The Economic Impacts of the End of Compact Grant Assistance in the Freely Associated States

DRAFT FOR DISCUSSION

May, 2020

This draft for discussion is being re-issued as of May 2020 without economic modeling updates to reflect the substantial but still emerging impacts of the COVID-19 pandemic on each Freely Associated State. Only the Table on p. 40 has been updated to reflect the (reduced) value of each FAS Compact Trust Fund as of 4/30/2020.

ASIAN DEVELOPMENT BANK

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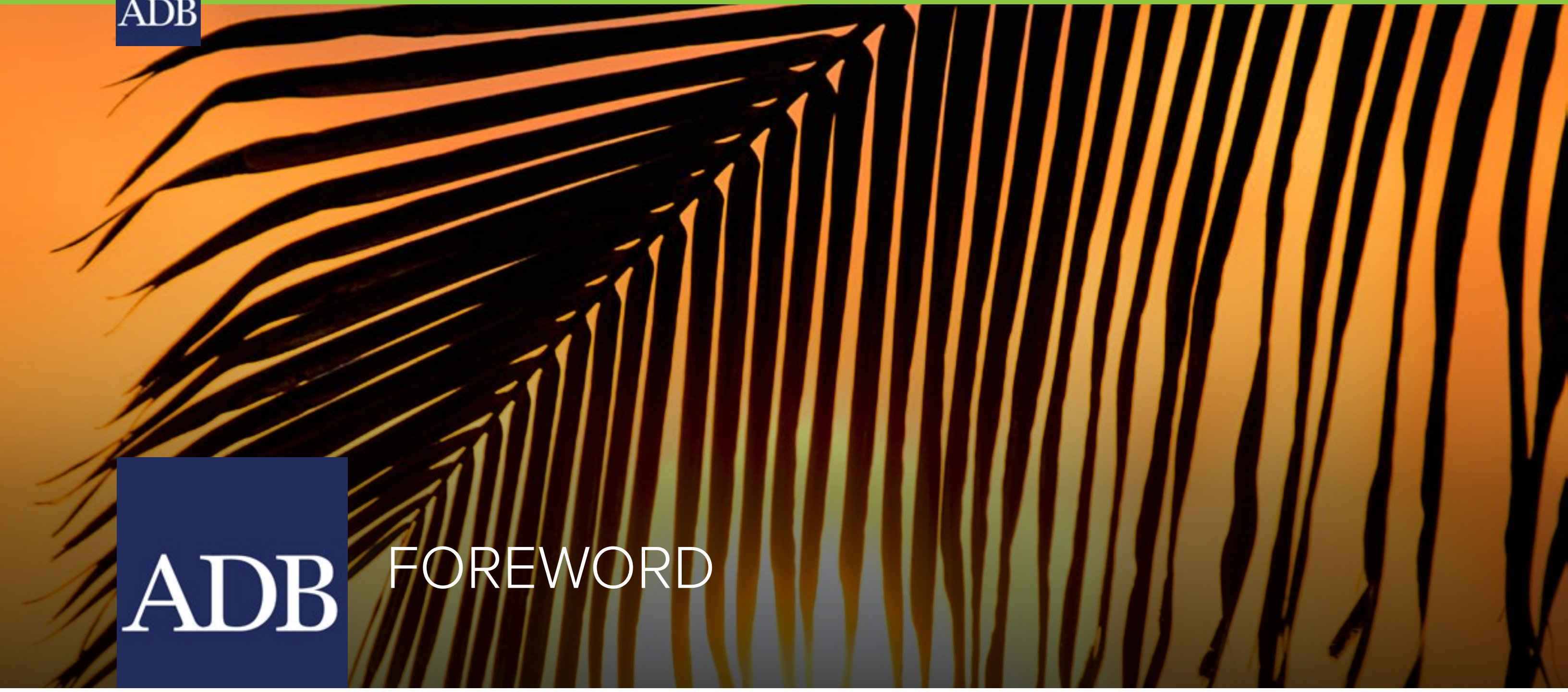

FOREWORD

The Asian Development Bank (ADB) commissioned this study to benefit its three North Pacific member countries and their development partners. It provides information and analysis about the Freely Associated States (FAS) as each of them approaches an important milestone in its respective Compact relationships with the US. At the time of conceiving this report, in late 2018, the range of possible outcomes at the end of each specified Compact funding period for the FAS was quite broad, and ADB believed that each affected party and its development partners would benefit from a professional study that estimated the range of potential fiscal adjustments and then modeled the associated economic outcomes.

This study was commissioned in May 2019. Since then, the US government has publicly announced its intention to negotiate an extension of Compact funding with each FAS. ADB decided to continue this study along the initially conceived lines: with two downward adjustment scenarios and one funding extension scenario. Given signals from Washington, the authors note the extreme unlikelihood of the most severe adjustment scenario for each FAS. Thus, the authors have extended their analyses for the less severe fiscal adjustment scenario and the Compact funding extension scenario. The less-severe case is noted as very similar to the outcome that would result even from a delay in a fully authorized and funded period of extension with each country. The Compact funding extension case, optimistically, provides all parties with the welcome challenge of ensuring additional resources have the greatest sustained impact to the benefit of each member country.

This study builds upon the ongoing work of the Economic Monitoring and Analysis Program (EconMAP), administered by the Graduate School USA with funding support from the Department of the Interior's Office of Insular Affairs. ADB trusts that the extension of information and analyses herein will prove beneficial to all interested parties.

Importantly, this study explicitly makes no recommendations to the directly affected parties. ADB looks forward to working with each FAS and its development partners to address needs that will surely arise. In the event of unlikely but conceivable severe fiscal outcomes, such work might entail a greater focus on mitigating the effects of painful fiscal adjustments. More optimistically, following a commitment by the US to extend the financial terms of each Compact, ADB could focus more directly on policy reform and in-country economic management needs to support the achievement of enhanced economic results.

ADB looks forward to a dialogue on this draft report in each country and welcomes feedback from all parties.

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COMPACT 101: STRUCTURAL FEATURES, TRENDS AND PREPAREDNESS FOR POTENTIAL SHOCKS

1 COMPACT 101: STRUCTURAL FEATURES, TRENDS AND PREPAREDNESS FOR POTENTIAL SHOCKS

This chapter describes the structure and timing of the initial and subsequent Compact funding periods for each FAS, followed by a timeline of key trends during the Compact periods. It is vital for readers to understand that the Compact of Free Association represented the choice each FAS made in order to terminate its status as territories under the UN Security Council mandate for the Trust Territory of the Pacific Islands. In all three cases, the Compact relationship delivered sovereignty and self-governance. Each FAS governs according to its own Constitutional provisions. Each has demonstrated an abiding commitment to free and fair democratic elections. The Compacts also included economic assistance provisions to support the development of each economy and support its ultimate achievement of self-reliance. Notably, there is greater similarity between the FSM and RMI provisions as they were negotiated in a similar timeframe and were passed into US law at one time. The Palau Compact negotiations followed a different track, even though the Palau Compact was passed into US law less than a year after the passage for the FSM and RMI. The Palau Compact came into effect fully 8 years after the Compacts for the FSM and RMI. Each FAS is addressed sequentially throughout this report.

FSM Compact Structural Features

FSM Initial Compact Period (FY87 to FY03)

The FSM Compact entered into full force on 3 November 1986, early in fiscal year 1987 (FY87). The Compact had been mutually approved on 1 October 1982. After that, each government required additional actions consistent with its respective constitutional processes. In the FSM, the Compact was approved by the Government as an international treaty and in a plebiscite observed by the United Nations (UN) on 21 June 1983, a sovereign act of self-determination. In the US the Compacts with the FSM and the RMI were approved by Public Law 99-239 on 14 January 1986.

Notably the Compact and its subsidiary agreements were approved as an "Executive Agreement of the United States containing international obligations." The Compact is treated within the US government as a treaty obligation that required not simply approval by resolution of the United States Senate, but rather by passage of a public law by both houses of the United States Congress. Pursuant to the Compact, 3 November 1986, marks the self-governance of the FSM with the right to conduct foreign affairs in its own name. On 17 September 1991, UN Resolution 46/2 granted FSM membership in the UN. The FSM has typically been within the top three countries in the UN with respect to coincidence of votes with the US. As of February 2019, the FSM had diplomatic relations with 92 countries.

Title II of the FSM Compact describes US economic assistance for the 15-year period from FY87 to FY01. A 2-year extension period was called for under section 231 and "the initial Compact period" is now used to describe the 17-year period from FY87-FY03. During this initial period, most funding was provided under section 211(a) as unspecified budgetary support. Of this total, 60% was alloted to current operations, while 40% was reserved for capital improvement projects.

The level of support to the FSM was designated as $60 million annually for the first five years, $51 million annually for the second five years, and $40 million annually for the third five years. The two reductions in funding after the 5th and 10th years of the initial Compact period are referred to as "step-downs." The second step-down was extraordinarily disruptive and required structural reforms including civil service retrenchment across all five governments of the FSM (national and four states).

Additional annual transfers totalling $14.3 million were provided for categories of expenditure including: energy, communications, marine surveillance, health and medical programs, scholarships, and education/health block grants. Lump sums for a total of $8.1 million were also provided in FY87 for Yap's Coast Guard station, communications hardware, and maritime surveillance support. Finally, the Compact also provided $20 million as seed financing for the FSM Investment Development Fund in FY87 to support private-sector lending. This last funding component partially compensated the FSM for the loss of tax and trade incentives that were unilaterally removed from the Compact by the US Congress. The supplemental years under the initial Compact—FY02 & FY03—were funded at the average level that prevailed during the initial 15 years. However, most of the incremental increase in funding for those two years was pledged—and subsequently contributed by the FSM in the amount of $30 million—to the FSM Compact Trust Fund (FSMCTF) created under the amended Compact.

Most of the specified annual transfer levels provided during the initial Compact funding period were adjusted for inflation by a formula that provided two-thirds of the annual change in the US GNP Implicit Price deflator, with a capped maximum annual adjustment of 7% (which never limited the annual adjustments.) An initial adjustment of 22% was applied to the affected initial year distributions, reflecting two-thirds of the inflation from the mutually agreed Compact negotiated terms at the outset of FY81 until the start of FY87. By the final year of the initial Compact period in FY03, the annual adjustment applied to the affected base grants was 58%.

Figure 1 provides a summary comparison of the features of the initial Compact period and the amended Compact period for the FSM.

FSM Amended Compact Period (FY04-FY23, "Compact II")

1. The parties agreed to the creation of a Compact Trust Fund (FSMCTF) that would accumulate during the amended Compact period. The fund was to be used after that period to replace annually appropriated sector grants that would terminate. While explicitly providing no guarantee for the level the FSMCTF would reach, or the level of distributions it would be able to support, the notional intent was to provide a smooth transition and a perpetual fund that would support the FSM, thus ending the need for extraordinary levels of annually appopriated US budgetary support. Initial deposits of $30 million from the FSM and $16 million from the US were anticipated to be available on 1 October 2003. The FSM deposited $30.3 million exactly one year late. The U.S. chose to delay its deposit, awaiting the FSM contribution, and made its initial deposit of $16 million on 5 October 2004. The FSMCTF was anticipated to be established on 1 October 2003; however, the amended Compact did not go into effect until 25 June 2004, and the FSMCTF was incorporated as a nonprofit corporation on 17 August 2004. The allocation of funds to the asset classes identified in the FSMCTF Investment Policy Statement did not occur until 10 August 2006—34 months into the amended Compact period. This delay was ill-timed, as the markets performed well during that period. The cumulative impact of the delay is estimated to be $51 million at the end of FY23 or approximately 5% of the projected value of the FSMCTF at that time.
2. The US insisted on significant changes in the accountability provisions attached to transfers during the amended Compact period. The ammended Compact revised the "Fiscal Procedures Agreement" (FPA), basing it heavily on the "Common Rule" that applies to federal grants to US states, territories, and local governments. The parties agreed on revisions to the FPA and also agreed to create a Joint Economic Management Committee (JEMCO), with oversight duties specified in the FPA.
3. The transfers—treated as grants from the US government—were required under section 211 to be awarded to six sectors: education, health, private sector development, capacity building in the public sector, environment, and public infrastructure. A seventh sector was created by mutual agreement pursuant to section 211—allowing for sector grants to cover the costs of enhanced reporting and accountability (ERA). However, ERA expenditures are limited to 2% of total annual grants. By action of the JEMCO, and consistent with the "will of the Congress" expressed in the amended Compact law, 30% of section 211 sector grant funding has been dedicated to public infrastructure.

Figure 1: Comparison of FSM Compact Features (Initial and Amended Compact Periods)

RECURRENT FUNDING

INITIAL COMPACT PERIOD FY87-FY03

- Annual Budgetary Support
  - 60 percent current operations (unrestricted)
  - 40 percent capital improvement
- $60 million annually for the first five years
- $51 million annually for the second five years
- $40 million annually for the third five years.
- $14.3 million annually for energy, communications, marine surveillance, health and medical programs, scholarships, and education/health block grants.
- Audit costs funded through annual OIA Technical Assistance Grants

AMENDED COMPACT PERIOD FY04-FY23

- Annual Budgetary Support to Specified Sectors
  - 70 percent sector grants for operations: education, health, private sector development, public sector capacity building, environment, and enhanced reporting and accountability.
  - 30 percent public infrastructure
- $76 million in FY04-FY06.
- 17 annual reductions (“decrements”) of $800,000 from FY07 through FY23 to reach a specified value of $62.4 million.
- Disaster Assistance Emergency Fund receives $200,000 annually.
- Audit costs matched up to $500,000 annually.

INFLATION ADJUSTMENT

INITIAL COMPACT PERIOD

- Two-thirds of the change in the U.S. GNP deflator, not to exceed seven percent; using FY81 as the base.

AMENDED COMPACT PERIOD

- Two-thirds of the change in the U.S. GDP deflator, not to exceed five percent; using FY04 as the base.

ONE-TIME FUNDING (Initial Compact Period)

- Lump sums for a total of $8.1 million in FY87 for Yap Coast Guard Station, communications hardware, and marine surveillance.
- FSM Investment Development Fund was seeded with $20 million to support private sector lending.

TRUST FUND (Amended Compact Period)

- Designed to accumulate during the Amended Compact Period.
- FSM initial contribution of $30 million.
- Initial allocation of $16 million for FY04. Contributions to the CTF increase by $800,000 in each of the 17 years from FY07 to FY23.

ACCOUNTABILITY PROVISIONS

INITIAL COMPACT PERIOD

- Section 211(b) overall economic development plan.
- Section 211(c) annual report on the implementation of the plan and use of Compact funds.
- Section 222 regular economic consultations.

AMENDED COMPACT PERIOD

- Section 104 of PL-108-188 Compact review during the year of 5th, 10th, and 15th anniversaries.
- Section 211(a) requires the establishment of a Fiscal Procedures Agreement (FPA).
- Section 211(c) requires an official overall Strategic Development Plan (SDP).
- Section 213 creates the Joint Economic Management Committee (JEMCO).
- Section 214 requires an annual report on the use of Compact Assistance.
- Article VIII, Section 2 requires the completion of annual single audits.

FEDERAL PROGRAMS & SERVICES

INITIAL COMPACT PERIOD

- Eligibility for a wide range of federal programs and services.
- Full access to FEMA for response to declared disasters.

AMENDED COMPACT PERIOD

- Eligibility for a similarly wide range of federal programs and services, except that Supplemental Education grant (SEG) ($12.23 million in FY05) served to “cash out” Head Start and certain primary and secondary education programs.
- Indirect access to FEMA funding through USAID for response to declared disasters.

4. The FSM agreed during the negotiations to a “cash-out” provision for education in which the FSM has foregone federal programs that previously supported Head Start (pre-K), primary, and secondary education in the FSM. The reason stated by US officials at the time was that some of the programs were not well-suited to the circumstances in the FSM and the cost of those programs, converted to annual grants, would provide more flexibility and improved outcomes in the FSM. The amount provided for this Supplemental Education grant (SEG) was $12.23 million in FY05 (allowing for a one-year transition under previously authorized federal programs in education for FY04). The amount was not provided as a permanent appropriation; rather it was left to the US Department of Education (DOE) to request annual budget allocations. Had the designated amount been considered a permanent appropriation, the nominal value would have grown from $12.23 million in FY05 to an estimated $15.7 million in FY23. Instead, as a result of the US DOE having requested none of the annually authorized partial inflation adjustments, and with two cuts due to US government-wide periods of sequestration, the FY23 level of the SEG projects to be $11.1 million which is equal to the FY19 level.

The FSM and US signed the amended Compact on 15 May 2003. The amended Compact was approved by the US Congress on 30 November 2003 and signed into law as US PL 108-188 on 17 December 2003, during the first quarter of FY04. The FSM Congress approved the amended Compact on 26 May 2004, following earlier ratification by the four states. The US and FSM signed documents to implement the amended Compact on 25 June 2004.

The funding structure of the amended Compact is relatively simple. It contains four funding streams for the FSM and a fifth that accumulates in the CTF. The four funding streams are as follows:

1. **Sector grants.** These started at $76 million in FY04 to FY06, and were followed by 17 sequential annual reductions of $800,000 each year (titled the “decrement”) to reach a specified value of $62.4 million in FY23. Since sector grants are adjusted annually by two-thirds of the change in the US GDP deflator, the nominal level of the sector grants has been relatively stable. Sector grants started at $76 million in FY04, peaked at $81.5 million in FY13, and are projected to be $81 million in FY23.

2. **Supplemental Education Grant.** The SEG, as described above, started as $12.23 million in FY05 and is projected at $10.9 million in FY23.

3. **Audit expenses.** The US will reimburse FSM for audit costs of up to $500,000 annually, with no inflation adjustment.

4. **Disaster assistance fund.** Since 2004, the US and FSM have each contributed $200,000, annually, to a Disaster Assistance Emergency Fund. The fund is intended to support disaster responses. Annual contributions (adjusted for inflation) are expected to reach $260,000 from each contributor in FY23.

5. **The Compact Trust Fund.** The FSMCTF, created at the outset of the amended Compact period, received an initial allocation of $16 million for FY04. The base contribution to the CTF increased annually in the 17 years after FY06 by the $800,000 value of the decrement; additionally, the contribution increases as a result of the partial inflation adjustment. The FY23 contribution value is projected at $38.4 million.

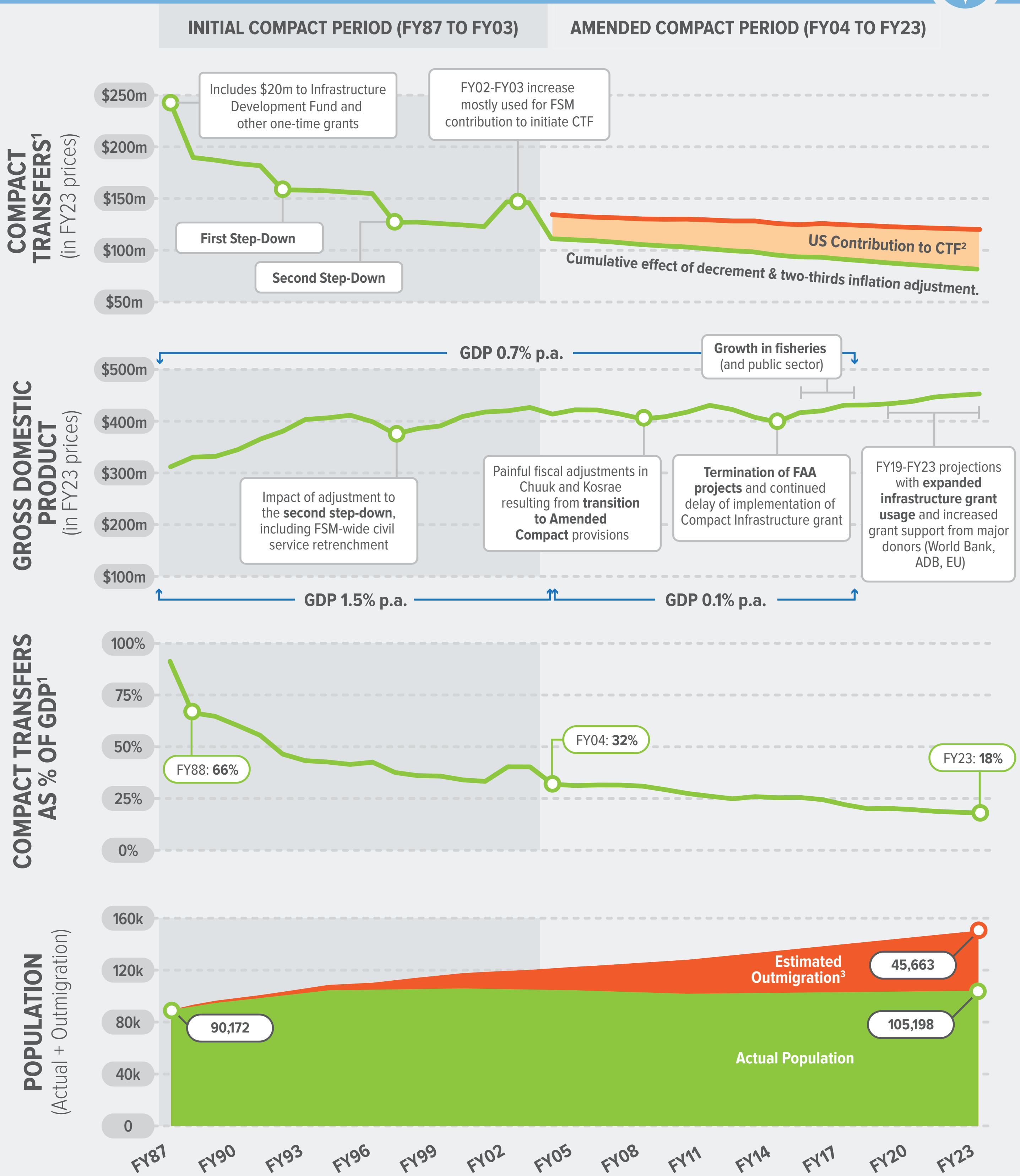
Under current terms of the Compact, all five funding streams are scheduled to terminate at the end of FY23. Thereafter, the FSM would receive only distributions from the FSMCTF, pursuant to a distribution policy to be adopted by the CTF committee within potentially severe restrictions described below. If the FSM were to receive FSMCTF distributions to the maximum allowed level, there would be significant volatility in annual distributions including the high probability of one or more years of zero distributions.

FSM Compact Timeline: Trends over both Periods (FY87 to FY03 & FY04 to FY23)

Figure 2 provides four charts covering the timeline from FY87-FY23 for the FSM.

- The first chart shows the transfers made available to the FSM by the US under the initial Compact period from FY87-FY03 and under the amended Compact period during FY04-2023. All values are expressed in FY23 prices.
- The second chart shows real GDP from FY87 to FY18 and projections through FY23, also using FY23 prices. A comparison of the two charts shows that FSM has achieved moderate but positive economic growth over the FY87 to FY18 period to-date, which is expected to continue through the FY87 to FY23 projected period. This real growth was achieved while the FSM received declining real transfers through the Compact.
- The third chart shows the combined impact of the declining level of transfers and the growing economy; specifically, the reliance of the FSM

Figure 2: FSM Compact Timeline



1. Compact transfers are based on award levels, and are not precisely equal to annual expenditures and/or drawdowns, especially during the Amended Compact Period. Transfers do not include Supplemental Education Grant (SEG) to maintain consistency across Compact periods and countries.
2. Compact Trust Fund contributions grew from $16 million nominal ($23 million in FY23 prices) in FY04 to $38.4 million in FY23.
3. FY04-FY11 FSM outmigration averaged 1.8% based on reliable US data. All other periods estimated by the authors.

on Compact transfers has declined from truly extraordinary levels during the initial Compact period to a projected level of 18% at the end of the amended Compact period.

- The fourth and final chart shows the gradual—but mounting—effect of emigration from the FSM. FSM's population is expected to grow from 90,172 people in FY87 to 105,198 people at the end of FY23. However, direct emigration over the period will have totaled an estimated 45,663 by the end of FY23, not including children born to FSM Compact migrants overseas.

Figure 3: Comparison of RMI Compact Features (Initial and Amended Compact Periods)

RECURRENT FUNDING

INITIAL COMPACT PERIOD FY87-FY03

- Annual Budgetary Support
  - » 60 percent current operations (unrestricted)
  - » 40 percent capital improvement
- $26 million annually for the first five years.
- $22 million annually for the second five years.
- $19 million annually for the third five years.
- $1.9 million annually for Kwajalein.
- $7.5 million annually for energy, communications, marine surveillance, health and medical programs, scholarships, and education/health block grants.
- Audit costs funded through annual OIA Technical Assistance Grants.

AMENDED COMPACT PERIOD FY04-FY23

- Annual Budgetary Support to Specified Sectors
  - » 70 percent sector grants for operations: education, health, private sector development, public sector capacity building, and environment.
  - » 30 percent public infrastructure
- $35 million in FY04.
- 19 annual reductions ("decrements") of $500,000 from FY05 through FY23 (with a $2 million increase for Kwajalein starting in FY14) to reach a specified value of $27.5 million.
- Disaster Assistance Emergency Fund receives $200,000 annually.
- Audit costs matched up to $500,000 annually.

INFLATION ADJUSTMENT

Initial:

- Two-thirds of the change in the U.S. GNP deflator, not to exceed seven percent; using FY81 as the base.

Amended:

- Two-thirds of the change in the U.S. GDP deflator, not to exceed five percent; using FY04 as the base.

ONE-TIME FUNDING (Initial)

- Lump sums for a total of $6.7 million in FY87 for communications hardware, and marine surveillance.
- RMI Investment Development Fund was seeded with $10 million to support private sector lending.

TRUST FUND (Amended)

- Designed to accumulate during the Amended Compact Period.
- RMI initial contribution of $25 million.
- Initial allocation of $7 million for FY04. Contributions to the CTF increase by $500,000 in each of the 19 years from FY05 to FY23.

ACCOUNTABILITY PROVISIONS

Initial:

- Section 211(b) overall economic development plan.
- Section 211(c) annual report on the implementation of the plan and use of Compact funds.
- Section 222 regular economic consultations.

Amended:

- Section 104 of PL-108-188 Compact review during the year of the 5th, 10th and 15th anniversaries.
- Section 211(f) requires an official Medium-Term Budget and Investment Framework (MTBIF).
- Section 213 requires the establishment of Fiscal Procedures Agreement.
- Section 214 creates Joint Economic Management and Fiscal Accountability Committee (JEMFAC).
- Section 215 requires an annual report on the use of Compact Assistance.
- Section 232 requires the completion of annual single audits.

FEDERAL PROGRAMS & SERVICES

Initial:

- Eligibility for a wide range of federal programs and services.
- Full access to FEMA for response to declared disasters.

Amended:

- Eligibility for a similarly wide range of federal programs and services, except that Supplemental Education grant (SEG) ($6.1 million in FY05) served to "cash out" Head Start and certain primary and secondary education programs.
- Indirect access to FEMA funding through USAID for response to declared disasters.

RMI Compact Structural Features

RMI Initial Compact Period (FY87-FY03)

The RMI Compact of Free Association entered into full force on 21 October 1986, early in fiscal year 1987 (FY87). The Compact had been mutually approved on 25 June 1983. After that, each government required additional actions consistent with its constitutional processes. In the RMI, the Compact was approved in a plebiscite observed by the United Nations on 7 September 1983, a sovereign act of self-determination. In the US the Compacts with the RMI and the FSM were approved by Public Law 99-239 on 14 January 1986.

Notably the Compact and its subsidiary agreements were approved as an "Executive Agreement of the United States containing international obligations." The Compact is treated within the US government as a treaty obligation that required not simply approval by resolution of the United States Senate, but rather by passage of a public law by both houses of the United States Congress. Pursuant to the Compact, 21 October 1986, marked self-governance of the RMI with the right to conduct foreign affairs in its own name. On 17 September 1991, UN Resolution 46/3 granted RMI membership in the UN. The RMI has typically been within the top three countries in the UN with respect to coincidence of votes with the US. As of July 2019, the RMI had diplomatic relations with 95 countries.

Title II of the RMI Compact describes the economic assistance for the 15-year period from FY87 to FY01. A 2-year extension period was allowed under section 231 and "the initial Compact period" is now used to describe the 17-year period from FY87 to FY03. During this initial period, the majority of funding was provided under section 211 as unspecified budgetary support. Of this total, 60% was allotted to current operations, while 40% was reserved for capital improvement projects. The level of support to the RMI was designated as $26.1 million annually for the first five years, $22.1 million annually for the second five years, and $19.1 million annually for the third five years. The two reductions in funding after the 5th and 10th years of the initial Compact period came to be called "step-downs." The second step-down was extraordinarily disruptive and required structural reforms including civil service retrenchment from the RMI national government.

An additional $1.9 million, not adjusted for inflation, was provided for Kwajalein, acknowledging US military equities. Additional annual transfers totalling $7.5 million were provided for categories of expenditure including: energy, communications, marine surveillance, health and medical programs, scholarships, and education/health block grants. Lump sums for a total of $6.7 million were also provided in FY87 for communications hardware and marine surveillance support. Finally, the Compact also provided $10 million as seed financing for the RMI Investment Development Fund to support private- sector lending. This last funding component partially compensated the RMI for the loss of tax and trade incentives that were removed from the Compact by the US Congress. The supplemental years under the initial Compact—FY02 and FY03—were funded at the average level that prevailed during the initial 15 years. However, most of the incremental increase in funding for those two years was pledged—and subsequently contributed by the RMI in the amount of $25 million—to the RMICTF created under the amended Compact.

Most of the specified annual transfer levels provided during the initial Compact funding period were adjusted for inflation by a formula that provided two-thirds of the annual change in the US GNP Implicit Price deflator, with a capped maximum annual adjustment of 7% (which never limited the annual adjustments.) An initial adjustment of 22% was applied to the initial year distributions, reflecting two-thirds of the inflation from the mutually agreed Compact negotiated terms at the outset of FY81 until the start of FY87. By the final year of the initial Compact period in FY03, the annual adjustment applied to the affected base grants was 58%.

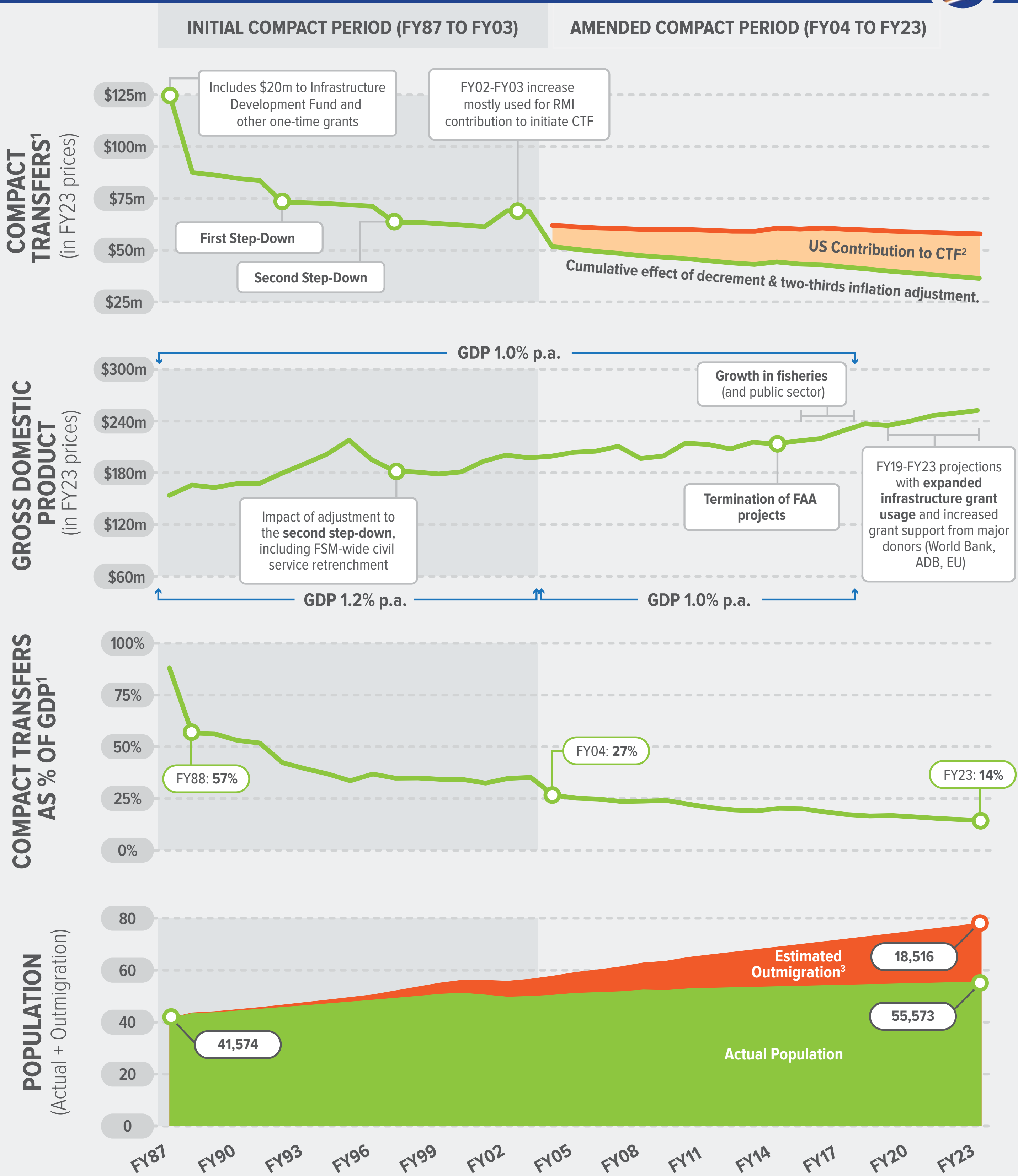
A comparison of the features of the initial Compact described above and the amended Compact period described below is summarized **Figure 3** for the RMI.

RMI Amended Compact Period (FY04-FY23)

The RMI entered into negotiations with the US for an extension to the originally specified economic assistance package at the outset of FY01 pursuant to section 231 of the Compact. Four key outcomes from the negotiations include:

1. The parties agreed to the creation of a Compact Trust Fund (RMICTF) that would accumulate during the amended Compact period. The fund was to be used after that period to replace sector grants that would terminate. While explicitly providing no guarantee for the level the CTF would reach, or the level of distributions it would be able to support, the notional intent was to provide a smooth transition and a perpetual fund that would support the RMI while ending the need for extraordinary levels of annually appropriated budgetary support. Initial deposits of $30 million

Figure 4: RMI Compact Timeline



1. Compact transfers are based on award levels, and are not precisely equal to annual expenditures and/or drawdowns, especially during the Amended Compact Period. Transfers do not include Supplemental Education Grant (SEG) to maintain consistency across Compact periods and countries.
2. Compact Trust Fund contributions grew from $16 million nominal ($23 million in FY23 prices) in FY04 to $38.4 million in FY23.
3. FY04-FY11 RMI outmigration averaged 1.7% based on reliable US data. All other periods estimated by the authors.

from the RMI and $7 million from the US were anticipated to be available on 1 October 2003. The RMI deposited $25 million nine months late on 1 June 2004 and made three subsequent deposits summing to $5 milllion ending on 5 October 2005. The US chose to delay its deposit, awaiting the initial RMI contribution, and made its initial deposit of $7 million on 3 June. The RMICTF was anticipated to be established on 1 October 2003; however, the RMICTF was incorporated as a nonprofit corporation on 28 April 2004, and the amended Compact did not go into effect until 1 May 2004. The allocation of funds to the asset classes identified in the RMICTF Investment Policy Statement did not occur until 30 September 2005—24 months into the amended Compact period. This delay was ill-timed, as the markets performed well during that period. The cumulative impact of the delay is estimated to be $34 million at trhe end of FY23 or approximately 5% of the projected value of the RMICTF at that time.

2. The US insisted on significant changes in the accountability provisions attached to transfers during the amended Compact period. In large part, the modified "Fiscal Procedures Agreement" (FPA) that was mutually agreed was based on the "Common Rule" that applies to federal grants to US states, territories and local governments. The parties also agreed to the creation of a Joint Economic Management and Financial Accountability Committee (JEMFAC), to have oversight duties specified in the FPA.

3. The transfers—now treated as grants from the US government—are required to be awarded to six initially specified sectors: education, health, private sector development, capacity building in the public sector, environment and public infrastructure. Under the terms of the Compact, the RMI committed to dedicate not less than 30% and not more than 50% of sector grants to public infrastructure. In practice, the 30% minimum allocation has prevailed.

4. The RMI agreed during the negotiations to a "cash-out" provision for education in which the RMI has foregone federal programs that previously supported Head Start (pre-K), primary, and secondary education in the RMI. The reason stated by US officials at the time was that some of the programs were not well suited to the circumstances in the RMI and the cost of those programs, converted to annual grants, would provide more flexibility and improved outcomes in the RMI. The amount provided for this Supplemental Education grant (SEG) was $6.1 million in FY05 (allowing for a one-year transition under previously authorized federal programs in education for FY04). The amount was not provided as a permanent appropriation; rather it was left to the US Department of Education (DOE) to request annual budget allocations. Had the designated amount been considered a permanent appropriation, the nominal value would have grown from $6.1 million in FY05 to an estimated $9.5 million in FY23. Instead, as a result of the US DOE having requested none of the annually authorized partial inflation adjustments, and with two cuts due to US government-wide periods of sequestration, the FY23 level of the SEG projects to $5.6 million which is equal to the FY19 level.

The RMI and US signed the amended Compact on 30 April 2003. The amended Compact was approved by the US Congress on 30 November 2003 and signed into law as US PL 108-188 on 17 December 2003, during the first quarter of FY04. The US and RMI signed documents to implement the amended Compact 1 May 2004.

The funding structure of the amended Compact is relatively simple. It contains four funding streams for the RMI and a fifth that accumulates in the CTF. The four funding streams are as follows:

1. **Sector grants.** This funding started at $35 million in FY04, and was followed by 19 sequential annual reductions of $500,000 each year through FY23 (titled the "decrement") to reach a specified value of $27.5 million in FY23, after accounting for a one-time increase of $2 million annually in FY14 dedicated to Kwajalein needs. Since sector grants are adjusted annually by two-thirds of the change in the US GDP deflator, the nominal level of the sector grants has been relatively stable. Sector grants peaked at $36.9 million in FY14, and are projected to be $35.7 million in FY23. Notably for the RMI, only $27 million in FY23 sector grants is scheduled to end. The remaining amount is permanently appropriated through the term of the US-RMI Military Use and Operating Rights Agreement (MUORA).

2. **Supplemental Education Grant.** The SEG, as described above, started as $6.1 million in FY05 and is projected at $5.6 million in FY23.

3. **Audit expenses.** The US will reimburse RMI for audit costs up to $500,000 annually, with no inflation adjustment.

4. **Disaster assistance emergency fund.** Since 2004,

the US and RMI have each contributed $200,000, annually, to a Disaster Assistance Emergency Fund. The fund is intended to support disaster responses. Annual contribtutions (adjusted for inflation) are expected to reach $260,000 from each contributor in FY23.

5. **The Compact Trust Fund.** The RMICTF, created at the outset of the amended Compact period, received an initial allocation of $7 million for FY04. The base contribution to the CTF increased annually in the 19 years after FY04 by the $500,000 value of the decrement; additionally, the contribution increased as a result of the partial inflation adjustment. The FY23 contribution value is projected at $21.4 million.

Under current terms of the Compact, all five funding streams are scheduled to terminate at the end of FY23, except that approximately 25% of the sector grant stream ($8.7 million) carries on under terms specified in the amended Compact. This is the amount that is dedicated to Kwajalein, and its timing is matched to that of the MUORA. Aside from the Kwajalein grant stream, the current terms of the Compact call for the RMI to take annual distributions from the RMICTF, pursuant to a distribution policy to be adopted by the CTF committee within potentially severe restrictions described below. If the RMI were to receive RMICTF distributions to the maximum allowed level, there would be signifcant volatility in annual distributions including the high probability of one or more years of zero distributions.

RMI Compact Timeline: Trends over both Periods (FY87-FY23)

Figure 4 provides four illustrative charts covering the full timeline from FY87-FY23 for the RMI.

- The first shows the transfers made available to the RMI by the US under the initial Compact period during FY87-FY03 and under the amended Compact period during FY04-2023. All values are expressed in FY23 prices

- The second chart shows actual measured GDP from FY87 to FY18 and projections through FY23, also using FY23 prices. A comparison of the two charts shows that the RMI has achieved moderate but positive economic growth over the FY87 to FY18 period to-date, which is expected to continue through the FY87 to FY23 projected period. This real growth was achieved while the RMI received declining real transfers through the Compact.

- The third chart shows the combined impact of the declining level of transfers and the growing economy; specifically, the reliance of the RMI on Compact transfers has declined from truly extraordinary levels during the initial Compact period to a projected level of 14% at the end of the amended Compact period.

- The fourth and final chart shows the gradual—but mounting—effect of emigration from the RMI. RMI's population is expected to grow from 41,574 in FY87 to 55,573 at the end of FY23. However, direct emigration over the period will have totaled 18,516 by the end of FY23, not including children born to RMI Compact migrants overseas.

Palau Compact Structural Features

Palau Initial Compact Period (FY95 to FY09)

The Palau Compact of Free Association came into full force on 1 October 1994, at the outset of fiscal year 1995 (FY95). The Compact had been mutually approved on 10 January 1986. After that, each government required additional actions consistent with its respective constitutional processes. In the US the Compact with Palau was approved by Public Law 99-658 on 14 November 1986. In Palau, however, the Compact approval process was delayed for nearly 9 years. Following seven referenda wherein the Constitutionally-mandated 75% majority was not achieved, a 1992 amendment to the Constitution reducing the 75% approval requirement to 50% enabled the eighth UN-observed plebiscite to be successful. The Compact was approved on 9 November 1993 by 68% of Palauan voters. The vote was considered a sovereign act of self-determination.

Notably the Compact and its subsidiary agreements were approved by the US as an "Executive Agreement of the United States containing international obligations." The Compact is treated within the US government as a treaty obligation that required not simply approval by resolution of the United States Senate, but rater by passage of a public law by both houses of the United States Congress. Pursuant to section 121 of the Compact, Palau became a self-governing entity, with the right to conduct foreign affairs in its own name, on 1 October 1994.

Palau was the last of the Trust Territories of the Pacific to be under the oversight of the UN Security Council. The Trusteeship was dissolved on 10 November 1994 by the unanimous approval of UN Security Council Resolution 956. On 15 December 1994, UN Resolution 49/63 granted Palau membership in the UN. Palau has, at least until the past few years, typically been within the top three countries in the UN with respect to coincidence of votes with the US. As of July 2019, Palau had diplomatic relations with 89 countries.

Title II of the Palau Compact describes the economic assistance for the 15-year period from FY95 to FY09. During this period, most funding was provided under section 211(a) as unspecified budgetary support. Palau's Compact designated $12 million annually for FY95 to FY98, $6 million annually for FY99 to FY04, and $5 million annually from FY05 to FY09. During the latter two periods Palau was authorized to distribute $5 million annually from the CTF to supplement its budget. Notably Palau chose to forgo that $5 million distribution for the initial three years from FY99 to FY01, before beginning their annual allowable draw of $5 million from the CTF in FY02.

Additional annual US transfers for a total of $2.781 million were provided for categories of expenditure including: communications, marine surveillance, health and medical programs, scholarships, and education/health block grants. Lump sums were provided in FY95 for infrastructure ($36 million); energy ($28 million), military options ($5.5 million), communications ($1.5 million), and $667,000 for surveillance, referrals and scholarships.

Most of the specified annual transfer levels provided during the initial Compact funding period were adjusted for inflation by a formula that provided two-thirds of the annual change in the US GNP Implicit Price deflator, with a capped maximum annual adjustment of 7% (which never limited the annual adjustments.) An initial adjustment of 46% was applied to the affected initial year distribution, reflecting two-thirds of the inflation from the mutually agreed Compact negotiated terms at the outset of FY81 until the start of FY95. By the final year of the initial Compact period in FY09, the annual adjustment applied to the affected base grants was 71%.

Figure 5 provides a summary comparison of the features of the initial Compact period and the Compact Review Agreement period for Palau.

Palau Compact Review Agreement Period: FY10-FY24

The Palau Compact requires a review on the 15th, 30th, and 40th anniversaries of Compact effectiveness. These reviews (titled Section 432 Reviews) assess the operating requirements of the Government of Palau and review the nation's progress toward meeting development objectives. While the Palau Compact provided no mandate to negotiate an extended period of funding, as was specified within the Compacts for the FSM and RMI, Palau made the case through the Review process, that an extension of funding was necessary to avoid a major fiscal shock. More importantly, Palau argued that an extension of funding was necessary to improve the likelihood of continued progress toward achieving the mutual goal of economic self-reliance. Three key outcomes of the negotiations included:

1. The parties agreed that the originally projected 12.5% annual growth rate for Palau's CTF was flawed and warranted redress. As such, the review

Figure 5: Comparison of Palau Compact Features (Initial and Amended Compact Periods)

	INITIAL COMPACT PERIOD FY95-FY09	COMPACT REVIEW AGREEMENT PERIOD: CRA Stopgap Funding FY10-FY17	COMPACT REVIEW AGREEMENT PERIOD: CRA Fully Authorized FY18-FY24
RECURRENT FUNDING	• Annual Budgetary Support: » $12m FY95 to FY98 » $7m FY99 to FY04 » $6m FY05 to FY09 » $2m for scholarships » $631k for surveillance and referrals » $150k for communications • Audit costs funded through OIA Federal Services Account.	Annual Stopgap Funding: • $13m annual special appropriation • Audit costs funded through OIA Federal Services Account.	• Annual Budgetary Support: $24.574m transferred in FY18 for use as follows: » $13.1m in FY18 » $8.1m in FY19 » $3.3m in FY20 • Infrastructure Maintenance Fund: $2m annually FY18-FY24. • Audit costs funded through OIA Federal Services Account.
INFLATION ADJUSTMENT	• Two-thirds of the change in the U.S. GNP deflator, not to exceed seven percent; using FY81 as the base.	• None of the amounts specified in the CRA are adjusted for inflation.	• None of the amounts specified in the CRA are adjusted for inflation.
ONE-TIME FUNDING	• $149m for Compact Road (FY01-FY07) • $36m in FY95 for infrastructure • $28m in FY95 for energy grant • $5.5m in FY95 for military options • $1.5m in FY95 for communications • $667K in FY95 for surveillance, referrals and scholarships		• $20m in FY18 for infrastructure projects
TRUST FUND	• $66m contribution in FY95 • $4m contribution in FY97		• $65m contribution in FY18
TRUST FUND DISTRIBUTIONS	• $5m annually from FY99 to FY09 allowed.[1]	• $5m annually from FY10 to FY17	• $5m in FY18 • $10m in FY19 • $14.8m in FY20 • $15m in FY21 • $15m in FY22 • $15m in FY23 • $15m in FY24
ACCOUNTABILITY PROVISIONS	• Section 231(a) requires an official National Development Plan (NDP) • Section 231(b) requires an Annual Report to the president of the US on implementation of the plan and use of Compact funds. • Section 432 Compact Review after 15th, 30th, and 40th years.		• CRA Section 4(e) created Economic Advisory Group (EAG) • CRA Section 5 and Appendix C created procedures to administer infrastructure grant.
FEDERAL PROGRAMS & SERVICES	• Eligibility for a wide range of federal programs and services.	• No change.	• No change.

1. Palau chose not to take CTF distributions from FY99 to FY01.

process established the objective of “topping up” the CTF to achieve—at least—its goal of providing $15 million annually through the fiftieth year (FY44). Midway through the review dialogue, the parties agreed to a new target of 5.5% annual growth, and used the new target for subsequent calculations.

2. The US insisted on changes to the accountability provisions for transfers during the CRA period. However, the new oversight requirements in Palau were significantly lighter than in the amended Compacts for the FSM and RMI. In the end, mutual agreement was achieved on the creation of an “Economic Advisory Group” (EAG) to monitor Palau’s economic progress and put forth recommendations that would, presumably, set the agenda of annual economic consultations. As of January 2020 the EAG had not met, but will likely make an initial set of findings that shows considerable progress by Palau toward the originally specified fiscal and economic policy objectives.

3. In addition to funding to directly increase the value of the CTF, a simplified schedule of funding was agreed as described below, to be provided in declining amounts through FY24.

The funding structure for the CRA period is relatively simple. It contains three funding streams for Palau and a fourth that accumulates in the Palau Compact Trust Fund:

1. **Budgetary support.** A total of $22.11 million (plus $2.47million already provided through an FY18 stop-gap appropriation) was provided to support spending similar to that negotiated in the original CRA as a supplement to agreed upon annual distribtions of specified amounts from the CTF for the years FY18 to FY20 (after which, Trust Fund distributions of $15 million are the only source of budgetary support).

2. **Infrastructure.** A total of $20 million in infrastructure funds is immediately available to fund mutually agreed infrastructure projects after funding is made available at the end of FY18.

3. **Infrastructure Maintenance.** $2 million is provided annually from FY18 to FY24, subject to Palau matching contributions of $600,000 annually from FY19 to FY24.

4. **Compact Trust Fund.** A total of $62.25 million was deposited into the fund at the end of FY18 as a supplement to (nearly) assure its ability to achieve its original goal.

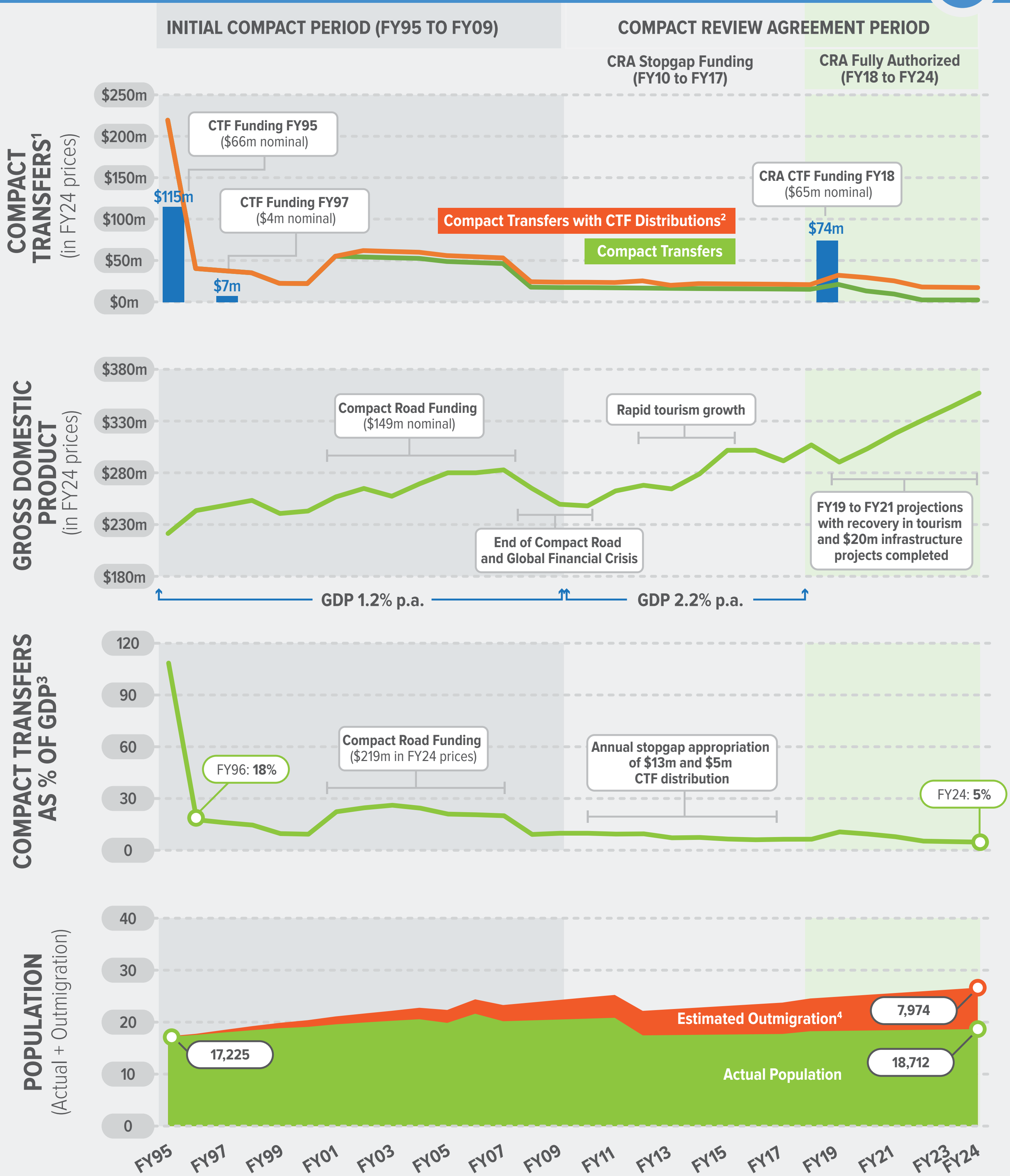
Three of the four funding streams were completely fulfilled with funds transferred to Palau at the end of FY18. Only the infrastructure maintenance funding stream continues, at $2 million annually through FY24, presumably because the funding is contingent on Palau fullfilling its quarterly matching requirements. The CRA originally included a fifth funding stream, but it was reprogrammed and distributed to the existing four. The fifth stream would have provided $10 million to offset fiscal arrears that Palau had at the end of FY09. However, both parties deemed the allotment unnecessary given the passage of time and the fiscal surplus position of the Government of Palau as of the end of FY18. Notably, all of the CRA funding was authorized and appropriated in FY18, so there was no need for the US to provide a full faith and credit pledge as existed during the initial Compact period.

Palau Compact Timeline: Trends over both Periods (FY95 to FY09 & FY10 to FY24)

Figure 6 provides four illustrative charts that cover the full timeline from FY87-FY23 for Palau.

- The first chart shows the transfers made available to Palau by the US under the initial Compact period from FY95 to FY09 and under the CRA period from FY10 to FY24. All values are expressed in FY24 prices.
- The second chart shows actual measured GDP from FY95 to FY18 and estimates through FY24, also in FY24 prices. A comparison of the two charts shows that Palau has achieved positive economic growth over the 24-year period to-date, which is expected to continue through the 30-year period from FY95 to FY24. This real growth was achieved while Palau received declining real transfers through the Compact.
- The third chart shows the combined impact of the declining level of transfers and the growing economy; specifically, the reliance of Palau on Compact transfers has declined from moderately high levels during the initial Compact period to a projected level of 5% at the end of the CRA period.
- The fourth chart shows the gradual—but mounting—effect of emigration from Palau. Palau’s population is expected to grow from 17,225 in FY95 to 18,712 at the end of FY24. However, direct emigration over the period will have totaled 7,974 by the end of FY24, not including children born to Palau Compact migrants overseas.

Figure 6: Palau Compact Timeline



1. Compact transfers are based on award levels, and are not precisely equal to annual expenditures and/or drawdowns, especially during the Amended Compact Period.
2. Compact Trust Fund distributions $5m per year FY02 to FY17; schedule grows from $9m in FY18 to $15m in FY24.
3. Compact Transfers as a % of GDP including distributions from CTF.
4. FY04-FY11 Palau outmigration averaged 1.7% based on reliable US data. All other periods estimated by the authors.

WHAT'S WRONG WITH THE COFA TRUST FUND RULES... AND CAN SAFER RULES ACHIEVE BETTER RESULTS?

What's Wrong with the COFA Trust Fund Rules?

The CTFs for FSM and RMI each operate under a "Trust Fund Agreement" established by US PL-108-188. The Agreements establish rules that we refer to as COFA rules. Amendments require mutual agreement of the parties and subsequent action of the US Congress.

Various studies of the FSM and RMI CTFs conducted by the GAO, ADB and GSUSA have identified common concerns about the COFA rules. Those studies have also identified opportunities to achieve better performance. Such improvements can be achieved at no cost and result in greater protection of the real value of each Trust Fund over the long run. There are also practical administrative amendments required to enable each CTF to be used as a source of annual distributions to support the FSM and the RMI on a timely and predictable basis. There now appears to be consensus among the principals that amendments are needed.

The most important change required in the operation of the CTFs is to establish a direct relationship between the allowable distribution (planned to begin in FY24) and the size of each CTF at the end of FY23. Under the current COFA rules there is no such linkage. The smaller the Trust Fund value in relation to the allowable distribution, the more severe this flaw becomes. The FSMCTF, with its smaller projected value relative to its allowable distribution size, faces more severe problems than does the RMICTF.

The Trust Fund Committees for both CTFs are exploring alternative distribution rules to move away from the expectation that the distributions in FY24 would match the real value of the FY23 sector grants. The methods considered include using a fixed percentage rate of distribution (4% or 4.5%) applied to the value of the CTF at the end of FY23 (or to a multi-year rolling average value of the CTF).

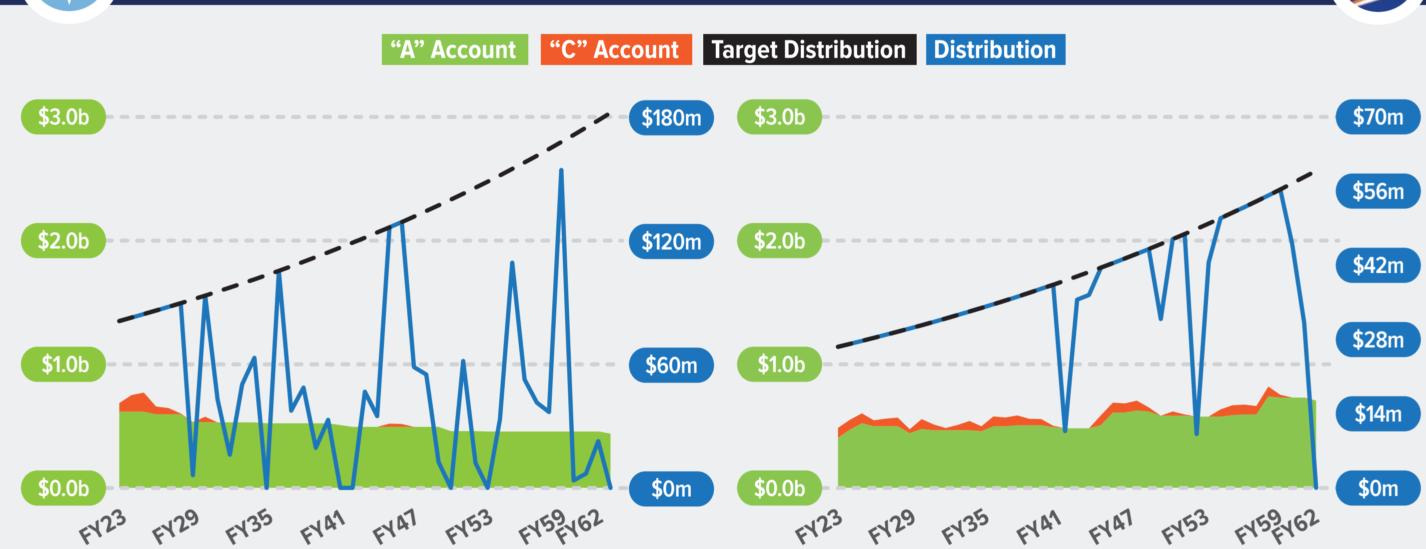
The figure below shows the devastating results that might occur if the prevailing COFA rules are followed based on the case of the FSM on the left and the RMI on the right where the projected value of the CTF at the end of FY23 is undeniably too small to sustain the real value of FY23 sector grants going forward. "Sim 9" is just one of 10,000 cases studied using a statistical method (Monte Carlo analysis) based on actual market returns of six asset classes allocated in a typical institutional investing approach.

In the case shown, the FSM would have suffered 6 years of zero distributions and several more years of near-zero over the period from FY24 through FY63. The RMI, with a relatively smaller distribution level relative to the projected size of its CTF still is shown to have several years of substantially reduced distributions including one zero distribution year. This performance compares unfavorably to the much smoother results from the same Sim 9 case using improved "SAFER" rules as shown for the FSM and RMI at the bottom of the opposite page. For the FSM, Sim 9 is not an especially poor case; the period reflects an average geometric rate of return of 7.1 percent—very near the expected average of 7.3 percent. In fact, Monte Carlo projections find that the FSM would suffer one or more years of zero distributions in 89 percent of total cases.

Can SAFER Rules Achieve Better Results?

To resolve the identified problems with the COFA Trust Fund Rules for the FSM and RMI, there are several practical administrative amendments to consider;

FSM and RMI CTFs under COFA Rules (Sim 9)



however, the most important methodological change required is to ensure a linkage between the annual distribution from each CTF and the value of each CTF.

The GSUSA has worked collaboratively with the ADB and the GAO studies. The GSUSA analysis has put a greater focus on comparing a wide range of potential distribution rules. The ongoing goal is to find an optimal distribution rule. Knowing there is now widespread understanding that the COFA Trust Fund Agreements for the FSM and RMI need to be amended (even if only for administrative viability) the ongoing work will be published and available for consideration by the principal parties. Optimization of the rule allows for an objectively scored better result for any given level of each CTF. Put another way, the level of funding required under a US Compact funding extension period will be less than the amount needed to get the same scored result under current law or under a non-optimized methodology.

It can be said that the primary, and perhaps only, principle of the COFA Trust Fund Rules as enacted into law was to protect the value of each CTF. Unfortunately, the rules as described have a tendency, supported by statistical analysis, to protect only the nominal value of each CTF and not the real value. We have proposed that there are three important principles to be considered: (i) the real value of the trust fund should be protected (over the long run); (ii) the trust fund should provide a targeted annual level of real distributions; and (iii) annual distributions should entail minimal volatility from period to period and, when volatility is required, the volatility should be of known magnitude to limit disruption to fiscal policy.

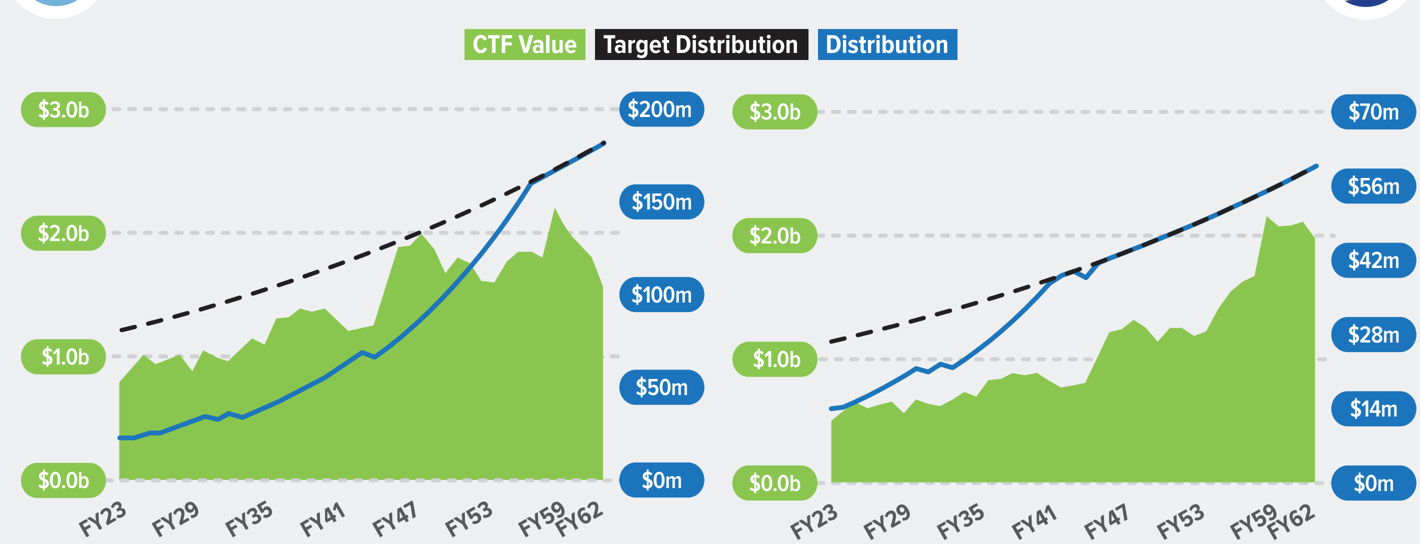
Once these three principles are considered, the method we have attempted to identify involves a one-time adjustment—in the first year of distributions. With that adjustment the CTF can be expected to perform well when assessed against the three identified principles. We call the one-time adjustment a "sustainability adjustment." We couple that with specific rules about annual distributions from year-to-year and label the holistic approach as the Sustainability Adjustment for Enhanced Reliability (SAFER) method. The size of the sustainability adjustment has been estimated in our Monte Carlo modeling approach so that our scoring method will yield a score of 95 percent. In statistical terms, this is equivalent to a 95 percent confidence level while allowing for equal weighting of the three principles.

The accompanying rules are important. While more detailed than a simple "fixed-rate" rule, they address the unavoidable reality in the investment world of upside and downside risks. Very briefly, once the SAFER adjustment is made, annual distributions stay the same in real terms every year unless an adjustment is called for. There is an annual test. An up or down adjustment will only occur if the CTF value has gone outside of defined guardrails. On the upside, when the fund has grown to more than 20 percent above the SAFER level, annual increases can be as much as 5 percent until the fund value falls below that +20 percent rail. On the downside, if the value of the Trust Fund falls 20 percent below the SAFER level, annual decreases of 5 percent are called for until the fund value returns above that -20 percent guardrail. The method is designed to keep volatility low and within defined ranges.

The figure below shows the improved results that occur if the SAFER method is utilized. "Sim 9" is used again. It is exactly parallel to the "Sim 9" shown for the FSM and RMI on the opposite page using COFA Rules. It is based on the same randomly chosen annual rates of return, in the same sequence, for the 40-year period from FY24-FY63.

As compared to the same case using COFA Rules, the SAFER results are scored higher but have one major downside. The bulk of the adjustment needed under SAFER occurs at the beginning of the distribution

FSM and RMI CTFs under SAFER Rules (Sim 9)



period—hence the fiscal adjustment we describe in the base and severe adjustment cases in Chapter 2. Thereafter, the tendency is for distributions to grow steadily... and eventually to catch up in real terms to the targeted adjustment. The average level of distributions is 60 percent of the target over the whole 40-year period as compared to the 42 percent using COFA Trust Fund Rules. Notably, there are only three minor annual downward adjustments over the full period and the target distribution has been achieved as of FY57 and thereafter. The results for the RMI are even more favorable using SAFER rather than COFA rules.

One important observation is that extending the Compact funding period to strengthen the value of each CTF in proportion to the desired value of annual distributions is, unsurprisingly, the most advantageous way forward for each FAS. Combining such an extension with improved rules yields compounded benefits.

2

MODELING THE IMPACT OF POTENTIAL COMPACT TRANSFER LOSSES

2 MODELING THE IMPACT OF POTENTIAL COMPACT TRANSFER LOSSES

This chapter outlines the potential impacts of reductions in funding provisions associated with the amended Compacts for the FSM and RMI expected after FY23, and the CRA for Palau after FY24. The chapter explores two scenarios for each country.

The first "**Base Adjustment Scenario**" assumes the FSM and RMI each move to a regime outlined in its Compact law. This regime has two key features. First, the FSM and RMI would transition from sector grants funded by US appropriations to annual distributions drawn down from their respective CTFs. The initial level of annual distributions pulled from the CTFs would be based on what is deemed for each country to be sustainable (with a high degree of confidence) and would thereafter be adjusted to fully offset the impact of inflation. The second key feature of the Base Adjustment Scenario is the assumption that SEG funding would cease.

The Palau Compact did not have a "cash-out" feature for federal education programs. Therefore, its Base Adjustment Scenario involves an initial distribution from the Palau CTF, which is deemed to be sustainable with a high degree of confidence and thereafter adjusted to fully offset the impact of inflation.

The second, "**Severe Adjustment Scenario**," assumes that all three FAS face the additional challenge of losing all US federal programs and services. This scenario is very unlikely, given the continued strength of the relationships between the US and the three FAS. The scenario is presented to show the ongoing value of the Compact relationships (and subsidiary agreement) to each FAS and, conversely, the ongoing reliance of each FAS economy on the continued relationship.

In order to undertake the analysis and interpret the results, it is necessary to not only specify the nature of the potential changes in Compact provisions for each FAS, but also the structure and recent performance of each FAS.

The chapter is divided into three sections—one for each FAS. Each section describes key features of the country's recent economic performance[1], the nature and magnitude of potential changes in Compact provisions, and avenues of adjustment to potential reductions in support. Subsequently, each section analyzes the two adjustment scenarios. The analysis utilizes a modeling framework developed by the Graduate School US.A (GSUSA), which adopts a modeling system based on the economic sector accounts of the three economies and utilizes programming techniques developed by the International Monetary Fund[2].

The Federated States of Micronesia

Economic Structure and Recent Performance Affecting Model Results

The FSM's economic performance has been weak during the amended Compact period, with annual

1 See recent GSUSA Economic Reviews of the three FAS for an in-depth analysis of economic structure and performance.

2 See recent GSUSA Economic Reviews of the three FAS for a discussion of the models.

growth averaging 0.1% from FY04 to FY18. This reflects the small size of the country, its remote geographical location, an uncompetitive private sector policy environment, and the failure of the economy to foster new private sector industries in areas of potential comparative advantage such as fisheries and tourism. Economic performance has been dominated by a large public sector, supported by the economic provisions of the amended Compact. With the drag on the economy caused by the declining inflation-adjusted value of Compact sector grants due to the annual decrement and lack of full inflation indexation, much of the economy has been in a perpetual state of decline.

A backlog of $176 million in unused FSM Compact funding for infrastructure has accumulated by the end of FY18—but remains available for use in a manner described below for the modeling efforts. The greatly reduced utilization of the infrastructure sector grant has substantially reduced a major source of potential economic demand. The FSM has thus suffered delays in needed improvements of the nation's capital stock and productive potential. There are ongoing efforts to improve the systematic institutional weaknesses that have delayed full utilization of the infrastructure grant.

A bright spot over the last few years has been the rapidly growing aid sector driven by multilateral donors, especially the World Bank and the Asian Development Bank. However, absorptive capacity has yet to catch up with potential, and timely utilization of these grants is a work in progress.

The FSM's federal structure is of special importance with respect to the interactions with development partners. The FSM comprises four state governments and a federal government, with much of the responsibility for public service provision—including education, health, and public safety—held by the state governments.

With declining inflation-adjusted Compact sector grants and little or no growth in domestic revenues at the state level, service delivery and public expenditures have been severely constrained. Despite these challenges, the state governments have adopted a prudent approach to fiscal policy and maintained fiscal balance and stability.

At the national government level, fiscal conditions are markedly different. In addition to tax revenues shared with the state governments, the national government benefits from the receipt of sovereign rents from fishing royalties under the Parties to the Nauru Agreement and implemented through the Vessel Day Scheme. Fishing royalties have grown from an average 5% of GDP prior to FY14 (with substantial year-to-year volatility through FY13), to 20% of GDP from FY14 to FY18 with minimal volatility. In FY18 receipts from fishing licenses were $70 million. The national government has also established an FSM tax domicile, primarily for Japanese captive insurance and major corporations. While this normally represents less than 2% of GDP, its value to the economy spikes periodically. In FY18, for example, it reached 23% of GDP due to receipt of large tax declarations (capital gains) by major corporations. The combination of fisheries revenues and the tax domicile revenues has resulted in large fiscal surpluses for the FSM national government. During FY14-FY18 this large structural surplus averaged 15% of GDP, peaking at 28% in FY18.

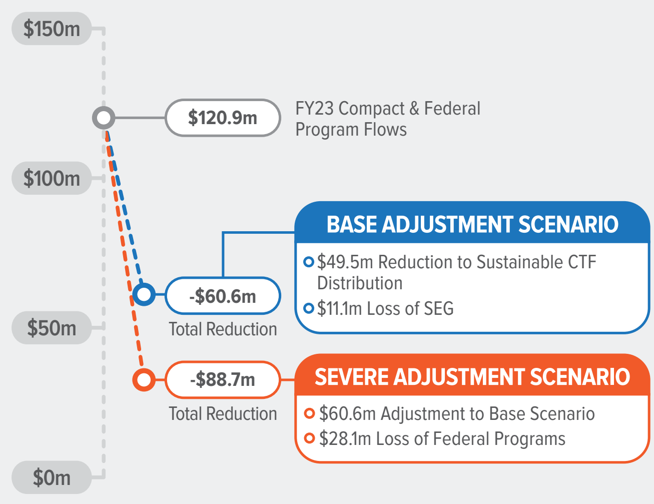
The large increase in resources has been utilized in two major ways. Firstly, and most importantly, the FSM has created a national trust fund (FSMTF) and increased its holdings of uncommitted funds. About two-thirds of the additional resources have been allocated to the fund or remain unspent. At the end of FY18 the FSMTF stood at $214 million--a significant achievement. Under a series of public laws, the national government has specified annual ongoing commitments to the fund, including 20% of domestic taxes, 50% of corporation taxes from the domiciled captive insurance and large corporations sector, and a further 20% of fishing fee revenues. The national government is committed to adding about $24 million annually to the fund, under conservative estimates.

Second, the increase in resources has permitted significant growth of national government congressionally specified projects and increased national government expenditures on goods and services. Since these expenditures are non-recurrent in nature, the true level of discretionary fiscal space and underlying structural surplus available is considerably larger than that represented as the annual surplus in the fiscal statistics. While it might be argued that the increase in the FSM's resources has represented a lost opportunity in service delivery at the state level, the national government has effectively avoided a destabilizing rise in state-level expenditures which would surely be unsustainable after FY23 in the absence of a Compact funding extension.

The FSM Base Adjustment Scenario

The base adjustment scenario predicts what will take place in the FSM if no actions are taken to extend the economic assistance provisions of the FSM Compact. Under the terms of the amended Compact, the level of Compact sector grants projected for FY23 equals $81.0 million. Absent an extension to Compact funding, in FY24 those grants will terminate with the

Figure 7: FSM Downward Adjustment Scenarios: Components and Magnitudes



Note: Sustainable distributions from the CTF ($31.5 million in FY23 prices) is assumed to be available.

presumption that FY24 transfers will be covered by a distribution from FSMCTF. For the purposes of this study, the GSUSA team utilizes an estimate of the sustainable distribution from each Compact Trust Fund based on the value it achieves at the end of the year prior to the start of distributions. This method utilizes a “Sustainability Adjustment for Enhanced Reliability” which hereafter is referred to as the SAFER method and which is described in other published works by the team and above. Using a statistical method called Monte Carlo analysis, the median value of the FSMCTF at the end of FY23 is projected at $1.05 billion, which results in a SAFER estimated distribution of $31.5 million. This potential reduction in transfers to support FSM government operations and capital investments is specified in Figure 7 as $49.5 million annually, which equates to 10.9% of projected GDP in FY23.

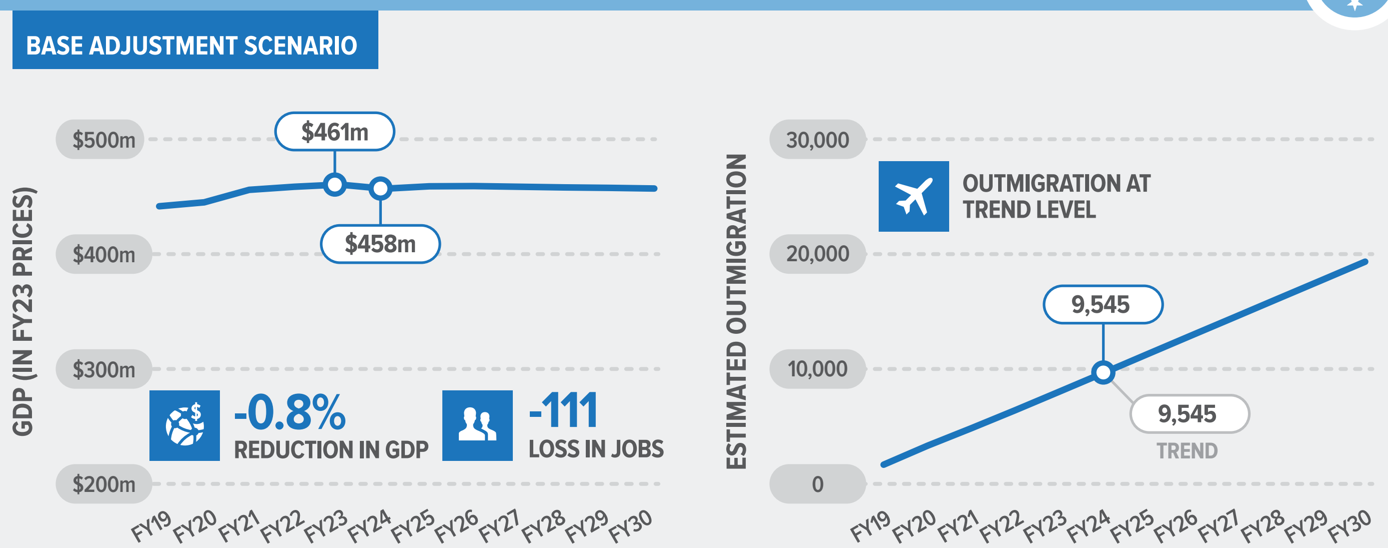
An additional decline in transfers will occur in the absence of an extension to Compact economic assistance through the loss of the SEG. There is no provision for the FSMCTF to replace this loss of annual transfers. This potential reduction in support to education programs (mostly for pre-K) in the FSM is specified in Figure 7 as $11.1 million annually which equates to 2.4% of projected GDP in FY23.

The total adjustment thus required under the baseline scenario is $60.6 million or 13.4% of GDP, an extraordinary fiscal shock for any economy.

In order to maintain fiscal balance, the FSM’s national and state governments will need to:

- Terminate all further contributions by the national government to the FSMTF.
- Drawdown from the FSMTF at the SAFER rate. The FSMTF is projected to attain $450 million by FY23 and could distribute $13.5 million in FY24.
- Reduce expenditures on Congressionally appropriated public projects to the FY12 level of $3.5 million. The FY18 level was $23 million.
- Reduce use of goods and services to the FY12 inflation adjusted level of $31 million in FY24 from the FY18 level of $46 million.
- Transfer the national government’s annual fiscal surplus of $35 million to the state governments.

Figure 8: FSM Base Adjustment Scenario: GDP, Jobs and Emigration



The above adjustments would return the national government to the inflation-adjusted operational level that existed prior to growth in sovereign rents. National government fiscal balance is just barely maintained; however, its fiscal surplus is fully exhausted. Fortuitously, the adjustments at the national level and transfers to the states are enough to avoid the need for any fiscal adjustment in the states.

Figure 8 illustrates the impacts of the Base Adjustment Scenario on the FSM's economy. The FSM economy is projected to decline by 0.8%. This reflects the impact of reducing national government spending on Congressional projects, reducing the use of goods and services. The subsequent reductions in economic activity are felt almost entirely by the private sector due to the reductions in demand for private sector services. This translates to losing nearly just over 100 private sector jobs or .7% of total employment.

Figure 8 also indicates the accumulated impact on migration. An estimated 1.6% of the population of the FSM—and its sister FAS nations—migrates to the US each year. Migration to the US has been observed to rise during periods of severe fiscal adjustment, such as during the large-scale civil service retrenchment required in the FSM and RMI as a result of the second step-down of funding during the initial Compact period, and during the large adjustments in Chuuk and Kosrae during the amended Compact period.

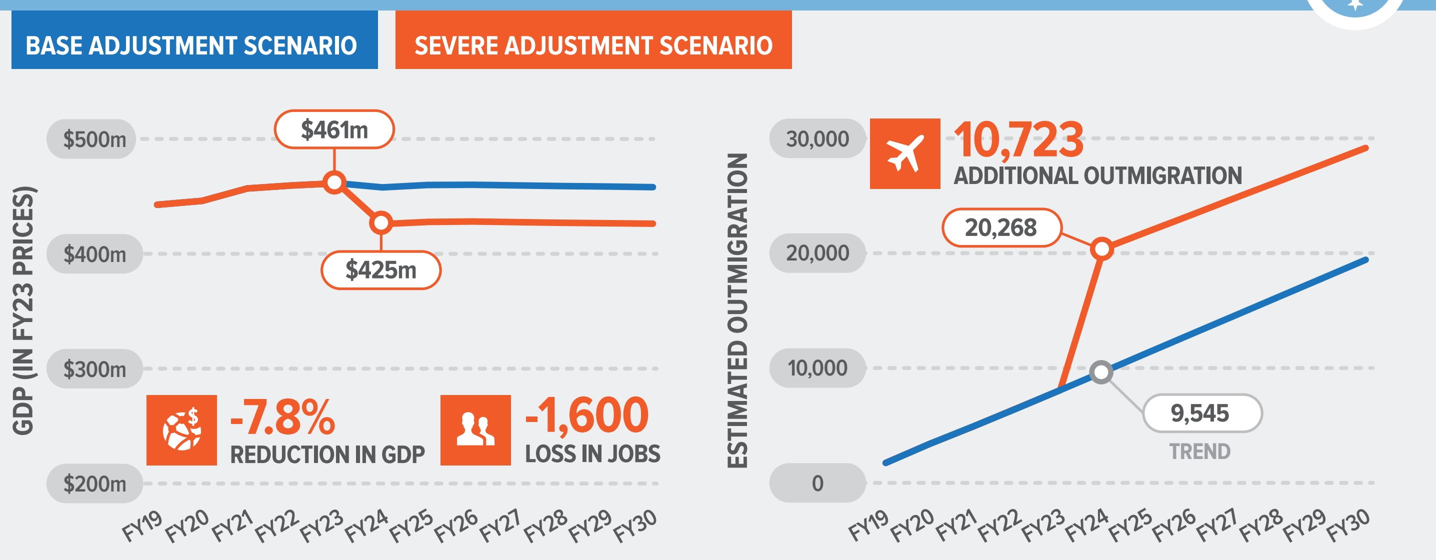
Figure 8 indicates trend migration of 1.6% of the population annually. The figure is designed to indicate the implied level of migration associated with a certain level of job losses. The estimate assumes an employee who loses his or her job migrates with dependents. The FSM has a dependency ratio of 6.7 people per job. However, in the base adjustment scenario since the loss in jobs is projected to be minor, no additional or induced migration is projected beyond the normal outflows. In practice, actual induced migration due to fiscal shocks is likely to be spread over several years, and not all primary job earners or dependents may migrate. The projections, while supported by observed migration spikes during past fiscal shocks, should be considered as indicative of a potential upper boundary.

The FSM Severe Adjustment Scenario

Under the unlikely, but important-to-model, severe adjustment scenario, the potential additional reduction in US funding to support nearly all of the listed programs and services totals $29 million annually which equates to 6.4% of projected GDP in FY23. Taken in addition to the base adustment, the total annual reduction in transfers would be $89.6 million annually, or 19.7% of projected GDP in FY23.

The FSM benefits from FDIC deposit insurance and US postal services, and the future of both is uncertain. Losing US postal services would increase costs for FSM consumers, while losing FDIC insurance could potentially sever relations with foreign banks and have serious implications for the delivery of financial services. The dollar value of FDIC insurance and the cost of subsidizing postal rates in the FSM are not know. Modeling the impact on public services, businesses, and households is beyond the current capability of the GSUSA macroeconomic modeling framework. The Severe Adjustment Scenario presumes the following:

Figure 9: FSM Severe Adjustment Scenario: GDP, Jobs and Emigration



- The national government loses its share of Federal programs estimated at $7 million.
- The national government supports the College of Micronesia by providing $12 million annually, thus offsetting the loss of Pell grants to preserve the institution.
- To maintain the national government's fiscal balance, only $15 million is transferred to the states, rather than the full $35 million envisioned under the Base Adjustment Scenario. Large public sector job cuts at the state level are required, ranging from 35% in Kosrae to 25% in Yap.

Figure 9 indicates the outcome of both the Base Adjustment Scenario and the Severe Adjustment Scenario. The overall impact on economic activity worsens from -0.8% in the Base Adjustment Scenario to -8% in the Severe Adjustment Scenario. Job losses rise from 111 to 1,600 or 9% of total employment. With national government surplus resources depleted, the incremental adjustment is felt entirely at the state level, where options are severely limited, resulting in forced reductions in civil servant staffing levels.

The impact on migration is extraordinary, resulting in nearly 11,000 new migrants to the US, or 11% of the population. The impact on the FSM would likely be disproportionate between Pohnpei, where the national government is an important employer, and the other states. Job loss in Chuuk is projected at 13%, Kosrae 16%, Pohnpei 7% and Yap 8%. The Severe Adjustment Scenario represents an existential threat to the FSM.

The Marshall Islands

Economic Structure and Recent Performance Affecting Model Results

For a small, dependent, geographically remote island nation, the RMI economy has performed satisfactorily—albeit modestly—with growth averaging 1.2% annually during the amended Compact period. Of the accumulated growth of 20%, nearly one-third was derived from expansion in the private and fisheries sectors. The public sector and government services have been the main drivers of economic growth, contributing more than half of the cumulative growth; financial services comprised the final one-fifth of the cumulative growth during the amended Compact period.

While RMI's amended Compact is structurally similar to the FSM's, the better economic performance of the RMI during the amended Compact period has enabled the nation to avoid the need for major fiscal adjustment, despite being challenged by a more aggressive annual decrement and a similar lack of full inflation indexation. While the RMI also experienced issues that delayed its use of the infrastructure grant, they were temporary and quickly resolved. As in the case of the FSM, the RMI has benefited from the rapidly growing aid sector driven by multilateral donors, especially the World Bank and ADB. However, absorptive capacity has yet to catch up with potential, and full utilization of grants is a work in progress. The impacts of increased development finance on the economy are yet to be observed.

In the longer-term, the RMI's economic potential may be limited, but sources of growth exist in tourism and the development of the Majuro lagoon public and private port facilities, which are a regional hub for the fishing industry.

The RMI has benefited from a significant increase in fishing revenues derived from participation in the Parties to the Nauru Agreement and its associated Vessel Day Scheme. Revenues from this source have grown from an average 3% of GDP prior to FY13 with significant year-to-year volatility to over 15% of GDP in FY18 with annual volatility almost eliminated. Before the increase in revenues, the RMI managed to attain fiscal balance in most periods, although during the global financial crisis, cash flow management was severely constrained, and the government went into a period of default on its external debt.

While the RMI has fully addressed the fiscal challenges of the financial crisis period with favorable growth in revenues, expenditures have largely matched the increase. Notably, expenditures grew by 40% from FY13 to FY18. Unlike the FSM, the RMI has not developed a pool of reserves either in the form of a domestic Trust Fund or in the form of fiscal space to allow for adjustment to a post-FY23 fiscal shock.

The RMI Base Adjustment Scenario

The RMI faces a somewhat less onerous threat of adjustment than the FSM. Under the terms of the RMI's amended Compact the level of non-Kwajalein targeted Compact sector grants projected for FY23 is $27 million. Absent an extension to Compact economic assistance, in FY24 that amount will terminate with the presumption that FY24 transfers will be covered by a distribution from the RMICTF. Using the Monte Carlo analysis, the median value of the RMICTF at the end of FY23 is projected at $664 million, with a corresponding SAFER distribution of $19.9 million. This potential reduction in transfers to support government operations and capital investments is specified in **Figure 10** as $7.1 million annually, which equates to 2.8% of projected GDP in FY23.

An additional decline in transfers will occur through the loss of the SEG. There was no provision for the RMICTF to serve as a source to replace this loss of annual transfers. Figure 10 illustrates the potential reduction in support to the RMI's education programs—$5.6 million annually, or 2.2% of projected GDP in FY23.

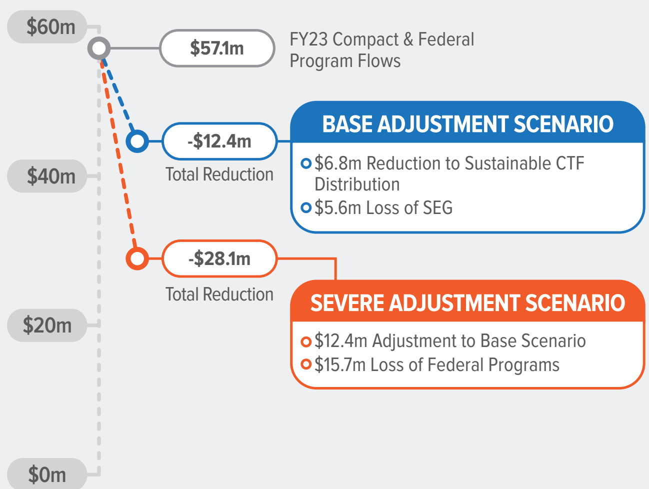
The total adjustment thus required under the RMI Base Adjustment Scenario is $12.7 million, or 5% of GDP. This represents a significant fiscal shock.

The Base Adjustment Scenario projections through the end of the amended Compact FY23 are based on continuation of the current policy stance. The economy is projected to continue to expand modestly by 1.2%, reflecting historical averages. In FY23 the economy is projected to support a fiscal surplus of 1.7% of GDP, which is a reduction against the FY18 level of 2.5%.

Unlike the FSM—with its complex relations between different levels of government—the RMI can more easily adjust to the projected 5% GDP loss from grants. It can do so at the national level by reversing the use of goods and services to the levels that existed before the increase in sovereign rents. Infrastructure spending is also projected to contract consistent with the new level of funding available from the reduced CTF distribution level.

The impact on the RMI economy of these adjustments is shown in **Figure 11** and the economy is projected to decline modestly by 1.3%. Given that the impact of the

Figure 10: RMI Downward Adjustment Scenarios: Components and Magnitudes



Note: Sustainable distributions from the CTF ($19.9 million in FY23 prices) is assumed to be available.

adjustments is in the demand for services, the impact is wholly born by the private sector which contracts by 2.8%. In terms of employment, 98 jobs are lost and total employment contracts by 1.2%.

Figure 11 also indicates the accumulated impact on migration. Approximately 1.6% of the population in the RMI migrates to the US each year. This observation is mostly insensitive to the state of the local economy, although migration has been observed to rise during periods of severe fiscal adjustment, such as during the large-scale civil service retrenchment required in the RMI as a result of the second step-down of funding during the initial Compact period. The figure indicates a baseline of migration accumulating during the period: the addition of roughly 1.6% of the population annually. Each of those employees affected by job loss is projected to migrate with his or her dependents. The dependency ratio in the RMI is estimated 5.4 people per job. However, the model dampens migration projections when the job loss is within 1.0% of total jobs. Additional migration is thus estimated to rise at a rate of just above the underlying trend.

The RMI Severe adjustment scenario

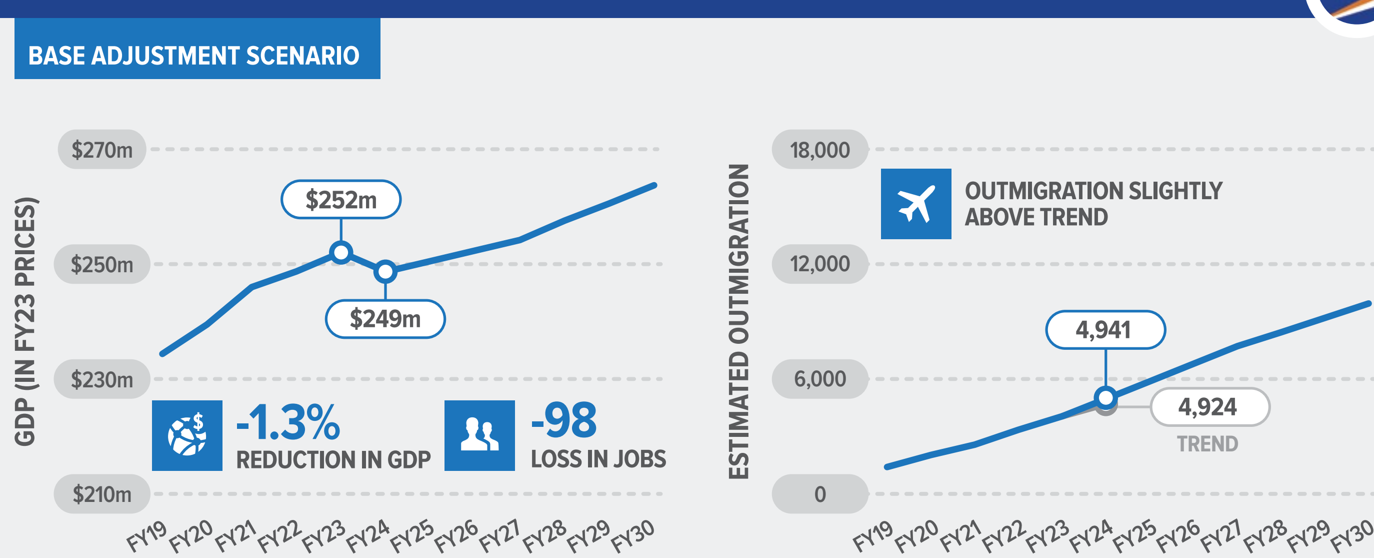
Under the unlikely, but important-to-model severe adjustment scenario, the potential additional reduction in US funding to support nearly all of the listed programs and services totals $16.9 for million annually which equates to 6.7% of projected GDP in FY23. Taken together with the base adustment, the total annual reduction in transfers would be $29.6 million annually, or 11.7% of projected GDP in FY23.

The RMI benefits from the provision of US postal services, the future of which is uncertain. Loss of postal services would imply higher costs for RMI consumers; however, the cost of subsidizing postal rates in the RMI is not known and modeling the impact on public services, businesses and households is beyond the capability of the GSUSA macroeconomic modeling framework as currently developed.

In order to restore fiscal balance under the severe adjustment scenario the following assumptions have been made:

- To redress the loss of Federal programs the government is required, in addition to the

Figure 11: RMI Base Adjustment Scenario: GDP, Jobs and Emigration



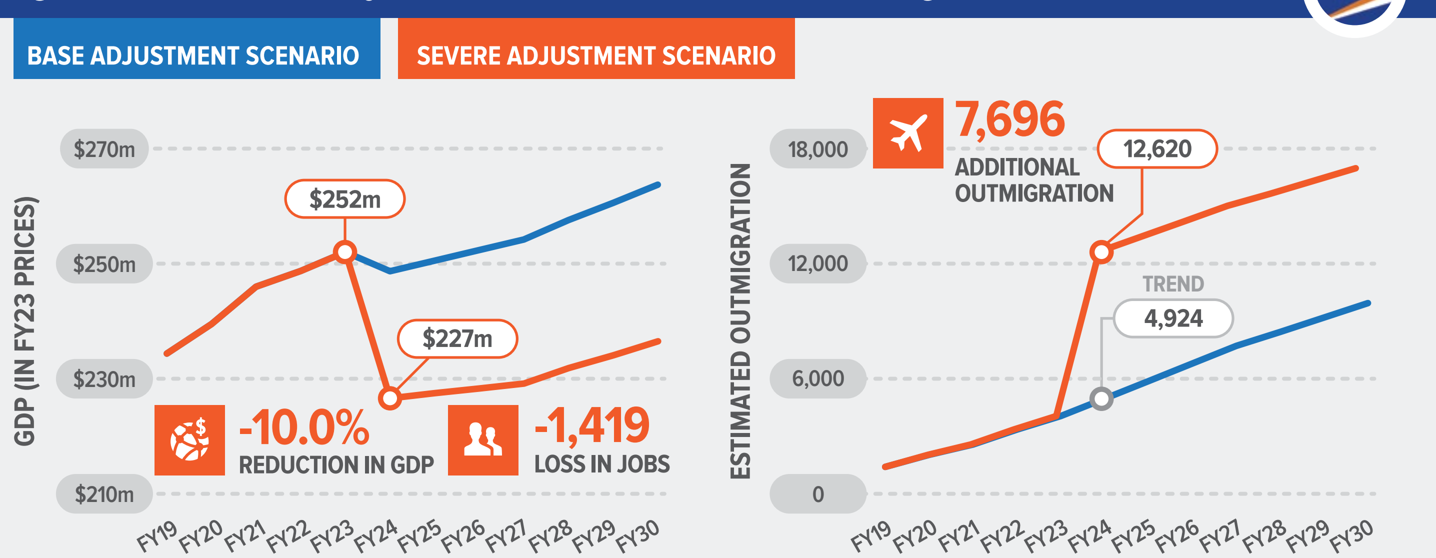
reductions necessary to restore fiscal balance under the base adjustment scenario, to cut expenses on administrative services by 25%. Proportional reductions in payroll and use of goods and services are assumed.

- To adjust to the loss of Pell grants, the government would have to shut down the College of the Marshall Islands. While this would be an extreme response, it appears necessary to allow the government to maintain essential services in primary and secondary education and health.

Figure 12 indicates the outcome of both the Base Adjustment Scenario and the Severe Adjustment Scenario. The impact rises from a loss in GDP of 1.3% to 10%. The job loss rises from 98 employees in the base scenario to over 1,400 (or 13% of total employment), in the severe adjustment scenario. The impact of the severe adjustment scenario is far more extreme than the base adjustment scenario. In the base adjustment scenario, adjustment is possible through reducing outlays on non-essential services where the impact avoided the need to cut civil servant jobs. The impact in the base scenario is on reduced demand for goods and services and falls disproportionately on the private sector. In the severe adjustment scenario, the government has no alternative but to cut services and jobs directly and, as a result, government contribution to GDP falls by 15%, which is twice the magnitude of decline of the private sector.

The potential impact on migration is substantial. The severe adjustment scenario could result in nearly 7,700 additional migrants to the US, or nearly 14% of the RMI population in FY23, if each eliminated employee migrates with dependents. In practice, actual migration is likely to be spread over more than one year and not all primary job earners or dependents migrate. The projections, while supported by observed migration spikes during past fiscal shocks, should be considered only indicative.

Figure 12: RMI Severe Adjustment Scenario: GDP, Jobs and Emigration



Palau

Economic Structure and Recent Performance Affecting Model Results

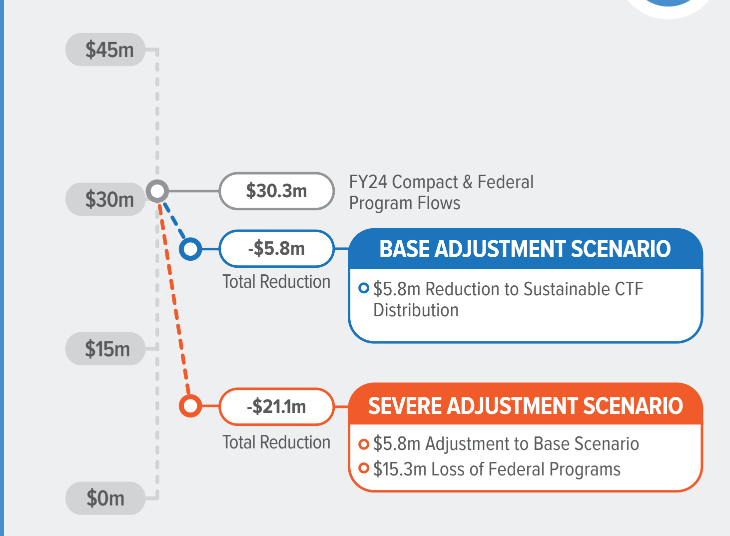
Palau's economic performance during the period FY04-FY18, overlapping with the amended Compacts of the FSM and RMI, has been modest with the economic growth averaging 0.8% during the period. This is lower than the RMI's of 1.2% growth, but considerably more than the FSM's .1% growth. Palau's low average growth during the period reflects high volatility between periods of strong growth in construction and the tourist industry, against periods of substantial contraction. The main drivers of growth have been tourism, retail, and information communication technology; with construction being a significant contributor, but highly variable.

While government represents a large share of the economy, it is less dominant than in either the FSM or RMI. The public sector has remained stationary in inflation-adjusted terms, with overall growth and variability arising from the private sector. In Palau, public expenditures represent 35% of the economy compared to 53% in the RMI and 43% in the FSM. Palau's private sector is far larger than in the two other FAS economies, representing 47% of GDP by production compared with 31% in the RMI and 19% in the FSM. Household production for home consumption (subsistence) is far higher in the FSM.

The structure and nature of the Compact relations are substantially different in Palau. In 2010 Palau agreed to a further 15-year period of economic support from the US known as the CRA. However, it was not until FY18 that the CRA was authorized and funds were appropriated by the US Congress. With additional support for the Palau CTF and resources for capital improvements, Palau is now entitled to draw $15 million annually in nominal terms for the duration of existence of the CTF. Palau remains a beneficiary of US education federal programs, which were "cashed out" and replaced by the Special Educational Grant for the FSM and RMI.

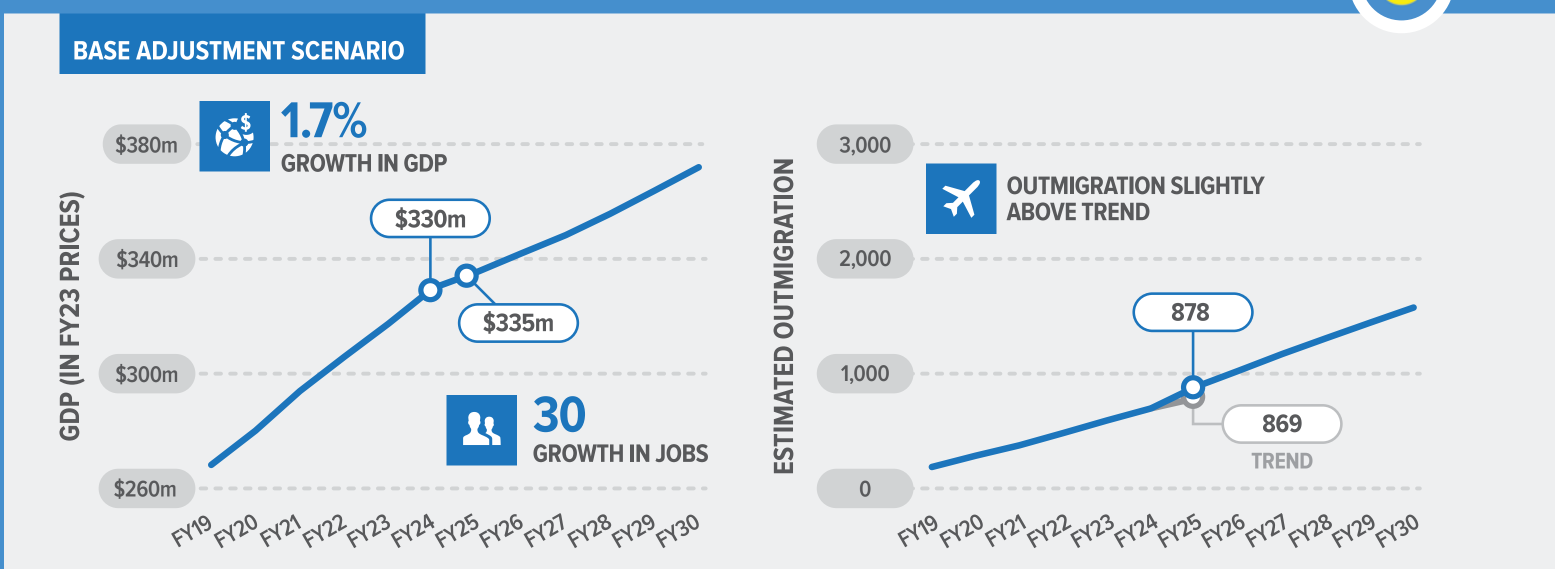
On the fiscal side, and reflecting the larger private sector, tax revenues are a larger proportion of Palau's economy (21%) than they are in the RMI (14%) or the FSM

Figure 13: Palau Downward Adjustment Scenarios: Components and Magnitudes



Note: Sustainable distributions from the CTF ($9.2 million) is assumed to be available.

Figure 14: Palau Base Adjustment Scenario: GDP, Jobs and Emigration



(12%). Sovereign rents—including the sustained growth in fisheries royalties and the FSM domicile for Japanese corporations, which have transformed government operations in the FSM and RMI—have also played an important role in Palau. However, while fisheries royalties have grown in Palau and made a key contribution to the economy in the recent tourism downturn, they are far less important and subject to possible decline with implementation of a marine sanctuary.

After a period of downturn in tourism, the Palau economy is projected to return to a more favorable environment with the sector growing at 2% per annum coupled with improvement from the current very low 30% level of plant utilization or occupancy rate to 45% in FY24. This implies an increase from the projected level of tourists in FY19 of 87,000 to 154,000 by FY24 i.e. 12% per annum, but below the peak reached in FY15 of 169,000. The economy is also expected to benefit from a series of infrastructure projects. Coupled with the rebound in tourism, the economy is projected to grow by average of 2.6% from FY19 to FY24.

The Palau base adjustment scenario

Palau faces the least severe potential consequences of adjustment after its current period of Compact funding assistance comes to an end after FY24. Under the terms of the amended Compact the level of distribution from the Palau CTF is limited to $15 million annually. Absent an amendment or extension to Compact economic assistance, in FY25 that annual distribution will not adjust for inflation.

Using the Monte Carlo analysis, the median value of the Palau CTF at the end of FY24 is projecrted at $317 million, with a corresponding SAFER distribution of $9.2 million. This potential reduction in transfers to support government operations and capital investments is specified in **Figure 13** as $5.8 million annually, which equates to 1.6% of projected GDP in FY24.

Palau's Compact does not have an SEG component, so the base adjustment scenario impact is limited to a reduction in distribution level from the Palau CTF.

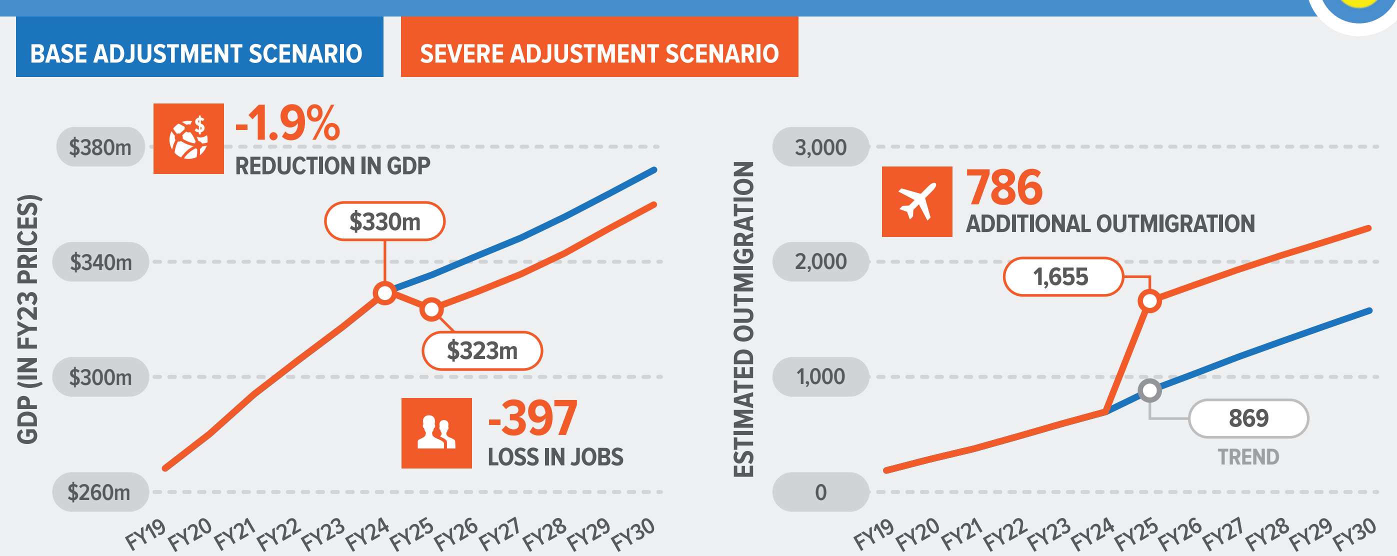
Figure 14 provides details of the impact of the base adjustment scenario on the economy. The base adjustment scenario requires an adjustment in drawdowns and conversion of the Palau CTF from the existing sinking fund approach to a perpetual fund. To maintain fiscal balance the government may consider:

- a wage freeze over a 2-year period; and
- a real cut in other non-payroll expenditures of 2%.

As a result of the adjustment, the fiscal surplus of 1.3% of GDP falls to 0.6% in FY25 and GDP growth falls from a projected 2.2% without adjustment to 1.7% with stabilization. The impact is thus a decline of 0.5% of GDP.

The impact on jobs in Palau is modest; with the underlying growth projected for the economy it remains positive. Migration is also projected to increase just slightly above the trend rate. The results projected for the base adjustment scenario suggest the Palau economy is relatively well placed to manage an adjustment of such a magnitude.

Figure 15: Palau Severe Adjustment Scenario: GDP, Jobs and Emigration



Palau Severe Adjustment Scenario

Under the unlikely, but important-to-model severe adjustment scenario, the potential additional reduction in US funding to support nearly all of the listed programs and services totals $15.3 for million annually which equates to 4.3% of projected GDP in FY24. Taken together with the base adustment, the total annual reduction in transfers would be $21.1 million annually, or 5.9% of projected GDP in FY24.

Palau benefits from the provision of US postal services, the future of which is uncertain. Loss of postal services would imply higher costs for Palauan consumers; however, the cost of subsidizing postal rates in Palau is not known and modeling the impact on public services, businesses and households is beyond the capability of the GSUSA macroeconomic modeling framework as currently developed.

In order to restore fiscal balance under the severe adjustment scenario the following assumptions have been made:

- The national government reduces the number of civil servants by over 20% with a matching adjustment in other non-payroll expenses.
- In the case of Pell, it is assumed the national government funds the former grant levels with a transfer to Palau Community College to fully make up the loss.
- The same assumptions are made with respect to the Palau Community Action Agency to maintain Head Start (pre-K) programs.

Figure 15 indicates the outcome of both the Base Adjustment Scenario and the Severe Adjustment Scenario. Under the severe adjustment scenario Palau's GDP growth in FY25 falls by 1.9% compared with FY24. Compared with the case before any adjustments, GDP is lower by about 4%. However, the impact of adjustment is quite different between the private and public sectors. Given the forced nature of adjustment, the public sector contracts by 22% at a rate proportional to the real cut in expenditures. On the other hand, the private sector comes out relatively unscathed given the continuing expansion projected in the tourism economy. The results of the fiscal shock modeled would be more extreme if, by chance, the severe adjustment shock coincided with the type of periodic tourism downturn Palau has frequently experienced.

Under the Severe Adjustment Scenario, Palau could lose 400 jobs. Based on FY18 data, Palau's labor market has more foreign workers (6,260) than Palauans (5,760). However, the civil service is dominated by Palauans, while the private and tourism sectors utilize a high proportion of foreign workers. The impact of the severe adjustment scenario is thus felt disproportionately in the Palauan segment of the labor market, with some of the displaced workers switching to the private sector.

As a result of the large number of job losses in the public service, many of the displaced workers are likely to migrate with their dependents. The labor dependency ratio in Palau is 2.0. The Severe Adjustment Scenario projects that nearly 800 Palauans would migrate to the US.

3

ADJUSTING TO POTENTIAL COMPACT FUNDING EXTENSION

3 ADJUSTING TO POTENTIAL COMPACT FUNDING EXTENSION

Chapter 2 outlined a response on the part of each FAS to reduced Compact funding without any modified development partner support and based on a program of fiscal austerity to achieve fiscal balance. The forced adjustments outlined in Chapter 2 assumed no immediate policy reforms and were largely based on expenditure compression. Fiscal balance was restored through the brute force of expenditure cuts and job losses. Leaving behind those painful scenarios it is possible to look forward with some optimism, using the GSUSA economic models to project the impact of a funded extension of the Compact for each FAS.

At the outset of this chapter the potential impact of a Compact funding extension is described for each FAS economy. Clearly, continued Compact resources would improve the outcome and avoid the cliff edge described in Chapter 2. Compact funding extension would also, if designed appropriately and funded sufficiently, fulfill the objective to establish perpetual trust funds, that would provide secure flows of resources with a high degree of certainty and without reductions in FY24/FY25. While the provision of a more secure future would avoid a shock, it would not in itself place each FAS on a higher growth trajectory. That must arise from within the FAS themselves with additional development partner support through programs to support and reward reforms.

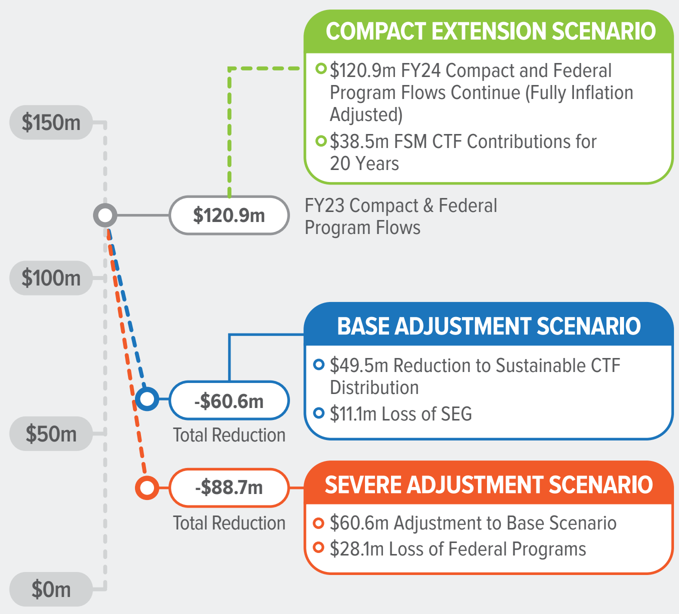
Compact Funding Extension

Continued US support assumes that the US renews and extends the amended Compact for the FSM and RMI at a level equivalent to the FY23 sum of the annual sector grants, SEG, audit, and CTF contributions. This “topline” level of ongoing US support would be subject to the same partial inflation adjustment rule that prevailed throughout the amended Compact period (two-thirds of the annual change in the US GDP deflator). However, it is assumed that the composition of the package would vary slightly from the amended Compact period. The projected levels of the sector of grants and the SEG (essentially converted into a Compact sector grant) would be fully indexed. This would end the 37-year period of partial inflation adjustment combined with periodic stepdowns (FY87-FY03) or annual decrements (FY04-FY23). Contributions to the CTF would also continue, but as a residual out of the total topline level of ongoing US support after allowance for the fully inflation-adjusted sector grants, SEG, and audits. The projections expect CTF contributions to stabilize in nominal terms albeit at lower levels than prevailed at the end of the amended Compact period. These conditions would continue for a specified period, our model uses a 20 year period. The total transfers from the US over this period would be considered sufficient in our model outcome if the CTF score at the end of the period is 95%.

As described below, the structure of support under an extension of the Palau Compact would differ from that for the FSM and RMI; but with the same objective of steady-state budgetary support, infrastructure funding, audit, and contributions to the CTF. The different approach assumed for Palau is necessitated by the fact that Palau received "lumpy" or front-loaded transfers, especially for infrastructure, under both the initial Compact period and during the CRA period. The specific amounts modeled were chosen to equate the structure during the Compact funding extension period to that of the FSM and RMI. Operating grants are assumed to be $15 million in FY24 prices and infrastructure is specified in proportion to the 70:30 percent operating grants-to-infrastructure grants ratio prevailing in the FSM and RMI. This leads to an estimated $6.5 million for infrastructure in FY24 prices. Finally, an additional annual contribution to the CTF is estimated at $3.5 million annually. As for the FSM and RMI, the topline contribution is adjusted for inflation using the two-thirds rule, while the transfers available to Palau annually would be fully inflation-adjusted. The CTF contribution is thus projected to gradually decline in real terms over the 20-year extension period. Simulations conducted by the GSUSA show that the CTF score achieved under the modeled 20 year period is 90.4%.

For all three FAS we do not account for the costs of achieving climate resilience. Credible institutions such as ADB and the World Bank are working to model—and insure against—the costs to nations to better prepare for climate events; however, the modeling approach used for this report cannot account for this important matter. It is reasonable to assume major infrastructure costs would increase by 25 percent or more for new investments. While resources are being made available to the FAS by donor partners, it is unclear if such assistance will be sustained at levels sufficient to offset the actual magnitude and frequency of climate events.

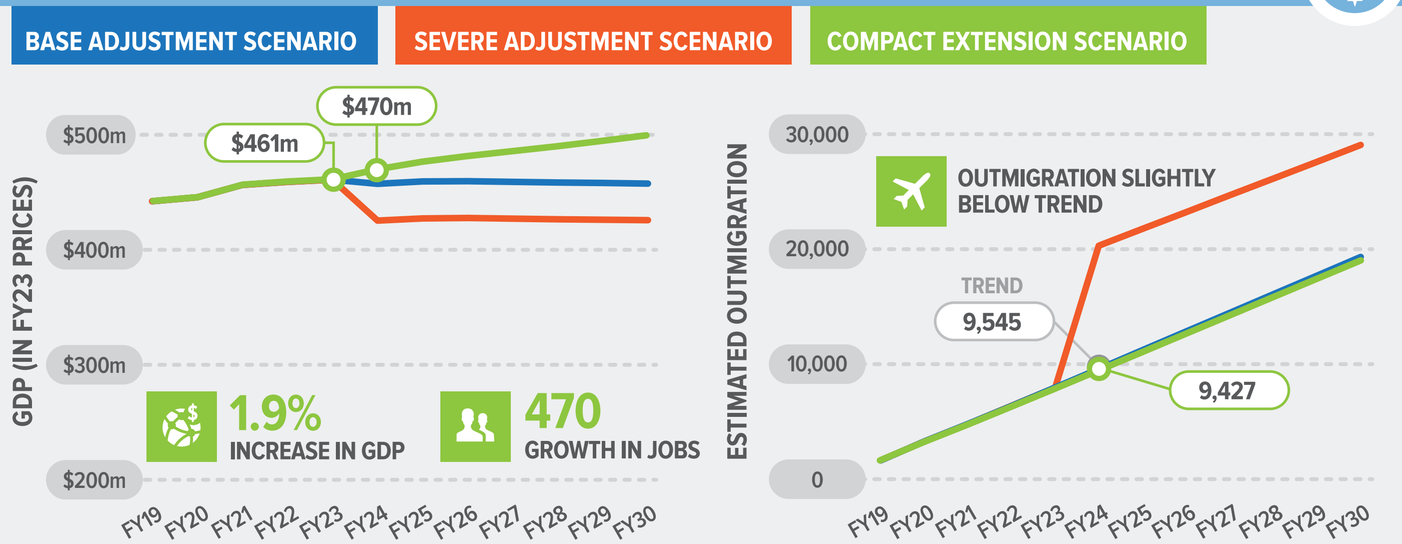
Figure 16: FSM Compact Funding Extension Scenario



The Federated States of Micronesia

In the FSM Compact funding extension scenario, sector grants, including the SEG, are projected to continue at FY23 levels fully indexed and with no decrement. **Figure 16** shows this FSM Compact funding extension scenario in comparison to the adjustment scenarios outlined in Chapter 2. In FY23 the fiscal drag imposed

Figure 17: FSM Compact Extension Adjustment Scenario: GDP, Jobs and Emigration



on the economy due to the decrement and lack of full indexation is estimated to be 0.32% of GDP. Model estimates indicate that economic growth would have been higher by approximately 0.35% annually if the fiscal drag had not been in place. The impact of continuing the Compact at similar levels to those of the amended Compact, but with full indexation and no decrement, should thus provide a modest boost to economic growth of about 1/3rd of a percent each year.

Continued Compact support to maintain CTF contributions for a term long enough to achieve a sustainable fund with a high degree of confidence would radically alter the economic and political environment in the FSM. Under such circumstance the revenue-sharing arrangements that currently exist between national and state governments would be subject to new dynamics. Arguments for recent sustained growth of sovereign rents to remain within the national government would require review. While many different revenue-sharing arrangements could be outlined, the modeling is based upon the following assumptions:

- Termination of further contributions by the national government to the FSMTF as the most prominent objective of the fund, to provide a source of revenue to replace insufficient FSMCTF resources, would no longer be required.
- Out of the FSMTF projected to be $450 million in FY23, it is assumed $100 million is set aside to support climate change and natural disasters.
- The remaining FSMTF corpus would provide a perpetual yield to be distributed to the state governments. Distributions would commence in FY24 but at an initial low rate and increase through FY30 until the SAFER drawdown target was attained. In the interim, funds would be accumulated in the FSMTF.
- Expenditures on public congressional projects are assumed to remain at the level projected during FY19-FY23 of $10.5 million annually.

Out of the continuing national government sovereign rents, a target transfer to the state governments of $25 million is projected. As in the case of the transfers to the state governments from the FSMTF, these additional funds would be released in an increasing amount over the FY24-FY30 period until the target was attained.

The above assumptions, while providing enough funds to maintain national government services at current levels, would initiate a wholly new environment at the state level. By FY30, the additional funds for the states would be close to $17 million or 3% of the projected level of GDP at that time. It is further assumed that state funds would be used to support basic services in education and health. After 37 years of fiscal drag, austerity, and reduced real value of funding at the state level, the new period under a Compact funding extension could materially improve the provision of essential government services. Of course, that is the optimistic projection of how funding level increases would be applied. Securing such improvements will require capacity building, development partner support, monitoring, and oversight to support the most effective and efficient use of the increased funds.

Figure 17 shows the impact of extending the amended economic provisions of the Compact on FSM's economy.

The impact on GDP is favorable and the economy grows by 1.9% in FY24, compared with the projected 0.8% reduction under the base adjustment scenario and the 8% reduction under the severe adjustment scenario. With the extension, the FSM economy continues to grow by an average of 1.0% in public sector led growth from FY24 to FY30, reflecting the gradual annual increase in revenue distribution from the national government and removal of the fiscal drag. The impact on employment is similarly positive with job creation expanding by an estimated 470 jobs or 2.4% in FY24 and then growing by over 1.3% annually through FY30.

Extending the Compact would also mitigate the emigration shock under the severe adjustment scenario. Emigration is projected to fall slightly below the underlying trend rate of 1.6%.

If the described extension of Compact funding were to last for another 20-year period, the FSMCTF is exceedingly likely to have achieved a sustainable level at the end of FY43. The scoring methodology used to optimize for the SAFER method uses scores for three categories: real value of the CTF, value of annual distributions, and (lack of) volatility of annual distributions. A score of 95% is analogous to a 95% statistical confidence level. Under the modeled Compact funding extension, the FSMCTF using SAFER rules achieves a score of 96% and there are zero cases of zero distributions over the period FY24-FY63. In the absence of Compact funding extension, the FSMCTF would score 33% using COFA rules and 89% of cases result in at least one zero distribution year over the period FY24-63.

The Marshall Islands

In the RMI Compact funding extension scenario, as in the case of the FSM, sector grants, including the SEG, are projected to continue at FY23 levels—fully indexed and with no decrement. **Figure 18** shows this RMI Compact funding extension scenario in comparison to the adjustment scenarios outlined in Chapter 2. In FY23 the fiscal drag imposed on the economy due to the decrement and lack of full indexation is estimated to be slightly higher than the FSM. Model estimates indicate that economic growth would have been higher by approximately 0.36% annually if the fiscal drag had not been in place. The impact of a continuation of the Compact at similar levels to those of the amended Compact, but with full indexation and no decrement should thus provide a modest boost to the economy of about 0.33%.

In the case of the FSM, Compact renewal enables release of the large fiscal surplus and distributions from the FSMTF to be allocated to the state governments. In the RMI, however, no such fiscal surplus has been established, and no significant pool of resources is available after FY23. As a result, the benefits of Compact renewal are restricted to the elimination of the fiscal drag.

Figure 19 shows the impact of the extension of the Compact on the RMI economy. Compared to the base adjustment scenario, the impact on GDP in FY24 is favorable as the economy avoids the need to adjust. GDP under the extension scenario is projected to grow by 0.4% compared with a reduction of 1.3% in the base adjustment scenario and a reduction of 10% in the severe adjustment scenario. Over the period FY24 to FY30 under the extension scenario, economic growth averages 0.9% compared with 0.6% in the base adjustment scenario and 1.0% during the amended Compact period. Employment is projected to grow at similar rates to GDP. Over the period FY24 to FY30 960 new jobs are created, but the projection for job growth in FY24 is only slightly above trend. As a result, the impact on migration is negligible.

The analysis indicates that the impact on the RMI economy of Compact funding extension is little different

Figure 18: RMI Compact Funding Extension Scenario

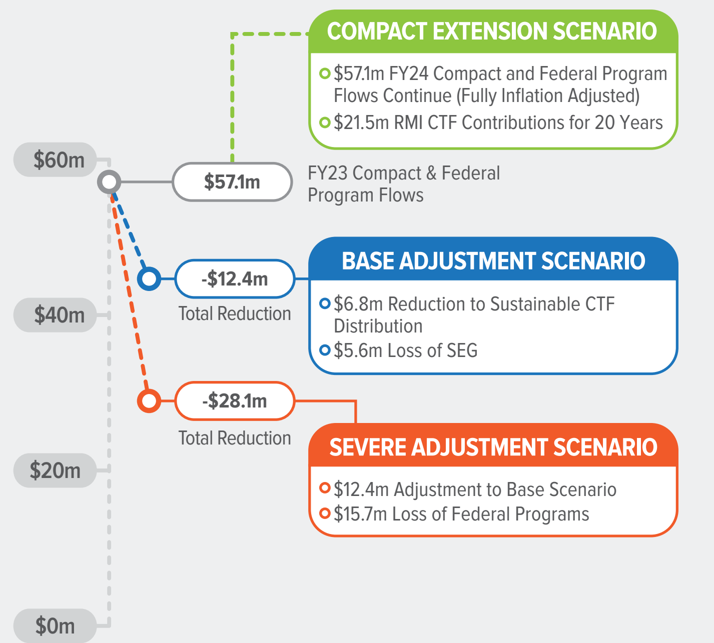
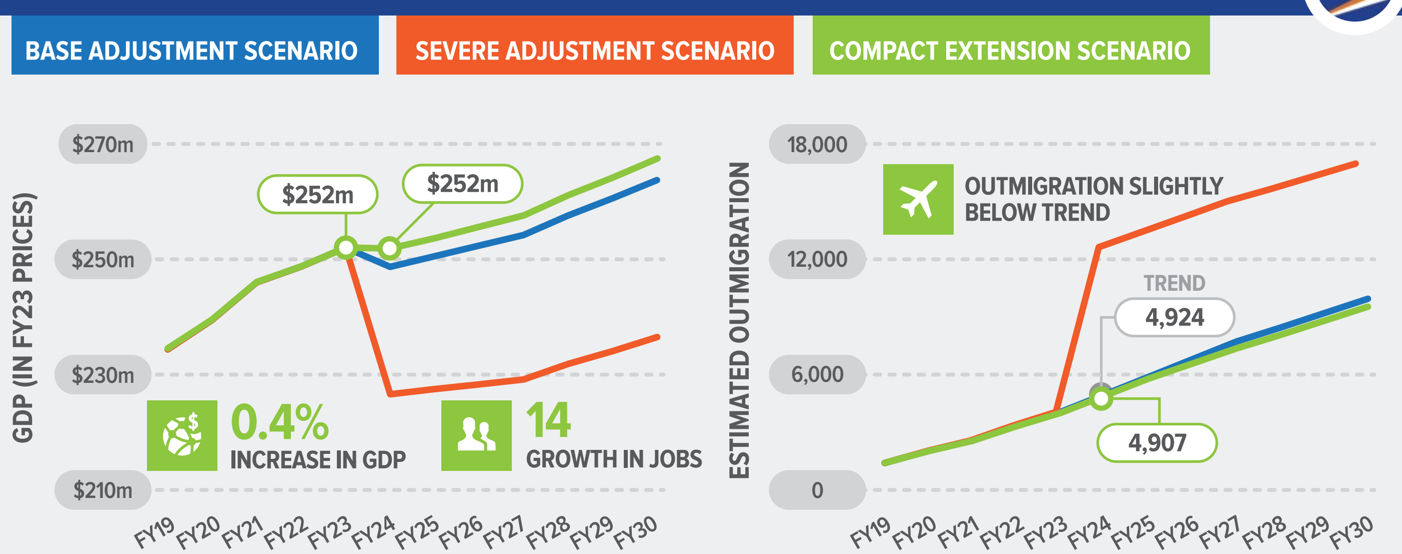


Figure 19: RMI Compact Extension Adjustment Scenario: GDP, Jobs and Emigration



from the base adjustment scenario. The RMI has already absorbed the benefit of the increase in sovereign rents and there is no pool of savings to buffer the adjustment. Still, the benefit of a known future and the economic security that Compact funding extension would entail would likely result in changes in behavior and economic benefits that the model is unable to simulate. The results of the Compact funding extension scenario illustrate that better results will require a commitment to policy reform in the RMI coupled with development partner support.

If the extension of Compact funding were to last for another 20 years, the RMICTF is exceedingly likely to have achieved a sustainable level at the end of FY43. The scoring methodology used to optimize for the SAFER method uses scores for: real value of the CTF, value of annual distributions, and (lack of) volatility of annual distributions. A score of 95% is analogous to a 95% statistical confidence level. Under the Compact funding extension, the RMICTF using SAFER rules achieves a score of 99% and there are zero cases of zero distributions over the period FY24-FY63. In the absence of an extension, the RMICTF would score 75% using COFA rules and 56% of cases would have at least one zero distribution year over the period FY24-63.

Palau

The Compact funding extension scenario for Palau considers continued US support to establish a perpetual Palau CTF and a further program of investment in infrastructure. **Figure 20** shows this FSM Compact funding extension scenario in comparison to the adjustment scenarios outlined in Chapter 2. The program entails three components:

- US operating grants are set at $15 million annually in FY24 prices.
- As noted the level of infrastructure grants is modeled at $6.5 million annually in FY24 prices so that the same 70:30 ratio for operating grants to infrastructure grants is established for Palau as exists already for the FSM and RMI.
- Annual contributions to the Palau CTF are set at $3.5 million in FY24 prices. Since the topline level of transfers from the US is presumed to maintain a two-thirds inflation adjustment, this component is modeled as the residual of that adjustment while allowing the other two components to be fully inflation adjusted.

Figure 21 shows the potential benefits of such an extension. As in all other scenarios, the projections assume fiscal balance. Without the need for adjustment in FY25 to a lower real distribution from the Palau CTF, the economy maintains its forward momentum, including the projected recovery of the tourism sector through the remainder of the CRA period. GDP is projected to grow by an average of 2.6% per annum during FY25-FY30. In comparison with the base adjustment scenario, this equates to a 0.6% annual improvement. This outcome is based on no change in the level of private sector activity and is solely due to the Compact funding extension which supports a modest expansion in the provision of public services of 1% per year from FY24 to FY30.

In the case of employment, the additional hiring associated with the infrastructure program and modest expansion in the provision of public services add an estimated 136 jobs in FY25 and an additional 300 jobs or 5% of the labor force above the level created under the base adjustment scenario through FY30.

Figure 20: Palau Compact Funding Extension Scenario

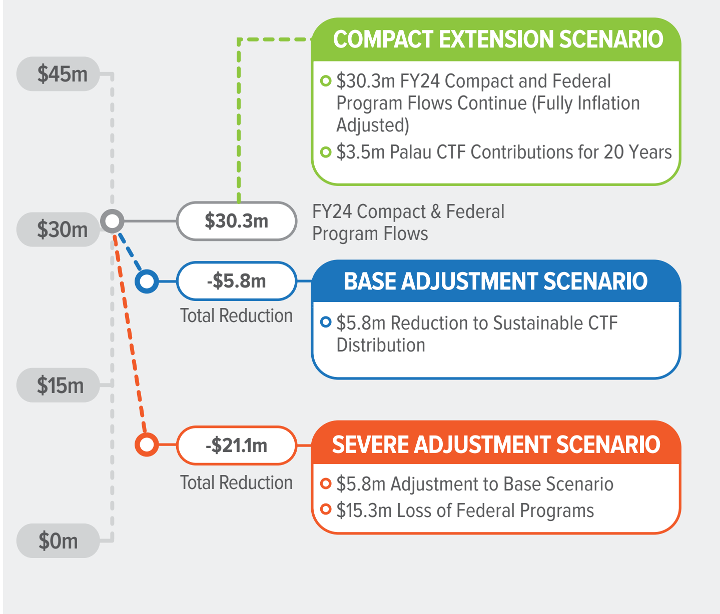
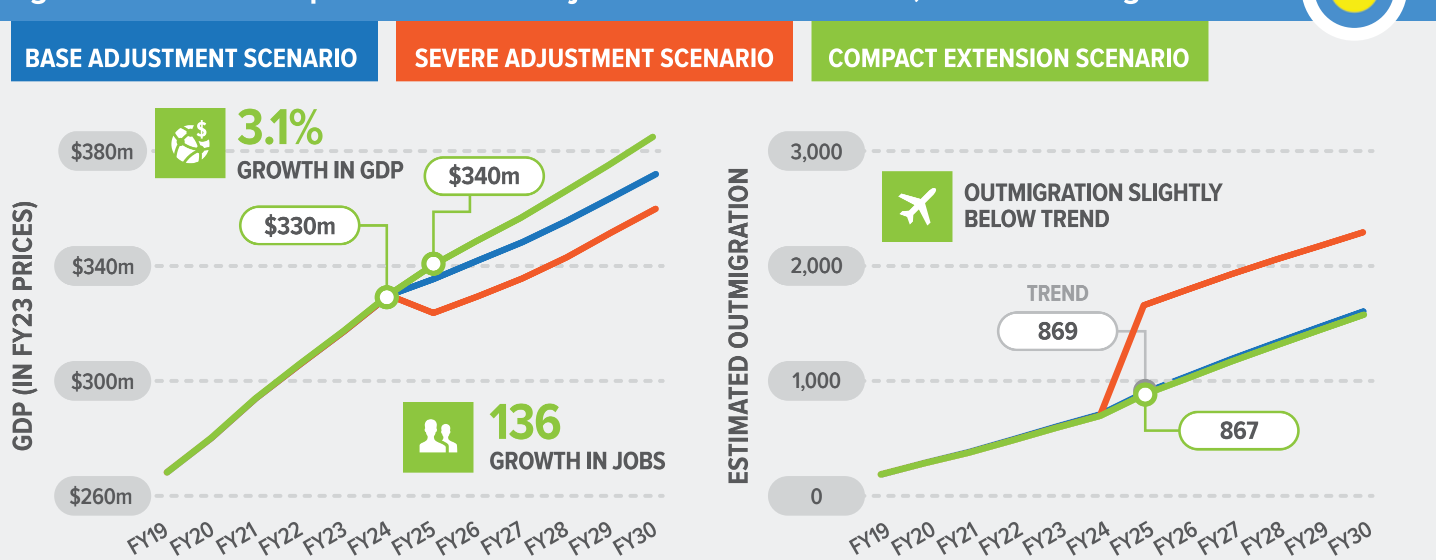


Figure 21: Palau Compact Extension Adjustment Scenario: GDP, Jobs and Emigration



Projections show a negligible reduction in migration in FY25 under the Compact funding extension scenario.

If the described extension of Compact funding were to last for another 20-year period, the Palau CTF is likely to have achieved a sustainable level at the end of FY43. The scoring methodology used to optimize for the SAFER method uses scores for three categories: real value of the Palau CTF, value of annual distributions, and (lack of) volatility of annual distributions. A score of 95% is analogous to a 95% statistical confidence level. Under the modeled Compact funding extension, the Palau CTF using SAFER rules achieves a score of 95% and there are zero cases of zero distributions over the period FY24-FY63. In the absence of Compact funding extension, the Palau CTF would score 62% using COFA rules and 18% of cases result in at least one zero distribution year over the period FY24-63. The COFA rules for Palau are such that the 18% of cases with a zero distribution is equal to the number of cases where the CTF is completely exhausted during the period.

Estimating the Cost to the US of Compact Funding Extension

The Compact funding extension scenarios for each FAS can be readily estimated based on the topline funding level for each FAS and assumptions about inflation over the 20-year period for the FSM and RMI (FY24-FY43) and for Palau (FY25-FY44). Recall that the topline funding level includes sector grants, SEG, audit, and CTF contributions for the FSM and RMI. The sector grants are generally assumed to retain the 70:30 proportion of operating-to-infrastructure support. For Palau, an equivalent structure includes a topline funding level made up of operating grants, infrastructure funding, audit, and CTF contributions. Table 1 below shows the estimated costs to the US for the modeled Compact funding extension scenarios. Also included is the projected score of the CTF at the end of the 20-year extension looking forward to the following 20 years after FY43 for the FSM and RMI and after FY44 for Palau.

Cost to the US of a 20 Year Compact Funding Extension (As Modeled)

	FSM	RMI	Palau
Total transfers/contributions in FY23/24 prices	$2.27 B	$1.02 B	$0.47 B
Total transfers/contributions in current prices	$2.79 B	$1.29 B	$0.58 B
Projected CTF score at end of FY43/44	92.80%	97.10%	90.40%

Estimated Compact Trust Fund Values at 4/30/2020

4

ARE BETTER RESULTS POSSIBLE?

4 ARE BETTER RESULTS POSSIBLE?

This chapter begins with a brief description of the preparatory actions taken by each affected party to prepare for potential outcomes at the end of the secure funding period under its respective Compacts. A brief summary of the policy agenda that each FAS and the development partners might undertake to achieve improved performance follows. Finally, the authors offer some concluding remarks.

Current State of Preparedness of the Parties

FSM

The FSM has established a working body, called the Joint Committee on Compact Review and Planning (JCRP). The JCRP was created “to coordinate the country’s preparation efforts towards effective and smooth … government upon expiration of the economic provisions of the Amended Compact of Free Association with the United States [after FY23].”

JCRP has designated a Chief Negotiator, the current Chief of Staff to the President of the FSM. JCRP has also made significant efforts to prepare for either a termination of the economic provisions under the Compact, or for negotiations to extend those economic provisions. While there is no planning or fiscal strategy framework that would be applicable across all five governments of the FSM, the national government has made comprehensive efforts to: (i) maintain a structural fiscal surplus to mitigate against a moderate level of adjustment, and (ii) set aside substantial funds in the FSMTF, with some funds designated for the states.

Thus, in terms of preparation for the possible fiscal outcomes in the post-FY23 period, the FSM, especially through the national government, has the means—if allocated to best address a fiscal shock primarily affecting the state governments—to substantially reduce the impact of a shock of the magnitude modeled in the base adjustment scenario.

The FSM is, however, quite unprepared to mitigate the greater impacts associated with the severe adjustment scenario. As such, that more severe scenario would result in unprecedented disruptions to public services, an alarming loss of jobs, especially in the public sector, and an astonishing spike of emigration.

RMI

The RMI named a Chief Negotiator, the then Minister of Foreign Affairs, and a negotiating committee staffed by the Ministry of Foreign Affairs and select government officials and outside counsel. The new Administration formed in January 2020 will likely modify the composition, and perhaps even the structure, of its Compact negotiation entity.

In terms of preparation for the possible fiscal outcomes in the post-FY23 period, the executive branch has initial drafts of a fiscal responsibility framework and a long-term fiscal strategy that would serve the government well in the event of forced fiscal adjustments. However, this is not equivalent to adopting a program that would—if fully implemented—put the RMI on a path to manage effectively a shock of the magnitude of the base adjustment scenario. Still, the magnitude of reforms that base adjustment scenario would force would not be unprecedented and would result in only a minor economic impact.

The RMI is quite unprepared to mitigate the greater impact modeled in the severe adjustment scenario. As such, the severe adjustment scenario in RMI would cause unprecedented disruptions in public services, a significant loss of jobs, especially in the public sector, and a spike in emigration.

Palau

Palau is, perhaps, getting a later start than its two sister FAS-nations in preparing for scenarios that may arise in FY25 after the end of its 30th year of a 50 year Compact of Free Association. The primary reason is that the CRA it signed on 3 October 2010, was not fully funded until September 2018. Some of the terms of the CRA are just now being discussed for implementation. In terms of preparing for an early start to negotiations (or an early convening of the next mandated section 432 Review), Palau has not created a statutory or officially designated entity. However, the President has designated an interim team to meet with US officials and to make recommendations about next steps. The members are led by the Vice President and include the Minister of Finance and the two Chairmen of the Ways and Means Committees in the Senate and House.

In terms of preparing for the possible fiscal outcomes after FY24, the executive branch has developed a program of actions that could—if fully implemented—enable Palau to manage the base adjustment scenario effectively. The program would leave Palau with some ability to mitigate the greater impacts of the severe adjustment scenario. However, the severe adjustment scenario would still result in significant disruptions to public services, significant job losses, especially in the public sector, and a spike in emigration.

United States

The US has a standing mechanism to monitor and implement its policies toward the three FAS—an Inter-Agency Group (IAG) that is led by the White House (National Security Council), and has both a small group with key agencies and a broader group meant to encompass all agencies with programs or interests in the FAS. The IAG holds meetings on an as-needed basis. Over the past two years, the IAG has scaled up engagement due to one key policy factor and one major timing factor. The policy factor of most concern to the US is the need to offset China's growing influence in the Pacific region, and specifically in the Western Pacific. This policy concern is captured by the US government's "Free and Open Indo-Pacific Strategy," which is shared with key regional allies, including Japan, Australia, and New Zealand. This policy concern as it relates to the FAS clearly raises the visibility and importance of the relationships with each nation and with the combined land and ocean space controlled through the three Compacts of Free Association with the FSM and the RMI until mutually dissolved and with Palau until that Compact expires at the end of FY44.

The timing factor which has led to the increased frequency and urgency of IAG meetings is the timing built into the three Compacts of Free Association. The inflection point for a change in funding arrangements happens after FY23 for the FSM and RMI and for Palau after FY24. As described in chapter 2, the consequences of letting the existing terms of each Compact prevail are significant—especially in the model results of the severe adjustment scenario for each nation. Alternatively, the benefits to an extension of substantial US funding are shown in chapter 3. The IAG is considering the possibility that a cessation of US funding could create a funding gap, which China could in turn leverage to increase its presence and influence in the FAS.

Major multi-lateral donors: WB, ADB, EU

The FSM and the RMI have recently benefited from a large increase in funding commitments from the World Bank and an unrelated, but timely, designation that allows for grant-only assistance. The grant-only status is the result of a joint World Bank-International Monetary Fund Debt Sustainability Analysis (DSA). The risks faced by the FSM and the RMI after FY23 contribute substantially to the debt stress finding. Current program plans indicate World Bank annual support for infrastructure and sector programs and projects at $20 million for the FSM and $15 million for the RMI. Each of the two FAS also have access to a regional ICT facility. The FSM has already received more than $50 million for fiber-optic connectivity plus, technical assistance in the telecommunications sector. The RMI has the potential to receive over $25 million for connectivity in addition to technical assistance.

Palau has the potential to borrow at non-concessional rates from the World Bank in the range of $12 million annually. To date Palau has chosen not to borrow from the World Bank. Indications are that each FAS could, potentially, receive as much as one-third of its program support in the form of budgetary support in the event of a major fiscal shock; however, such support would typically be associated with macroeconomic or sector policy reforms that had already been achieved.

ADB has provided long-standing support to all three FAS. ADB follows the DSA finding and thus currently provides grant-only funding to the FSM and the RMI. Current program plans indicate ADB's annual support for infrastructure and sector programs and projects is $13 million for the FSM and $10 million for the RMI. Palau can borrow roughly $20 million annually from ADB. To date Palau has outstanding balances of $48 million with the ADB for loans that supported water and sanitation improvements and ICT investments. Indications are that each FAS could, potentially, receive as much as a third of its program support in the form of budgetary support in the event of a major fiscal shock; however, ADB would need to ensure that policy reform was addressed in any such allocations.

The increased presence of multilateral donors creates an opportunity for those donors to play an increased role in development partner collaboration. Beneficial collaboration is dependent upon strong macroeconomic and sector data systems and policy analysis capacity within each FAS. There is an important role for support to fiscal and economic management in all three countries with a focus on capacity gap-filling and, more importantly, long-term capacity-building.

ADB has a history dating back to 1996 of supporting development partner meetings in the FSM and RMI. Periodically, ADB supported each country with technical support through resident advisory teams. There is a correlation between that level of intensive support with periods of effective reform and accelerated improvements in public financial management (PFM). Government commitment to policy reform and PFM improvements is a necessary condition; however effective implementation of country commitments is also associated with extended technical support that involves substantial investments in local hire counterparts and advanced training.

Major Bi-Lateral Donors

Japan aids all three FAS. Infrastructure projects remain the largest share of support. Japan also provides support for sector projects, equipment purchases, and scholarships. Indirectly, Japan funds UNDP for support to the FAS in disaster preparation and through Australia to support operating costs under the maritime patrol boat program. The Government of Japan has initiated its own "Free and Open Indo-Pacific Strategy." While its aid levels to the Pacific will increase, modalities will remain the same. There is no direct mechanism for Japan to provide budgetary support in the event of a major fiscal adjustment, and embassy officials in two of the three FAS embassies indicated they have received no requests related to the potential FY24/FY25 adjustments. Officials indicated they are tracking the matter closely with each FAS and through dialogue with their US embassy counterparts.

Taiwan,China is an important development partner for the RMI and Palau. Programs in each country were recently renewed (after 20 years) to maintain a similar level of annual funding. All the support to Palau is in the form of projects. The same is desired by Taiwan,China in the RMI; however, a portion of annual assistance can be reprogrammed to provide budget support. Taiwan,China has also committed a total of $40 million to the RMICTF. Taiwanese embassy officials in both countries indicated they have received no requests related to the potential FY23/FY24 adjustment.

China is an important development partner for the FSM. The focus of the program is large, visible construction projects. Examples include: a multi-purpose gym at the national campus of the College of Micronesia, vital ships for inter-island transportation; homes at the Palikir capital for the leadership of all three branches of the FSM national government; and state capital complexes for Pohnpei and Chuuk. The FSM currently receives grants from China and is thus not subject to any risk of debt stress. China has announced its intention to continue its program of support to the FSM through major projects, sector projects, and scholarships.

Australia provides a relatively small amount of support to the FAS. All three share an annual direct and regional aid allocation of $5 million to support regional projects, scholarships, and PACTAM advisors for capacity-building. All three of the FAS also benefit from Australia's Maritime Patrol program. In 2019 Australia renewed support for that maritime program to include a new fleet of boats and associated surveillance equipment. There is no direct mechanism for Australia to provide budgetary support in the event of a major fiscal adjustment and officials from their FSM embassy covering all three FAS indicated they have received no requests related to the potential FY23/FY24 adjustment. The same officials referred to the Australian Prime Minister's plan to open an embassy in every Pacific Island Forum nation. Thus, Australia plans to open new embassies in the RMI and in Palau with a likelihood that direct aid budgets will be enhanced accordingly.

Potential Reform Agenda for Improved Performance with Compact Funding Extension

The discussion in the previous section indicated potential economic benefits of the modeled Compact funding extension. The results differ among the three FAS, with economic performance improving the greatest in the FSM. Palau shows significant potential benefits and the RMI shows only a modest positive impact. The different impacts reflect the differing circumstances of the three nations and, importantly, the varying degrees of US support. As chapter 1 outlined, the potential outcomes of the coming negotiations are not known with certainty. It is clear, though, that the US is committed to a negotiation process likely to lead to an extension. While the severe scenario is unlikely, the eventual outcome of negotiations might lie anywhere between somewhat worse than the base adjustment scenario and the best-case robust Compact funding extension scenarios.

The growth projections in chapter 3, although an improvement over the downward adjustment scenarios of chapter 2, indicate the impact of public sector-led growth through a sustained fiscal stimulus rather than through enhanced private sector activity. The initial and amended Compact periods both placed emphasis on economic sustainability and development. These important objectives will likely continue to feature in any mutually agreed Compact funding extension. Implementation would, therefore, entail reform programs to improve not only the efficiency and effectiveness of service delivery in the public sector, but also reform to support private sector development. In the case of favorable Compact negotiations, reforms coupled with a secure and known future, would place the three FAS on a higher growth trajectory. In the case of less favorable Compact funding extension terms, donor assistance and domestic reform will become essential to sustain even disappointing economic performance.

It is not within the scope of this study to outline a specific program of reform for each FAS. Rather, an indicative list of key areas of reform is provided. In separate, country-specific papers, further specification both on progress to-date and priorities going forward for the same key areas of reform will be detailed. In that more detailed format, the role of the development partner community will also be discussed to support the specific elements of the reform process.

Key areas of public sector reform

The following list indicates some of the areas with potential for improvement within the public sector:

- Fiscal responsibility
- External debt
- Tax reform
- Public financial management
- Fiscal reserves
- Social security and pension reform
- State-owned enterprise reform

Key areas of reform for private sector development

The recent World Bank 2019 "Doing Business Survey"[1] provides an overall assessment of the environment for private sector development in the FAS. The FSM, RMI and Palau rank 160, 150 and 133 out of a total 190 countries included in the study, indicating a generally weak environment for private sector growth. Two further studies conducted by the Pacific Private Sector Development Initiative provide an excellent analysis of the environment for private sector development in the RMI[2] and Palau[3], confirming the picture presented in the World Bank overview. No similar evaluation has been conducted for the FSM in recent years. The following are some of the issues affecting private sector growth in need of reform:

- The regulatory environment
- Land reform
- Credit availability
- Foreign direct investment
- Domestic fishing policies

Development Partner support and coordination

The former section is intended to provide an indication of the breadth of reform issues that require attention and resolution for the economies to function well and

1 World Bank, *Doing Business 2019; Training for Reform*, The World Bank, Washington DC, 2019
2 Pacific Private Sector Development Initiative (PSDI), *Republic of the Marshall Islands: Private Sector Assessment*, Sydney, Australia, 2017.
3 Asian Development Bank, *A private sector assessment for Palau: Policies for sustainable growth revisited*, Mandaluyong City, Philippines, 2017.

to achieve sustained improvements. The development partner community has supported reforms in the past, but the opportunity provided by a Compact funding extension could be an impetus to accelerate the reform agenda. While opportunities for growth in small remote island economies are limited, reforms in both the public sector and the environment for private sector growth could bring about better results. The development partner community has a vital role to play in building capacity and supporting reforms.

During the last few years—with the emergence of the World Bank as a major player in the subregion, coupled with additional resources from ADB—the development partner community has been well placed to finance public infrastructure alongside sustained, complementary technical assistance. While budgetary support has not been a part of the recent development partner programs, it could be used to support and reward the implementation of long-delayed reforms. In summary, in the case of less favorable compact negotiations, coordinated donor action will be essential for mitigating shocks and smoothing adjustments. In the case of a favorable outcome of Compact funding extension, development partner actions can assist each FAS to improve its economic growth rates and help ensure growth is increasingly driven by the private sector.

Concluding Observations

This study has attempted to provide timely analysis of just three scenarios. Already, in discussions with the principal parties, it has become clear that the range of likely scenarios differ in some important ways from those specific scenarios modeled in this study. Still, this study's scenarios are intended to "bracket" the likely outcomes. It seems clear that all likely negotiated outcomes will be an improvement on the "severe adjustment scenarios." It may be possible that the assumptions used and the US funding level implicit in 20-year versions of the "Compact funding extension scenarios" will prove to be overly optimistic. If so, then the study will have succeeded in providing both a lower bound and an upper bound. It is hoped that the analysis may thus prove useful to the affected parties as they prepare for negotiations. The announcement by the US government that it seeks negotiations to extend all three Compact funding periods has been welcomed by all three FAS governments. The modeling shows that the opportunities for improved economic performance, job creation, and perhaps even a modest reversal of emigration trends for each FAS are enhanced in proportion to the level and length of ongoing Compact and related federal funding.

This study has also attempted to avoid offering recommendations or proffering advice. It would be tempting to conclude, for example, that the relatively weaker performance of the FSM economy over the recent period was primarily a function of the prevailing policy environment. The FSM's own policy reform commitments remain partially or wholly unfulfilled; however, it is important to recognize that the FSM, with its unique federal structure, has spent at least the last eight years preparing for a major post-FY23 fiscal adjustment. To the FSM's credit, the minimal impact of the "base scenario adjustment," shows that the FSM has prepared itself to adjust to that level of fiscal shock without a major decline in economic activity or loss of jobs. In the event of a robust Compact funding extension, even the most pessimistic economists might set aside their prototypical "dismal" outlook and agree with the positive outcomes modeled for the FSM.

The authors confess that the scenario analysis used in this study relies heavily on a specific approach to how the Compact Trust Funds may be managed in the future. It is recognized, for example, that in the "base and severe scenarios" the immediate shift to what is defined as a SAFER distribution rule calls for a potentially severe, one-time adjustment at the very outset. For the FSM and RMI the parties could choose to take larger—even maximized—distributions in the early years. However, the modeling indicates that such an approach increases—and in the case of the FSM—virtually ensures future years with minimal or even zero distributions. The approach modeled with an insistence on shifting immediately to a sustainable distribution level may lead to an overstatement of the adjustment that might be required in the near-term. But this approach has one important virtue. Painful adjustments are not masked by pushing them just beyond the horizon of the modeling results. In the event of a robust Compact funding extension, the benefits of a SAFER distribution rule will remain while the immediate pain of a substantial adjustment would be either mitigated or eliminated entirely.

The authors are hopeful that in an "all good things go together" scenario, the combination of a robust Compact funding extension will be coupled in time with an increase in major development partner financial and technical assistance. This will allow for each FAS to effectively increase its efforts with respect to fiscal and economic reforms consistent with its own desired path to sustained economic growth.

ASIAN DEVELOPMENT BANK