the nation. The structure of the FSM economy is heavily dependent on the public sector but also substantially dependent on fisheries activity and sovereign rent receipts. The economy relies very little on tourism and visitor arrivals; nevertheless, the projected economic consequences of the COVID-19 pandemic are significant.

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The longer COVID-19 threatens the people and the fragile health system of the FSM, the greater the indirect effects on the government's fiscal position and on the fisheries sector. More ominously, if the FSM is afflicted with actual COVID-19 cases and community transmission, the negative economic impact will be much worse. In this *Technical Note*, it is assumed public health restrictions on arrivals will remain through FY2021 and a return to normal access and post-pandemic economic activity begins in October 2021.

The governments of the FSM entered the current fiscal year, FY2020, with a mixed fiscal position. At the state level, revenues and expenditures were largely balanced, but with limited reserves to draw upon and limited fiscal space to endure adverse shocks. At the national level, the government has been running a significant surplus reflecting the growth in the Vessel Day Scheme (VDS) fisheries receipts, and the FSM domicile for Japanese companies. About two-thirds of the additional revenues have been saved in the FSM Trust Fund or as uncommitted reserves. At the national level there is thus significant fiscal space to adjust to direct impacts on the national government's fiscal position and to assist the states, affected individuals and businesses to mitigate the impact of the current crisis. At the state level the impact of declining economic



activity, especially within the private sector, will increase the fiscal drag of the amended Compact's declining transfers. The combined result will increase fiscal stress with limited reserves to offset fiscal deficits.

The challenge before the FSM will be to balance the need to provide some forms of counter-cyclical stimulus or compensation to affected individuals and businesses while also limiting the negative fiscal impact of the cyclical shock at the state level. This EconMAP *Technical Note* utilizes current statistical data and insights from numerous stakeholders across various sectors, as well as macroeconomic modeling, to project the impact of COVID-19 and to outline a range of fiscal measures for government consideration.

It should be noted that the modeling techniques used for this study do not account for potential behavioral changes by the FSM's domestic consumers. It is possible that domestic demand will be further depressed than this model indicates if, despite the dominance of government wages and spending in the economy, the consumption behavior of individuals is markedly reduced due to fear of worsening impacts from COVID-19 or due to changes in interactions in response to public health restrictions placed on social gathering. If such behavioral changes do occur, they will be reflected in future updates to the model. Increased saving during the COVID-19 pandemic would deepen the economic decline within the FSM; however, such crisis-driven saving would likely lead to increased aggregate demand in the economy when restrictions are removed.

## ***Basic Assumptions Used in the Analysis<sup>1</sup>***

### **Agriculture**

Agriculture in FSM occurs predominantly at the household level, for subsistence and local sale. There is some export of local crops, mostly by air cargo and betelnut (from Yap) typically

<sup>1</sup> The assumptions made are as of 5/11/2020 and will be revised as further information is available.

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*Fish catch from Diving Seagull based in Yap is projected to increase in FY2020 and FY2021 after a very weak year in FY2019.*

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carried as checked baggage, that cannot resume without restoration of passenger air service from United Airlines. Yap exports of betelnut may be shifted in some measure to air cargo on the limited United Airlines flights and on the dedicated APA cargo charter flights. PetroCorp reports 46 percent growth in the supply of husked coconuts to their existing coconut processing unit in Pohnpei. They also report an expansion of community enterprises which are expected to add to the growing supply of coconuts for processing in Pohnpei and eventually on Tonoas in Chuuk. There is also anecdotal evidence of increased own-production and production for local sales in all four states, but this awaits confirmation and quantification.

### **Fisheries**

The fisheries industry in the FSM comprises a set of activities: household subsistence, small scale fishing producing small volumes of fish for exports utilizing ice chests and coated cargo boxes on commercial flights, purse seine operations in Pohnpei and Yap, shore-based support to the longline industry in each state, except Chuuk, and the operations of the National Oceanic Resource Management Authority (NORMA). Export of fish on commercial flights from small scale fishing activity is projected to decline due to reductions of flights disembarking from the FSM. The export of skipjack tuna caught by Caroline Fisheries Corporation based in Pohnpei is projected to remain unchanged



through the pandemic, fish catch from Diving Seagull based in Yap is projected to increase in FY2020 and FY2021 after a very weak year in FY2019. The shore-based Luen Thai transshipment service for export of sashimi grade tuna is also projected to continue unchanged—but completely reliant upon Asia-Pacific Airlines (APA) cargo flights to continue operating under any prevailing COVID-19 travel advisory. The contribution to the domestic economy from this latter activity is quite small

Unlike fisheries in the RMI, FSM management of the fisheries industry is supported through NORMA—a component of the FSM national government<sup>2</sup>. While this *Technical Note* does not anticipate that NORMA's administrative activities will decrease, the temporary closure of the observer program which monitors the fish catch of the purse seine fleet will result in loss of revenues to the national government. It appears NORMA will assign shore based tasks to unutilized observers, so there may not be a complete loss of income for the affected individuals. As per the United Nations System of National Accounts (SNA), fishing rights/VDS revenues are treated as property incomes which are additional to—rather than part of—gross domestic product.

Of critical importance to the FSM has been the rapidly growing source of funds from the Vessel Day Scheme of the Parties to the Nauru Agreement (PNA). The low prices of tuna experienced at the beginning of the year coupled with travel restrictions have reduced demand for vessel days and placed downward pressure on VDS daily rates.

The FSM is currently allocated about 7,300 fishing days of Party Allowable Effort under the PNA. During 2020 it is understood NORMA has sold its total allocation of days. Skipjack tuna prices are projected to rise for the 2021 season, which will ease downward pressure on prices. However, there remains significant risk of a reduction of recent VDS

rates below the \$11,000 per day achieved over the last few years.

The industry is in a considerable state of flux and uncertainty; this *Technical Note* assumes domestically flagged or FSMa days will be sold at prior year's prices while bilateral days will continue to be sold at historic prices. This assumption of stable VDS rates and full demand for available days for sale must be frequently revisited due to the significance of this source of income to the national government's fiscal position.

### Hotels and Restaurants

Tourism is not large in the FSM and the hotel and restaurant sector accounted for only 1.7 percent of Gross Domestic Product (GDP) during FY2016-FY2018. Hotels, which cater to both visitors from overseas and interstate FSM travelers, are now running virtually empty. Only about 10 percent of the output of the hotel and restaurant sector is derived from domestic demand from in-state residents. With minimal out-of-state travelers, sector output is projected to fall to exceptionally low levels.

The FSM's GDP-by-industry statistics have not been updated to reflect a more comprehensive treatment of the tourism sector. A portion of activities now reported in the transport sector would best be reported in a broader tourism sector. The update required has been completed for Palau and the RMI; however, data issues reducing the accuracy of the entirety of industry level output estimates for the FSM must first be effectively addressed. It is hoped that the authorities will fulfill their commitment to produce and share with the statistics office the required industry-level data derived from the gross revenue tax base while also protecting the privacy of the underlying tax data in a manner consistent with the FSM's international obligations.

<sup>2</sup> As a result, the direct contribution of NORMA to GDP is accounted for under the national government.



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*Projections indicate construction output will fall from its already low level in FY2019 by 7 percent in FY2020 and further 6 percent in FY2021.*

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### Construction

With the drop in FAA projects and minimal domestic expenditures from the infrastructure sector grant under the amended Compact, the contribution of construction to the economy has fallen from 6.6 percent during a peak in FY2011 to a modest 1.8 percent of GDP in FY2018. While there are some significant People's Republic of China grant funded projects, including the recently completed Chuuk government buildings, and the planned national conference center and Pohnpei state administrative building renovations, these mostly utilize temporary Chinese labor and are not anticipated to significantly boost GDP during the current pandemic.

Current World Bank projects in the maritime sector involving port development and resilient road development (\$80 million) will take time to design and are not anticipated to begin prior to the end of FY2021. Similarly, ADB projects in alternative energy (\$15 million), and water and sanitation projects in Kosrae and Chuuk (initially \$5 million) have yet to reach the design stage and are also unlikely to favorably impact the FSM economy during the COVID-19 crisis.

Current travel restrictions constrain travel to the FSM of specialist engineers and project personnel, although it is understood that much can be accomplished by virtual means. Current travel restrictions are also beginning to hinder the supply of goods into the FSM. Construction of the FSM PetroCorp's coconut processing project in Tonoas, Chuuk, remains underway but has suffered temporary delays due to

FSM and Chuuk State travel restrictions that impact the travel of key individuals. Projections indicate construction output will fall from its already low level in FY2019 by 7 percent in FY2020 and further 6 percent in FY2021.

### Transport and Communications

The transport and communications sector includes both public sector and private sector components. The travel and transshipment sub-sectors are among the more significantly impacted industries in the FSM economy. Affected activities include local interstate shipping, port and airport operation, shore-based airline operations, on-shore bunkering and resupply<sup>3</sup>. Tourism operators such as diving, surfing and ground transport are also included, albeit at a smaller scale.

The impact of flight reductions combined with recent travel advisories have restricted purse seine fishing vessels from docking. Instead, each vessel is required to transship its catch outside the reef. Current projections indicate that output is likely to fall by 37 percent during the two-year period of FY2020 through FY2021, as compared to FY2019. Measuring just the private sector components of the entire sector, the decline is fully 80 from FY2020 through FY2021, as compared to FY2019.

### Public Sector

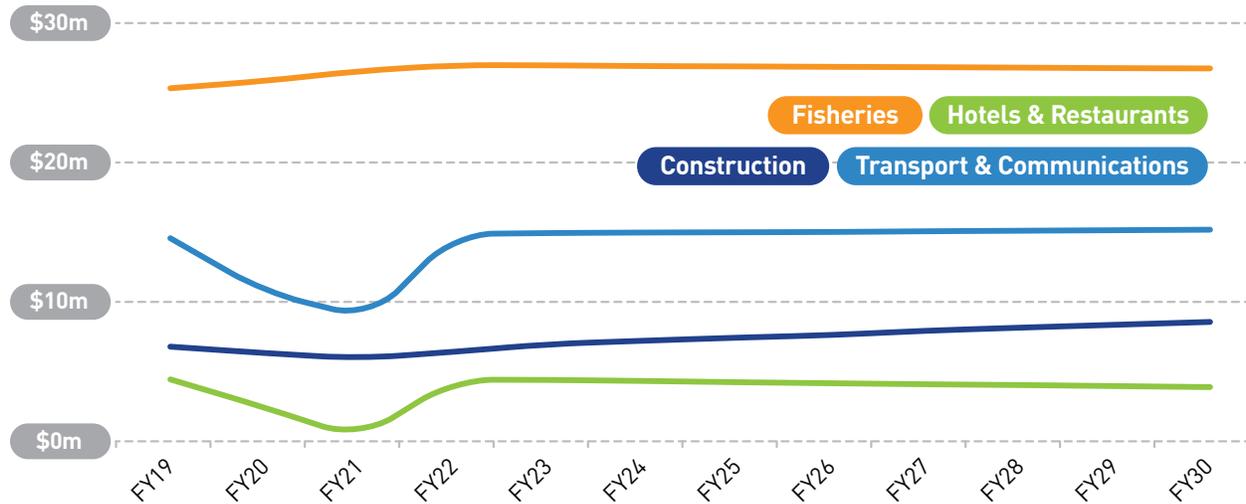
No change in the current levels of government operations or in public expenditures on programs has been assumed other than adjustments in normal government operations at the state level due to the fiscal drag of the amended Compact. Implicit in this assumption is that budgets for travel, utilities, fuel, and other areas where spending would likely decline due to pandemic circumstances will be shifted to areas of increased spending needs; however, the national government has announced a \$15

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<sup>3</sup> Ticket and cargo sales by foreign airlines are treated as service imports and are not considered part of domestic gross domestic product.



**Figure 1 Major Industries Affected by the Pandemic (Value Added Constant Prices)**



million COVID-19 stimulus package, which has not been included in the projections as an additional national government expenditure and as an addition to the general level of demand in the economy. This package is discussed in the following section.

It is understood there are significant increases in the health budget, but that the majority of these will be donor financed. Once these figures have been fully specified, the projections will be updated; however, given the level of donor response, especially to support health sector needs, minimal impact is expected on the overall fiscal position.

### Major Industries Affected by the Pandemic

Figure 1 shows the major industries which are affected by the pandemic. Fisheries is projected to grow in FY2020 and in FY2021 reflecting the increase in Diving Seagull catch following a very weak year in FY2019. The hotel and restaurant sector is projected to fall by 46 percent in FY2020 and then a further 75 percent in FY2021, reflecting the absence of tourists and minimal interstate visitors. Similarly, the transport and communications sectors are projected to decline by 27 percent in FY2020 and a further 14 percent in FY2021.

Given the total output in the transport and communications sector, the impact on GDP loss is greater in magnitude than the impact of the hotels and restaurants sector.

Construction activity is projected to fall modestly reflecting the likely constraints to project implementation during the COVID-19 pandemic, and despite substantial funding commitments from donors, including through the Compact infrastructure grant. Finally, the large wholesale/retail sector is not shown in Figure 1 as its decline closely mirrors the economy-wide projections; that sector's decline includes an estimated 85 percent reduction in demand for aviation gas from the FSM's sole fuel distributor, PetroCorp.

### COVID-19 Donor Assistance

The economic and fiscal projections undertaken in this *Technical Note* do not take into account donor assistance already underway and additional assistance which is very likely to be made available to the FSM from its major bi-lateral and multi-lateral partners. As a follow-up to this Technical Note we expect to quantify the full range and application of internal and external mitigating efforts so that the combined impact of those efforts can be simulated in



the economic model and the net impact of the COVID-19 response will be estimated. While the primary purpose of this document is to assist the governments of the FSM in developing their own economic and fiscal response policies, it is hoped the analysis provided will be beneficial to the ongoing dialogue the FSM undertakes with its donor partners.

Notably, the initial EconMAP expectations about the magnitude of the COVID-19 impact were quite low and closer to the early estimates put out by other international financial institutions. Updating the model with actual statistics and data and insights from key sectoral stakeholders improved the estimates, indicating deeper and broader impacts on the FSM economy. It is hoped that this analysis will assist the FSM and its donor partners in designing their programs at a time when missions cannot be sent to complete in-country review and due diligence.

## Economic and Fiscal Impact

### Economic Impact

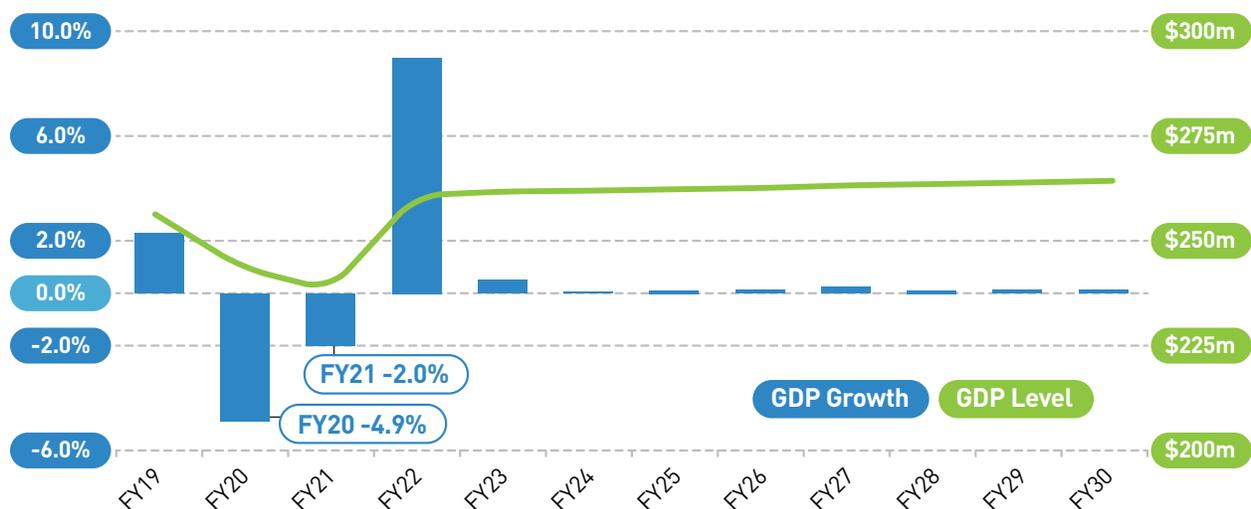
The economic impact of COVID-19 on the FSM economy is shown in [Figure 2](#). Projections indicate the COVID-19 pandemic will cause

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a 4.9 percent drop in GDP in FY2020 and a further 2.0 percent reduction in FY2021—a combined reduction of 6.7 percent over the two year period. The major contributing factors to the total reduction are led by the transport and communications sector, which is responsible for 2.1 percent of the overall decline.

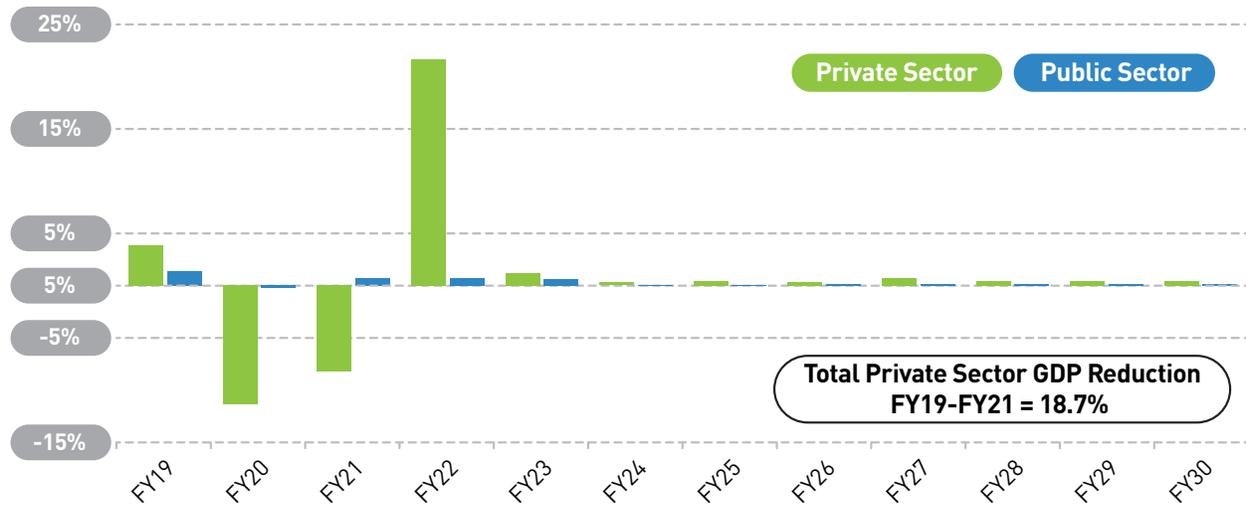
Tourism is responsible for a slightly lower proportion of the loss at 1.5 percent. While the hotels and restaurants are proportionately hit the hardest, its minor contribution in recent years reduces the impact on the overall economy. The reduction in the wholesale and retail trade is consistent with the overall reduction in the economy during the two years and contributes 0.8 percent of the total loss in the economy.

**Figure 2** Projected GDP Level and Growth





**Figure 3** Projected Private and Public Sector Growth



Notably, the total loss to the economy projected during this period is the most severe experience by the FSM economy during the amended Compact period since FY2004. The \$15 million mitigation effort initiated by the national government—if it were to be included in the modeling estimates—would reduce the decline in GDP from 6.7 percent to 6.0 percent over the two-year period. Given that the measured impact of the mitigation effort does not directly affect production levels in the worst affected sectors of transport and tourism, the effect of

the fiscal stimulus on measured GDP is not as great as may be anticipated.

An example may help to explain: if a hotel operator is given funds through the mitigation program and those funds are used to pay employees and offset utility, social security and other costs, the measured output (value-added) of the enterprise is not affected at all. The added stimulus thus adds only to aggregate demand and, indirectly, to some additional output in the economy when spent.

**Figure 4** Economic Prospects at the State Level, FY2019–FY2030

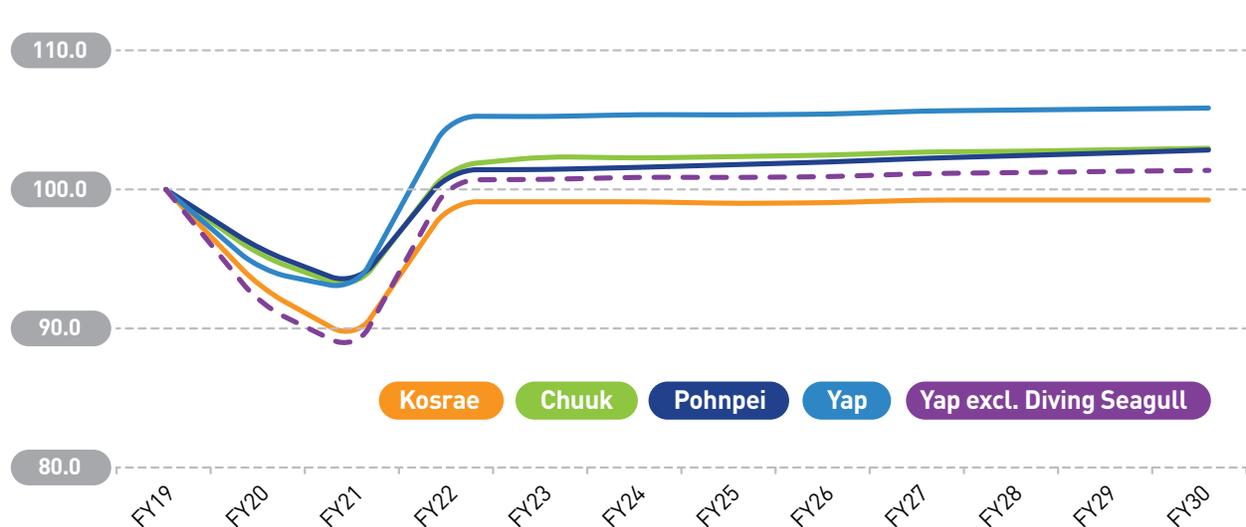




Figure 3 indicates the impact of the pandemic on the private and public sectors. The public sector is projected to decline only incrementally in FY2020 and then grow slightly thereafter through FY2023. The majority of the COVID-19 impact, however, is felt on the private sector. In FY2020 a large reduction of 11.4 percent is indicated, and in FY2021 a further reduction of 8.2 is projected. Overall a very sizeable loss in cumulative output of 18.7 percent is projected for the private sector.

While the overall impact of the pandemic on the economy may appear “conservative,” when the structure of the economy is taken into account it is clear that the impact is highly uneven. During the crisis, the public sector remains largely unaffected, while the impact on the private sector is severe. This uneven characteristic can be taken further as, for example, individual enterprises in the hotel and restaurant sector may see output decline to zero during the COVID-19 pandemic. This illustrates the need for careful targeting in the mitigation efforts of the national government and its donor partners.

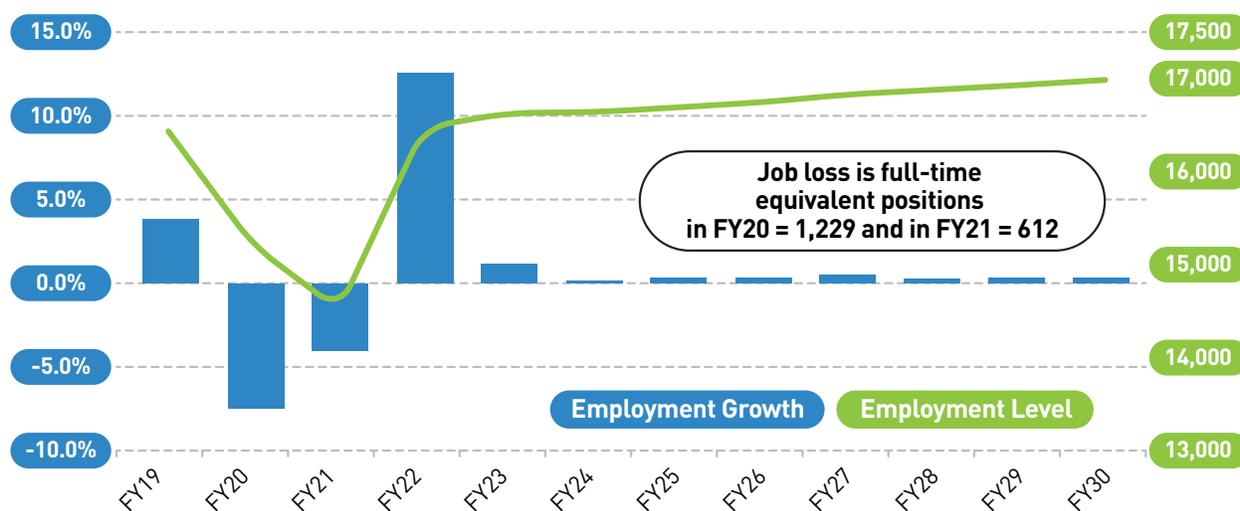
Figure 4 describes the impact at the state level. GDP is normalized with FY2019 being equal to 100. As with the uneven economic impact of the COVID-19 pandemic between private

*As with the uneven economic impact of the COVID-19 pandemic between private and public sectors the impact at the state level is also uneven.*

and public sectors the impact at the state level is also uneven. In Pohnpei, the host of the national government, state GDP declines by 6.4 percent over the two-year period. In Chuuk and Yap the decline mirrors the FSM-wide decline of 6.7 percent. In Kosrae the decline is larger, at 10.3 percent.

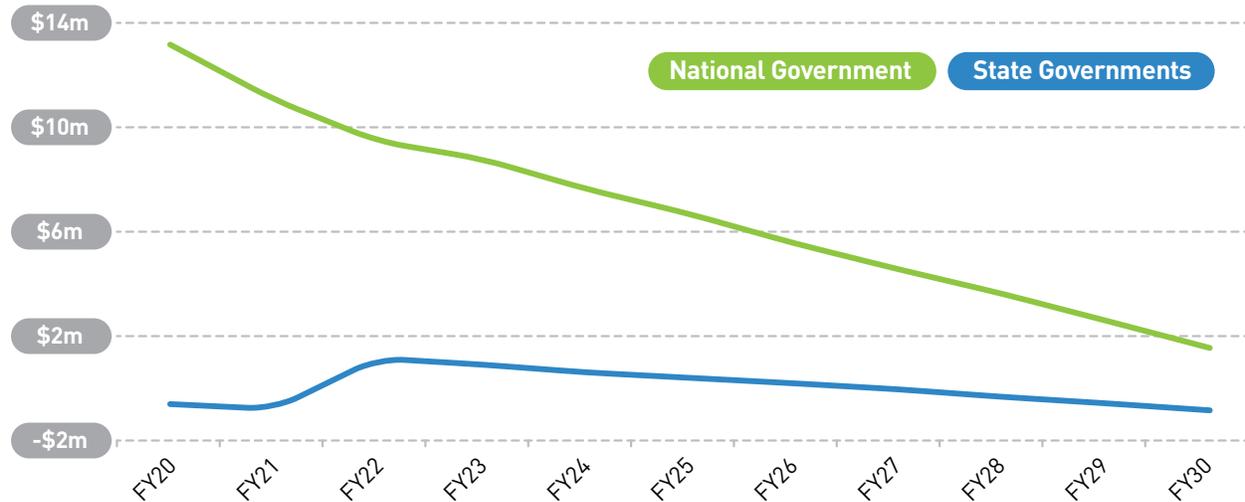
In the case of Yap, the significant increase in fish catch projected for Diving Seagull gives a distortionary impression of the impact on the small state; Figure 4 thus displays the impact on Yap state with and without the increase in fish catch (the latter is indicated by the dotted line). For Yap without its purse-seiners, an overall loss in state GDP of 11.1 percent would be projected placing it at a greater impact than even Kosrae.

**Figure 5** Projected Employment Level and Growth





**Figure 6** State and National Government Fiscal Balance, FY2020–FY2030



### Employment Impact

The impact of COVID-19 on employment is shown in [Figure 5](#) indicating both level of jobs and annual changes. There is an implied total loss of 1,841 jobs over FY2020 and FY2021, which ranges across a series of sectors and represents a reduction of 11 percent of the FSM-wide employment from FY2019 levels. If a job loss of this size transpires it would be the largest employment reduction in FSM since the civil service retrenchment program, which was required in the wake of the FY1997 second stepdown during the initial Compact funding period.

It should be noted that the loss in jobs should be understood as a reduction in full-time-equivalent (FTE) positions rather than a specific loss in employed persons. Firms are likely to institute reduced hours for employees before terminating jobs. The hotel and restaurant sector is projected to lose 669 jobs given the near absence of commercial flights into the FSM. An additional loss of 609 jobs across transport, shipping, port services, aviation, and airport ground handling is projected, along with further reductions anticipated in retail/wholesale trade of 248, and 167 in construction.

While some reduction in employment is anticipated at the state government level reflecting continuing adjustment to the fiscal drag of the amended Compact, the vast majority of the job loss is concentrated in the private sector and—to a lesser extent—impacted public enterprises. The mitigation programs available through the FSM stimulus package, US CARES act, and ADB Pacific Disaster Resilience Program should greatly assist reducing poverty and alleviating the burden of the crisis on households.

### Fiscal Impact

The fiscal outturn is projected in [Figure 6](#) and is decomposed into the fiscal position of the national and state governments. The state governments are assumed to operate on a balanced budget rule and adjust to the annual fiscal drag implicit in the amended Compact and the COVID-19 cyclical downturn to attain fiscal balance. That said, there may be short-term deviations such as the reductions in FY2020 and FY2021 where the fiscal outturn is worse than budgeted and there is a lag in response.

During the FY2020-FY2021 period the four states suffer from reduced tax revenues



which fall by 6 percent for Chuuk, 7 percent for Kosrae, 3 percent for Pohnpei, and 8 percent for Yap. However, in terms of total state government revenues and reflecting the dominance of Compact flows, the proportional reduction of revenues is more moderate: 1.2 percent for Chuuk, 0.9 percent for Kosrae, 1.0 percent for Pohnpei, and 1.4 percent for Yap. In fact, if the national government chose to make the states whole to provide a stimulus and avoid a decline in output, the FSM mitigation plan would only require an additional \$1.3 million in addition to the \$15 million already committed.

The national government has achieved large fiscal surpluses in recent years, averaging 15 percent of GDP from FY2015 through FY2019. In FY2019 an unusual level of corporate tax receipts from the FSM domicile for major Japanese corporations resulted in a large fiscal surplus. For FY2020, with revenues returning to normal levels in the FSM domicile industry and constant levels in nominal terms for sovereign rent receipts from fishing royalties, a fiscal surplus of \$15 million is projected. Over time, this surplus is projected to decline as expenditures rise with inflation, with the level of legislative projects assumed to remain flat at \$17.5 million annually. The overall fiscal position of the national government is thus projected to deteriorate over time—reaching near balance by FY2030—reflecting the fact that a large percentage of revenues are fixed in nominal terms and expenditure trends show increases closely tracking inflation.

### Emergency Fiscal Response

As previously noted, the FSM is in receipt of significant COVID-19 related resources from the ADB (\$6.0 million under the Pacific Disaster Resilience Program (PDRF), and \$470 thousand from the Asia Pacific Disaster Response Fund to kickstart disaster response planning), and the U.S. CARES Act for both technical assistance through the Department of the Interior (\$7.7 million) and unemployment assistance to compensate

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job losses of US and Freely Associated State citizens for a period of time but without a specified amount<sup>4</sup>.

The U.S. approved an out-of-cycle emergency allocation of \$7.0 million of unallocated Compact sector grant funds, primarily for health sector needs. The US Centers for Disease Control has also provided approximately \$1.0 million through their emergency response program. The ADB also stands ready to mobilize funds to consider (a) replacement of \$6.0 million under the PDRF to be available for subsequent emergencies; and (b) a further large grant to support COVID-19 from a regional allocation for “Countercyclical Support Facility Pandemic Response Option” or CPRO. Further, the national government has itself announced a \$15 million stimulus package.

The magnitude of these resources and application of the funds to affected individuals and businesses is already underway. Once greater clarity becomes available, the combined impact of the internal and external mitigation efforts will be simulated in the economic model and the net impact of the COVID-19 response will be estimated.

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<sup>4</sup> Projections indicate lost income for the FTE levels specified as \$5.8 million in FY2020 and an additional \$7.5 million in FY2021.



## Financing

The management of fiscal policy at the state level has been such that governments have been forced to operate on a balanced budget rule; adjustment is virtually mandatory, although often with a lag. At the national government, resources have been plentiful, resulting in fiscal surpluses and accumulation of savings in the FSM Trust Fund or as uncommitted reserves.

Under conditions where the state governments have no access to financing, and where the fiscal stimulus package of the national government is greater than the projected fiscal surplus, resources are available in the first instance through diverting funds that would otherwise have been deposited into the FSM Trust Fund, or if the unmet needs are large enough, withdrawing funds from the corpus of the FSM Trust Fund. In both instances the use of such funds requires Congressional authorization under FSM public law. With additional health needs largely covered through grant-based donor financing and additional mitigation from the US and ADB, needs for external deficit financing are not currently anticipated during the FY2020 through FY2021 period.

### ***Fiscal Policy and the Need for an Internal Adjustment Program***

The preceding analysis is based on the EconMAP economic model. The projections indicate three distinct fiscal trends that have emerged: (i) a short-term COVID-19 related fiscal shock at the state level, (ii) fiscal drag at the state level due to lack of full indexation and annual decrement through the remaining years of the amended Compact, and (iii) long-term, gradual fiscal deterioration moving from surplus to near balance at the national government by FY2030.

In any fiscal adjustment program, there are three areas of policy action: revenue enhancements, expenditure adjustments, and access to financing. The optimal balance

between these policy actions and the nature of adjustments—temporary or permanent—depend on the assessed nature of the fiscal shock. Permanent adjustments with minimal use of financing are required in the case of structural deficits, whereas temporary adjustments and greater reliance on financing may be required to overcome short-term shocks such as COVID-19.

In the case of the impact of COVID-19 and fiscal stress at the state level, the state governments have little recourse to financing. The national government on the other hand has a strong fiscal position and a sizeable trust fund that can be utilized for limited resource transfers or grants to states, to compensate for loss in tax revenues and additional COVID-19 related expenditures.

To date, the position of the FSM National Government has been to not compensate the FSM states for the fiscal drag associated with annual decrements embedded in the amended Compact. The national government has been understandably wary to set in motion long-term, fiscally unsustainable transfers. This policy seems entirely appropriate for the “fiscal drag” component of state level fiscal stress. The COVID-19 pandemic-related fiscal stress is, however, entirely cyclical in nature and merits urgent consideration for assistance from the national government to the states.

For the national government, the long-run, gradual deterioration in its financial position suggests incremental adjustments will be required. Since revenues are largely fixed through resource rents or external grants, expenditure adjustments—likely through slowing the rate of growth, rather than nominal cuts—would be the major source of adjustment over an extended period of time.

In sum, the national and state governments of the FSM will likely need to consider an integrated and balanced approach to fiscal adjustment and financing, including modest inter-government transfers and moderate long-term adjustments in order to emerge from



the current crisis with a more robust long-run fiscal stance. For this EconMAP *Technical Note*, the looming issue of the termination of the existing financial assistance under the amended Compact after FY2023 is not addressed. That matter is already the subject of bi-lateral discussions between the U.S. and each of the Freely Associated States. The onset of negotiations is expected as soon as May 2020.

### Revenue Measures

Given the structure of the FSM's revenues with only 16 percent of total revenues derived in FY2018 from taxation, and other grant and resource rents largely independent of COVID-19, the FSM fiscal account is somewhat insulated from the current downturn in the world economy. However, reported reductions in tax collections that are significantly larger than anticipated requires periodic monitoring. The focus on revenue and tax measures should thus be to strictly maintain compliance and collections throughout the crisis period.

The national government should avoid the direct use of the tax system to provide relief, especially generalized relief, to the private sector and to individuals. Rather, relief and mitigation efforts should be targeted as directly as possible to individuals and businesses directly impacted by the COVID-19 crisis. Of course, tax and FSM Social Security data must be used as valuable data sources for estimating—and later documenting—incremental changes in business turnover and individual incomes. But the policy approach of rebating gross revenue taxes or even other taxes has the undesirable result of providing a greater level of compensation to less affected businesses, and a lesser level of compensation to more negatively affected businesses. Effective and efficient use of limited COVID-19 mitigation resources requires great attention to the design, targeting and scaling of compensatory support to affected businesses.

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### Expenditure Measures

At the state level expenditures have remained largely static in nominal terms since the start of the amended Compact, mirroring the stagnant nature of nominal revenues, and represents a significant reduction in real service delivery of 35 percent over the period from FY2004-FY2019. Given the implied impact of the reduction on education and health, there is a compelling argument that public expenditures at the state level should be increased.

This policy issue is complicated, as noted above, by the uncertainty of funding levels that may be available under the Compact (or through the Compact Trust Fund) after FY2023. Setting aside that important matter, it is more straightforward to assert that additional reductions in expenditures in response to the cyclical impact of the COVID-19 pandemic are not recommended. Alternatively, the current minor loss in tax revenues and the substantial additional needs for COVID-19 related expenses in each state could be supported through transfers from any combination of the national government and the FSM's donor partners.

At the national government two-thirds of the remarkable growth in its revenue base—derived from sovereign rent receipts—has been saved in the FSM Trust Fund or as uncommitted reserves. This has been a laudable achievement. However, the remaining one-third



of the increase has led to a rapid expansion in certain categories of expense, namely professional and contractual services, and in public congressional district projects. From an average of \$1.4 million FY2009-FY2014, the professional and contractual services category had reached \$21.5 million of annual expense by FY2018. Similarly, public congressional district projects have risen from an average of \$3.3 million annually in FY2004 through FY2012 to a peak of \$23.4 million in FY2018. Both discretionary categories of expense suggest clear scope for downward adjustments to make room for both the immediate needs to respond to COVID-19 and to reverse the projected long-term deterioration of the national government's fiscal stance going forward.

### Financing

The above analysis suggests that after allowance is made for bilateral and multilateral donor finance to support mitigation programs, internal resources at the national government should be sufficient to address needs. However, what is not currently addressed is the need at the state level for additional funding to compensate for a modest decline in tax revenues and uncompensated additional costs—especially in health care, if any. These needs can be achieved through transfers from the national government or from savings from the stimulus package as unemployment benefits shift to the CARES act.

In the neighboring Micronesian state of the Republic of the Marshall Islands, consideration is being given to donor-financed budgetary support to supplement mitigation efforts. The FSM might wish to develop this option, but it will necessitate adoption and commitment to a set of policy reforms—certainly at the level of the health sector, and possibly at the level of macroeconomic and public financial management reforms. Policy reform has received some attention in the FSM in recent years, but the current time may be it may be an appropriate time for the FSM to reconsider

many of the initiatives, such as tax reform, that have been previously proposed but not implemented. This *Technical Note* will be updated when the precise amounts and policy conditions (if any) related to of donor funding is fully specified through donor consultations with the FSM.

### Potential Components of a Fiscal Response

The FSM government has already designed and is now implementing an Economic Stimulus Package. In addition to the measures already proposed, the government, working with the FSM's donor partners, may consider a COVID-19 response and mitigation program that includes the following generalized categories, among others:

1. First and foremost, a health sector strengthening program to address the threat of the COVID-19 pandemic and to make lasting improvements to the FSM's ability to provide sustained, high quality health services to its population.
2. An extended unemployment relief program, possibly administered through the Social Security Administration, for:
  - FSM citizens, other FAS citizens and U.S. citizens that would be supported by some combination of FSM funding, other donors, but especially through the U.S. CARES Act in coordination with the U.S. Department of Labor; and
  - Possibly other affected individuals that are not supported through the U.S. CARES Act, including informal workers and non-U.S./non-FAS foreign nationals previously employed in the FSM.
3. A business relief program that provides:
  - Subject to financing availability: direct support to businesses in directly impacted sectors—with priority to small businesses, perhaps measured as (presumptive) loss of gross revenues—to



be confirmed through subsequent Gross Revenue Tax filings; and

- Government guaranteed loans, perhaps through the FSM Development Bank and/or commercial banks, to businesses in directly impacted sectors to cover (i) fixed costs to maintain lease payments and physical plant and equipment through the downturn; and, perhaps, to finance physical improvements that will allow small-scale construction and rehabilitation opportunistically during the downturn.
4. A public sector expenditure control program at the national level that provides fiscal space to support relief programs. Elements of such a program might include reductions in the use of goods and services including travel, reduction of professional and contractual services, and reduced levels of spending on public congressional projects. Revenue flows otherwise committed to the FSM Trust Fund appear to have been diverted to support the FSM's program which makes eminently good sense given the urgent and temporary nature of the COVID-19 crisis.
  5. A program of national government transfers to support government operations at the state level in the provision of basic services that are not covered under the modestly reduced local revenues, plus previously FY2020 budgeted Compact sector grants and the \$7 million of supplemental (unallocated) Compact sector grants.
  6. Acceleration of public investment projects, including necessary attention to minimizing bottlenecks to project design, planning, engineering, and foreign labor needs. It must be recognized at this time, given the lack of readiness of the World Bank and ADB funded projects, that implementation of many of the larger planned projects will not proceed rapidly.

These six outlined components of an overall Fiscal Response are provided in general form

for consideration of the FSM leadership. With the release of this Technical Note in June 2020, the FSM national government is already well advanced in its response and working with its many donor partners to match offers with needs. Given the fiscal challenges that the FSM was already preparing itself for across all five governments, it is important that the depth and breadth of the eventual response be sized and timed to reflect support from FSM's donor partners.

## ***Conclusion***

The economic and fiscal impacts projected in this note are based on an economic model of the FSM economy. The impacts, of course, are driven by the structure of the economy. While developments will take their course, the size of the projected outcome, given the assumptions relating to the various sectors in the economy, is reasonable and of the right order of magnitude. These can be modified as more information comes to light becomes available.

Importantly, the analysis indicates the compelling need to implement a response and mitigation program to maintain stability and to explore all channels with the FSM's partners for potential financing sources. Optimistically, the application of targeted internal and external assistance to bolster health sector investments, to improve the resilience of the health system, to provide budgetary resources to offset revenue losses due to the projected decline in economic activity, and to provide direct support to affected individuals and businesses, will be sufficient to offset much of the projected threat to the FSM economy and to its fiscal position going forward.

## About EconMAP

The Economic Monitoring and Analysis Program (EconMAP) provides professional expertise to support statistical development and economic analysis in the three Freely Associated States (FAS) of the Republic of the Marshall Islands (RMI), the Federated States of Micronesia (FSM) and the Republic of Palau (ROP). Annual program outputs for each FAS include the development of economic statistics, the publication of Economic Reviews, and the delivery of economic presentations. Occasional topical reports and technical notes are also published occasionally.

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