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

**DRAFT FOR DISCUSSION**

April, 2022

ASIAN DEVELOPMENT BANK

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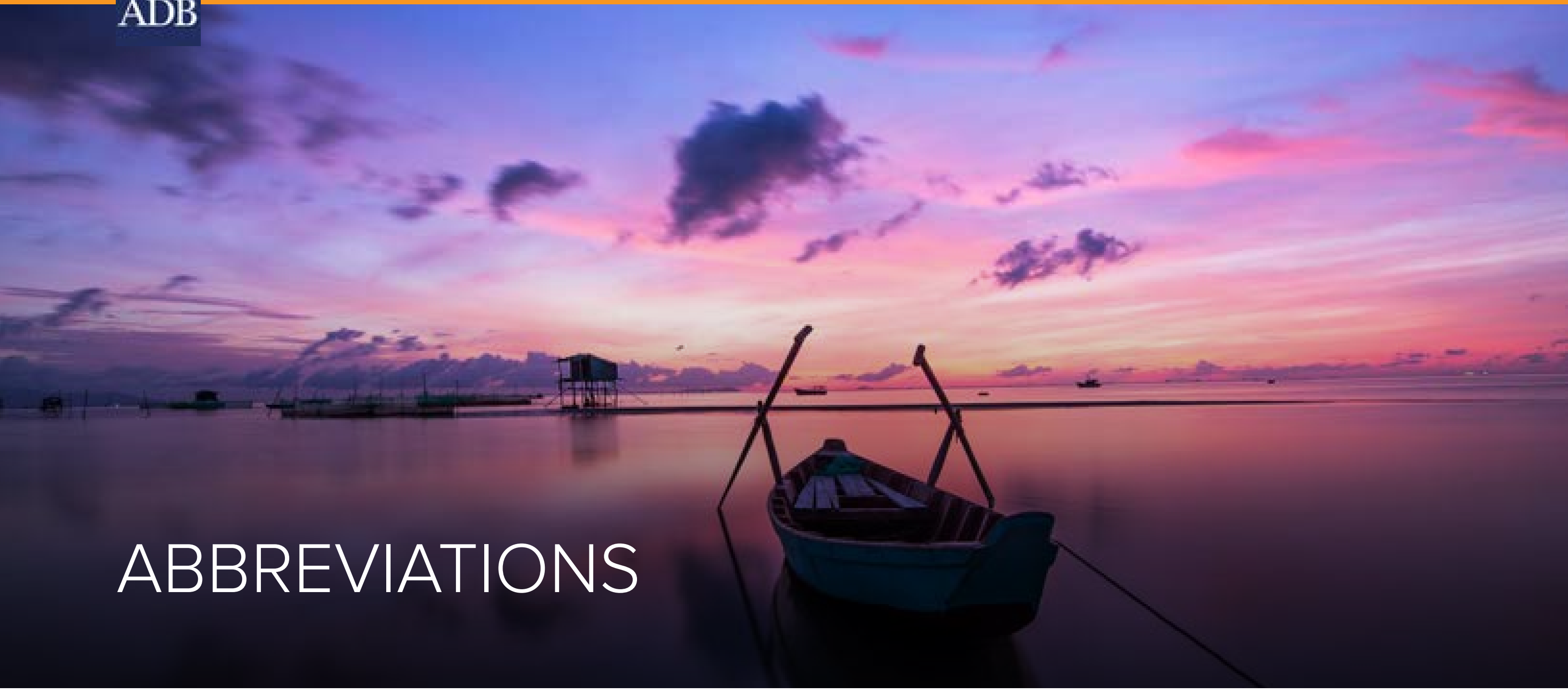

# ABBREVIATIONS

**CURRENCY EQUIVALENTS**

Currency unit: United States dollar (US$)

**ABBREVIATIONS**

| | | |
|---|---|---|
| ADB | — | Asian Development Bank |
| Amended Compact | — | second phase of the Compact (FSM and RMI), FY2004–FY2023 |
| CARES | — | Coronavirus aid, relief, and economic security |
| CDC | — | Centre for disease control |
| COLA | — | cost-of-living adjustment |
| COVID | — | Corona virus disease |
| CoM | — | College of Micronesia |
| Compact | — | Compact of Free Association with the United States (FSM, RMI and Palau) |
| Compact I | — | first 17 years of the Compact, FY1987–FY2003 (FSM and RMI), and Palau, FY1995-FY2009 |
| CPI | — | consumer price index |
| CPRO | — | Coronavirus pandemic relief option |
| CRA | — | Compact review agreement (Palau), FY2010-FY2024 |
| CTF | — | Compact Trust Fund |
| DOE | — | Department of education |
| DOI | — | Department of the Interior (US) |
| DRP | — | Disaster Resilience Program |
| DSA | — | Debt sustainability analysis |
| EAG | — | Economic advisory group (Palau) |
| FAA | — | Federal Aviation Administration |
| FAS | — | Freely Associated States |
| FDI | — | foreign direct investment |
| FDIC | — | Federal Deposit Insurance Corporation |
| FPA | — | Federal procedures agreement |
| FPUC | — | Federal Pandemic Unemployment Compensation |
| FSM | — | Federated States of Micronesia |
| FSMa | — | Federated States of Micronesia arrangement |

| | | |
|---|---|---|
| FSMCTF | — | Federated States of Micronesia Compact Trust Fund |
| FSMTF | — | Federated States of Micronesia Trust Fund |
| FTE | — | Full time equivalent (jobs) |
| GAO | — | Government Accountability Office |
| GDP | — | gross domestic product |
| GNI | — | gross national income |
| GNP | — | gross national product |
| GRT | — | gross receipts tax |
| GSUSA | — | Graduate School USA |
| HEALS | — | Health and livelihoods support program |
| HLDP | — | Housing loan development program |
| ICT | — | information and communication technology |
| IAG | — | Inter-Agency group (US executive) |
| IMF | — | International Monetary Fund |
| IATA | — | International Air Transport Association |
| ICOR | — | Incremental Capital Output Ratio |
| ICT | — | Information and communications technology |
| IOM | — | International Organization for Migration |
| JCRP | — | Joint Committee on Compact Review and Planning |
| JEMCO | — | Joint Economic Management Committee |
| JEMFAC | — | Joint Economic Management and Financial Account-ability Committee |
| MUORA | — | Military use and operating rights agreement (RMI) |
| NDBP | — | National Development Bank of Palau |
| NORMA | — | National Oceanic Resources Management Authori-ty (FSM) |
| OIA | — | Office of Insular Affairs (DOI) |
| PACTAM | — | Pacific Technical Assistance Mechanism (Australia) |
| PBL | — | Policy based loan |
| PCR | — | Polymerase chain reaction |
| PFM | — | Public financial management |
| PNA | — | Parties to the Nauru Agreement |
| PPUC | — | Palau public utilities corporation |
| PUA | — | Pandemic Unemployment Assistance |
| RISES | — | Recovery through Improved Systems and Expendi-ture Support |
| RMI | — | Republic of the Marshall Islands |
| RMICTF | — | Republic of the Marshall Islands Compact trust fund |
| ROC | — | Republic of China |
| ROP | — | Republic of Palau |
| RUS | — | Rural Utilities Service (RUS) |
| SAFER | — | Sustainability adjustment for enhanced reliability (GSUSA) |
| SEG | — | Supplemental Education Grant |
| SOE | — | State-owned enterprise |
| TA | — | technical assistance |
| TSMRF | — | Tourism sector mitigation relief fund |
| TT | — | Trust Territory |
| UNDP | — | United Nations Development Program |
| US | — | United States |
| VDS | — | Vessel Day Scheme |

**NOTE**: Each FAS governments' fiscal year (FY) ends on September 30.

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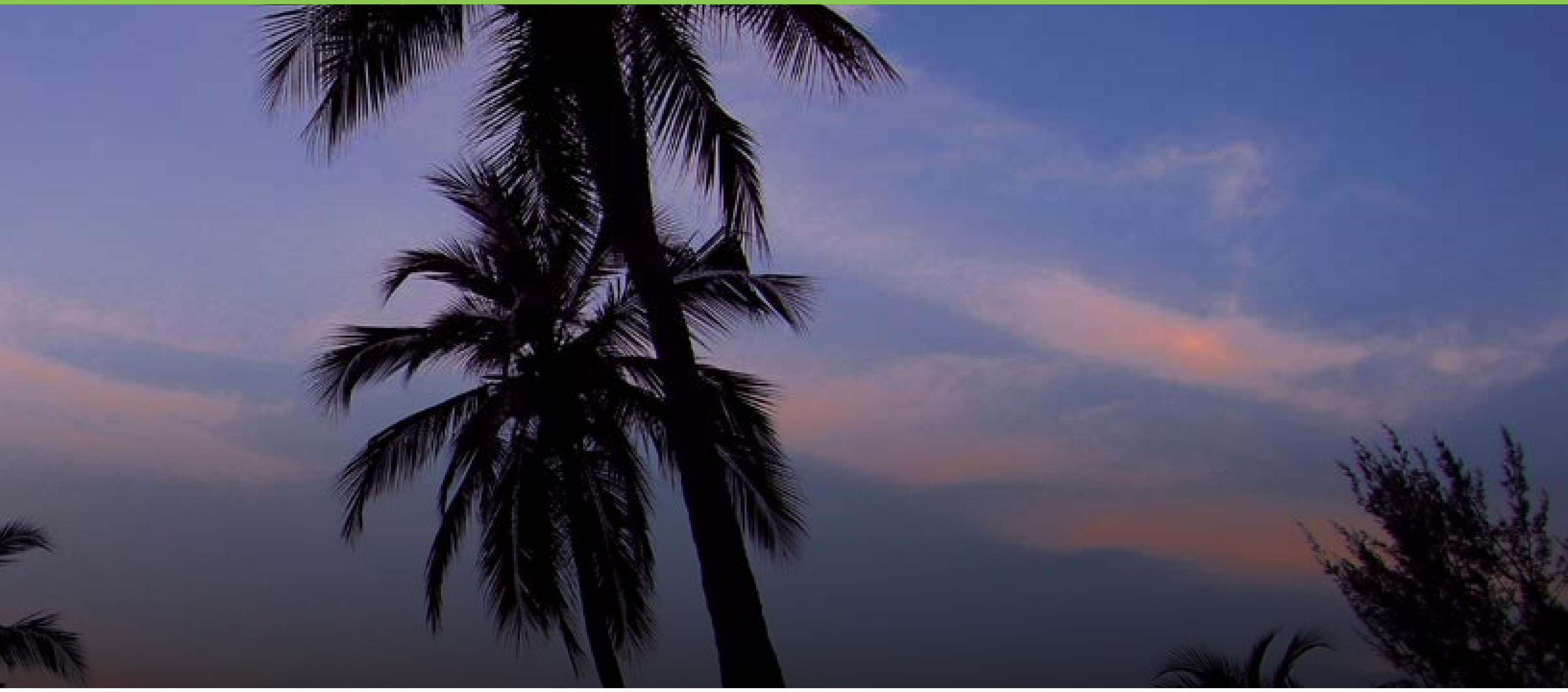


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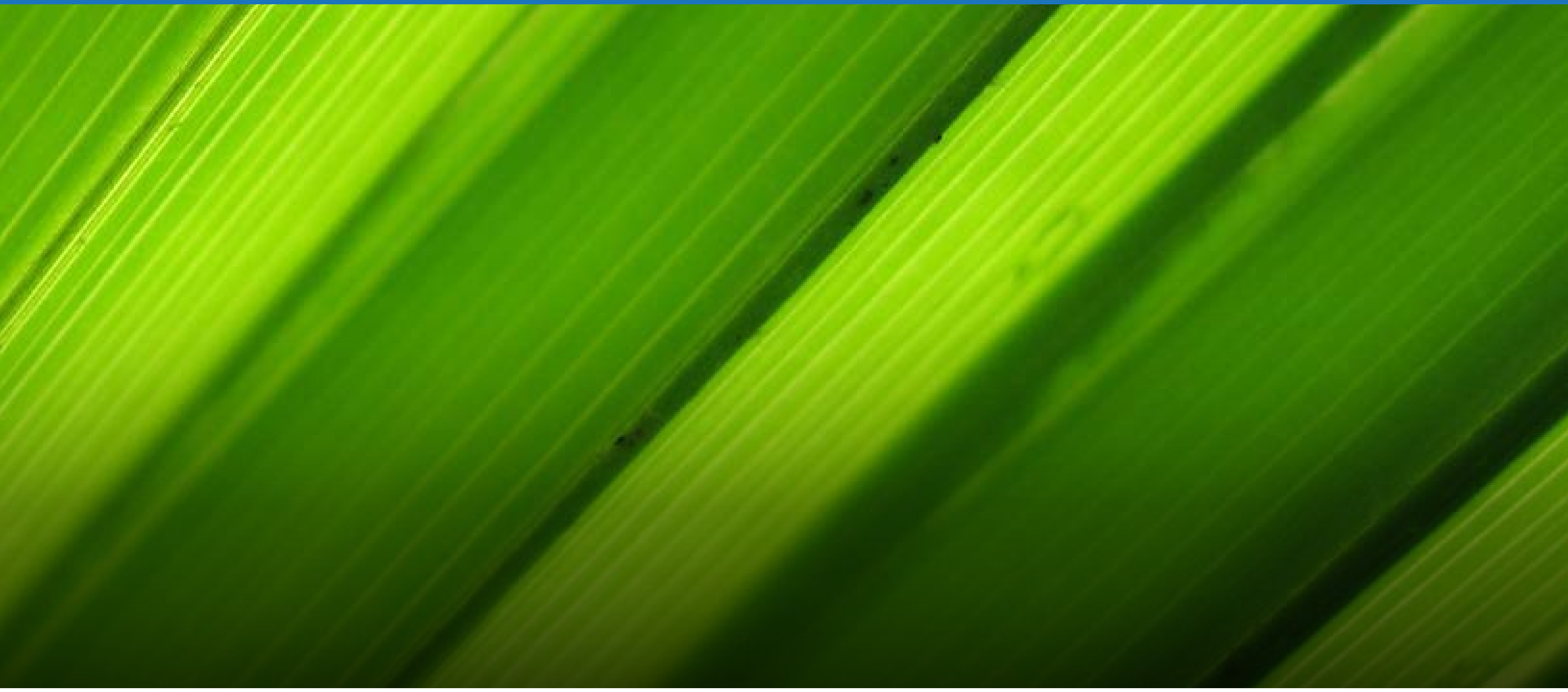

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# FOREWORD

**The Asian Development Bank (ADB) commissioned this study to benefit its three North Pacific member countries and their development partners**1[1]. It provides information and analysis about the Freely Associated States (FAS) as they approach an important milestone in their respective Compact relationships with the United States (US). At the time of conceiving this report, in late 2018, the range of possible outcomes at the end of each specified Compact economic assistance period for the FAS was quite broad, and ADB believed that the affected parties and their development partners would benefit from a professional study that estimated potential fiscal adjustments and modeled the associated economic outcomes.

**US announces intention to negotiate extension of Compact economic assistance**. This study was commissioned in May 2019 with two downward adjustment scenarios and one funding renewal scenario. Since that time, the US government announced its intention to negotiate an extension of Compact economic assistance with each FAS, and ADB decided to continue this study with one downward adjustment scenario and one funding renewal scenario. The downward adjustment scenario is nearly identical to the outcome that would result even from a delay in a fully authorized and funded period of renewal with each country. The renewal case, optimistically, provides all parties with the welcome challenge of ensuring that additional resources provide for a sustained benefit to each FAS.

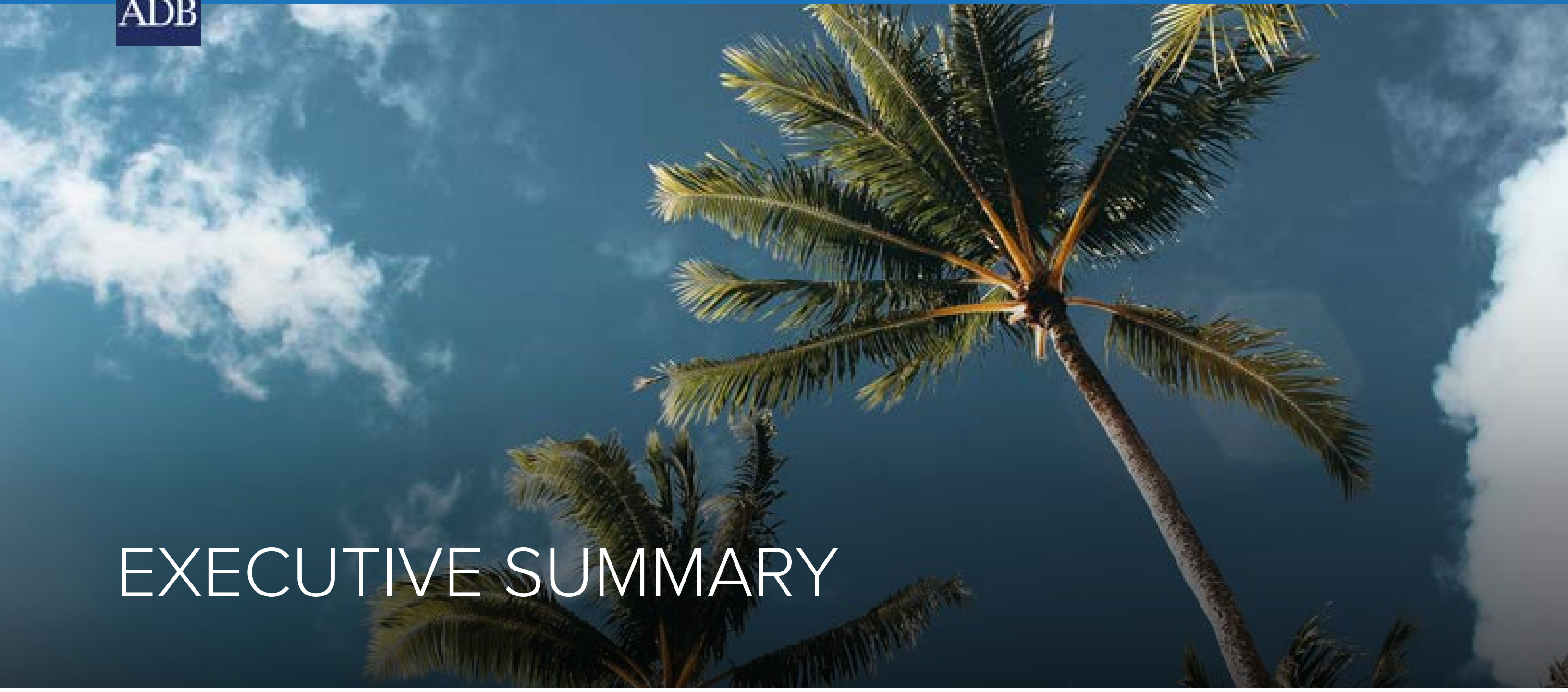
**COVID-19 has had an adverse impact on the economies of the FAS**. Since the original three-country study and report was shared in draft form with all affected parties in January 2020, the world has entered the COVID-19 pandemic with varying degrees of impact on each FAS. Given the breadth and depth of the pandemic, the use of updated model assumptions was deemed beneficial, so this report serves to update all prior scenario projections and incorporates the latest data to take into account the impacts of the COVID-19 pandemic. The impact of the COVID-19 pandemic on the Federated States of Micronesia (FSM) and the Republic of the Marshall Islands (RMI) has been less severe compared with the Republic of Palau (Palau) as tourism is less important in the current economic structure of the RMI and FSM than in Palau.

**ADB trusts that the provision of information and analyses herein will prove beneficial to all interested parties**. . This project's series of reports builds upon the ongoing work of the Economic Monitoring and Analysis Program (EconMAP) which is administered by the Graduate School USA (GSUSA) with funding support from the Department of the Interior's Office of Insular Affairs (DOI-OIA).

[1] See Graduate School USA, The Economic Impacts of the End of Compact Grant Assistance in the Freely Associated States, Economic Issues Paper No. 1, Honolulu, March 2020.

**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 as they arise. In the event of the downward adjustment scenario, such work might entail a greater focus on mitigating the effects of fiscal adjustments. More optimistically, following the commitment by the US to economic assistance renewal of each Compact, ADB could focus more directly on policy reform and in-country economic and fiscal reforms to help achieve enhanced economic results.

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



# EXECUTIVE SUMMARY

## Compact Structural Features, Trends and Preparedness

**Compact structural features**. The Compacts between the US and the three FAS delivered sovereignty and self-governance to each nation, included economic development assistance, and provided the right of FAS citizens to move to the US. Each of the FAS have had two periods of economic assistance from the US; they are now conducting negotiations for a third round of assistance.

The FSM and RMI Compacts entered into force in 1986 with the initial economic assistance provided for fiscal year (FY) 87-FY02. During this period, most funding was provided as budgetary support for current operations and capital improvement projects. Near the end of the period, the US, FSM, and RMI negotiated amended Compact agreements. The amended Compacts provided for economic assistance for FY03-FY23 and included several changes. Compact trust funds were established for the FSM and RMI, with US annual contributions rising over the 20-year period. US-FSM and US-RMI committees were established to provide more accountability of annual grants to targeted sectors such as education, health, and infrastructure. Also, the US established a supplemental education grant (SEG) for FY 04-FY23 that cashed out several existing US federal programs. Under the terms of the FSM and RMI amended Compacts, annual grants terminate at the end of FY23; thereafter, the FSM and RMI receive annual distributions from the trust funds. In addition, the SEG also ends at the end of FY23.

The Palau Compact came into effect in 1994, with the initial assistance provided for FY95-FY09. The US provided general budget support, sector specific support, funds to establish the Palau Compact Trust Fund, federal services, and committed to constructing a road system. The Compact included a schedule for trust fund distributions starting within the 15-year period. The Palau Compact requires a review on the 15th, 30th, and 40th anniversaries of the Compact. The US and Palau concluded a Compact Review Agreement (CRA) in 2010 for FY10-FY24 that provided budgetary support, funded infrastructure, infrastructure maintenance, and contributed to the Palau Compact Trust Fund. In addition, the agreement created an “Economic Advisory Group” (EAG) to monitor Palau’s economic progress and put forth recommendations that would set the agenda of annual economic consultations. US Congressional action to approve the CRA was delayed, and the agreement went into effect in September 2018.

**Compact trends**. The three FAS all experienced economic growth during the compact period and the level of Compact transfers fell over time, reducing their reliance on compact transfers. FSM and the RMI achieved moderate but positive real economic growth from FY87 to FY18 which is expected to continue through FY23. This growth occurred while the FSM and RMI received declining real transfers through the Compact. The reliance of the FSM and RMI on Compact transfers declined from very high levels during the initial Compact period to a projected level of 23% and 15% of gross domestic product (GDP) respectively in FY23. Palau achieved positive economic growth over the FY94 to FY18 period, which is also expected to continue through FY24. Palau achieved this real growth while also receiving declining real transfers through the Compact. The reliance of Palau on Compact transfers (including distributions from the Compact Trust Fund) has declined from moderately high levels during the initial Compact period to a projected level of 5% of GDP in FY24.

Citizens of the three FAS have emigrated over time to the US under the terms of the Compacts, with the total number in the US growing over time. The combined population of the three FAS nations is estimated to be about 179,000 in FY23/FY24, while the cumulative number of citizens from the three FAS that have emigrated is 72,000 ( not including children born to FAS Compact migrants in the US).

**Preparedness**. The three FAS have each established a team to represent them as they engage with the US regarding further assistance. The FSM established the Joint Committee on Compact Review and Planning (JCRP) and has designated a Chief Negotiator. The RMI named a Chief Negotiator and a negotiating committee staffed by the Ministry of Foreign Affairs, other government officials, and outside counsel. The President of Palau has designated a negotiating team led by the Minister of Finance.

The US has a standing mechanism to monitor and implement its policies toward the three FAS—an Inter-Agency Group (IAG) led by the White House National Security Council. The IAG has scaled up FAS engagement due to US concern about the need to offset China's growing influence in the Pacific region and the scheduled expiration of ongoing economic assistance through the three Compacts. The Presidents of the US and the three FAS nations met at the White House in May 2019 and the US identified two co-negotiators in April 2020. Several meetings were held in 2020. Following a period of minimal formal interaction, in March 2022, the US President appointed a Special Presidential Envoy for Compact Negotiations. The US anticipates meetings as early as May with an expressed desire to reach mutual agreement with each FAS as early as possible.

The FSM and the RMI have benefited from recent large increases in grant funding commitments from the World Bank. 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. The ADB has provided long-standing support to all three FAS; it 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 may borrow at non-concessional rates from the World Bank in the range of $12 million annually and can borrow roughly $20 million annually from ADB. To date, Palau has not borrowed from the World Bank, but it had an outstanding pre-COVID-19 pandemic balance of $48 million with the ADB for loans that supported water, sanitation, and ICT investments. As described in this report, Palau was forced to borrow heavily to manage the fiscal shock of the COVID-19 pandemic.

# FAS Economic Structure and Performance

The analysis of FAS economic structures and performance serves two purposes. Firstly, it provides the reader with a brief overview of each of the three FAS, the structure of their economies and economic performance before the impact of COVID-19. Secondly, it provides the reader with an understanding of the reasons for the divergent impact of COVID-19 on the

3 FAS economies. The impact of COVID-19 on the FSM and RMI economies has not been significantly different to the normal volatility in growth experienced during the economic cycle. However, for Palau the impact has been devastating.

**Economic structure**. Development status differs among the FAS. The FSM is the least developed of the three FAS with the private sector representing 22% of GDP with the major private sector activity focused on retailing to provide goods and services to the local economy. For the RMI the private sector represents 33% of GDP, with fishing being the major component. For Palau, the most developed of the FAS, the private sector represents 47% of GDP with tourism comprising 38% of private sector activity. The FSM has the largest household sector comprising subsistence and informal sector activities representing 24% of GDP as compared to the RMI at 13% and Palau at 10%. Among the FAS, the RMI has the largest public sector at 30%, with Palau at 28% and the FSM at 25%. The structure of the three economies reflects the development paths adopted in each. In Palau, the nation has adopted a tourism-based growth model, yet it still relies on donor support for the public sector and infrastructure needs. The RMI has adopted a two-part strategy of public sector-led growth with parallel development of its fisheries sector. The FSM has implemented neither a public sector-led nor a private sector-led development strategy; however, the FSM's combined state and national planning efforts are aimed at promoting a multi-sector private sector-led growth strategy.

**Economic growth in each of the FAS has been lackluster.** The RMI has achieved the best growth rate during the period from FY01-FY19, with an average annual growth rate of 1.2%, while Palau with the most developed economy has grown by an average rate of 0.6% during the same period. The FSM attained a 0.2% average growth rate. All three economies have been beset by a high degree of economic volatility, with Palau experiencing the greatest volatility due to the nature of its tourism-reliant economy.

**Fiscal structure**. In terms of fiscal structure, tax revenues reflect the degree of development in the economy with Palau attaining 41% the highest proportion of tax revenues of total revenues with the RMI and FSM recording 22% and 14%. While all three FAS have relied on the same set of taxes inherited from Trust Territory (TT) days the FSM score displays a particularly low level of tax effort. Sovereign rents derived from fishing fees and in the FSM's case from the domicile for major Japanese corporations now represent a large share of tax revenues in the FSM and RMI, 43% and 28%, respectively, while Palau receives only a modest 8% of revenues from this source. Reflecting the dependent nature of the three FAS, grants remain a critical component of the landscape since independence and TT days recording 38%, 48% and 37% in the FSM, RMI and Palau, respectively.

**Fiscal performance**. Each FAS has displayed a different approach to fiscal policy. In the FSM, reflecting the nature of the Federation, there are differences between national government performance and that of the four states. The national government has benefited from the recent and significant growth in sovereign rents, while the four states have not benefited directly from that increase; rather the states have continued to rely upon Compact sector grants for their major share of revenues. This has led to large fiscal surpluses at the national level averaging over 20% of GDP in recent years as the state governments' collective fiscal envelope has been constrained as each state has struggled to sustain fiscal balance as the real level of grants has declined. In the RMI, revenues, and thus, the fiscal envelope, has grown rapidly in recent years reflecting the increase in fishing fees, but expenditures have rapidly caught up with the increase. The outturn has been that the RMI has sustained a balanced but continuously fragile fiscal position. In the case of Palau, the nation has maintained a conservative fiscal position and the level of government has remained constant in real terms. During the tourism boom years as revenue rose rapidly, the nation set aside the surplus into a general fund reserve that ended up serving the nation well during the COVID-19 pandemic.

# The impact of COVID-19 on the economies of the FAS and outlook through the remainer of the amended Compact

In the early months of 2020, the onset of the COVID-19 global pandemic ravaged the global economy with unprecedented reductions in GDP and rapidly rising unemployment. To reduce the spread of the virus, global travel restrictions were implemented which led to a collapse of international travel and tourism. In response to the pandemic the FAS effectively closed their borders in March/April 2020 and as a result the FAS remained COVID-free until 2022. The restrictive travel policies and the priority placed on health, at a time of highly limited demand for international travel, served the FAS well. As of the start of 2021, the FAS benefited from the U.S. vaccination effort and in collaboration with the CDC began rolling out nationwide immunization programs. At the end of September 2021, Palau had effectively vaccinated its entire adult population, and reopened its borders to vaccinated and COVID-19 free travelers. Vaccination rates in the more geographically disbursed populations of the FSM and RMI have been markedly lower, and borders remain closed.

**Mitigation programs**. The FAS benefited from donor and internal programs to mitigate the health issues and economic costs of COVID-19. US health programs provided the major source of funds to mitigate the potential impact of a COVID-19 outbreak. The FAS also benefited from the US CARES Act: Federal Pandemic Unemployment Compensation (FPUC) and Pandemic Unemployment Assistance (PUA) -- these benefits supported economic livelihoods of FAS workers. The ADB has been a major contributor to the three nations through grants under the COVID-19 Pandemic Relief Option (CPRO) to the FSM ($14 million) and RMI ($16 million) and with loans to Palau ($20 million). The ADB provided an additional $55 million to Palau through a Policy Based Program loan to support government operations and mitigation programs, but contingent upon a series of reforms. All three FAS developed their own internal programs: the FSM Congress initiated a tourism sector mitigation relief fund; the RMI established a Response and Preparedness Plan; and in Palau the CROSS Act provided unemployment benefits to foreign workers, a temporary jobs program and provided relief to affected segments of the private sector.

**Economic Impact**. In the case of the FSM and RMI, the economic impact of COVID-19 has been significant but not outside the normal volatility experienced during the economic cycle. GDP fell over the two-year FY19-FY21 period by 5% in the case of the FSM and 5.9% in the RMI. In the case of Palau, the impact has been devastating, with GDP falling by 8.6% in FY20 and a further 17.6% in FY21: a total of 25% over the two-year period. The different impact reflects the structure of the three economies. The FSM with a large public and small private sector was the least affected. The RMI economy suffered a slightly larger impact due to its greater dependence on fisheries. In both cases, the private sector endured the worst of the crisis while public sector activities remained largely untouched. In the case of Palau, reliance on an industry dependent on travel saw the total collapse of its tourism sector. With strong donor support, Palau has been able to insulate the impact of COVID-19 from the non- tourism-based economy, but the private sector contracted by over 38%.

**Fiscal**. The impact of COVID-19 on the fiscal position of both the FSM and RMI is expected to be minor. The mitigation grant funds received by the two FAS have provided for local needs without the need for significant local funding. In fact, the fiscal positions of the two FAS will show improved fiscal surplus in FY20 and FY21 reflecting a buildup of grant funds not yet expended during the period. However, in FY22 and FY23, these funds will be drawn down and without replenishment from grant sources, existing mitigation programs will need to be funded from domestic sources. In the case of Palau, the COVID-19 pandemic has precipitated a series of unprecedented deficits, reaching 18% of GDP in FY21 at the height of the adverse economic impact and before the anticipated recovery. Support from ADB loans to fund the deficits is expected to total 36% of GDP. The increase in borrowing is projected to push the debt/GDP ratio up to 90% of GDP in FY21, but then it will fall sharply with the anticipated economic recovery, to 62% and from that point gradually decline to more sustainable levels.

## Modeling the impact of non-renewal of Compact assistance

**A Scenario based approach**. The modeling of a scenario with non-renewal of Compact assistance is built on several key assumptions. The FSM and RMI each move to the regime outlined in their Compact law that has two key features. First, the FSM and RMI would transition from sector grants funded by US appropriations to annual distributions from their respective CTFs, but the initial level of annual distributions from the CTFs would not be based on the level of expiring grants but would be a level that 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 non-renewal of Compact assistance is the assumption that SEG funding would cease. In the case of Palau, the adjustment would be limited to annual distributions as specified in the original Compact law, but at a reduced level deemed to be sustainable with a high degree of confidence and thereafter adjusted to fully offset the impact of inflation.

**FSM impact**. In the case of the **FSM** the projected level of the CTF in FY23 is estimated to provide a sustainable draw of $36.0 million in FY24 which requires a substantial adjustment. The adjustment to a sustainable drawdown would result in large reduction of funds to finance government operations that is $47.5 million below the FY23 level, a resource cut equivalent to 11.3% of GDP. The loss of SEG also entails a further reduction in funding, equal to 2.6% of GDP, bringing the total to 13.9%. Almost all of the adjustment would occur at the state level. The FSM economy is projected to contract by 8.6% of GDP under the non-renewal scenario. Most of the adjustment will be felt in the public sector GDP which contracts by 20.4%, while the private sector GDP contracts by 5.1%. The resultant job losses result in a projection of almost 11,800 new migrants to the US.

**RMI impact**. In the case of the **RMI** the projected level of the CTF in FY23 is estimated to provide a sustainable draw of $24 million in FY24 which requires an annual adjustment of $3.6 million, which equates to 1.3% of projected FY23 GDP. There is also a need for the RMI to adjust to the loss of SEG. This requires an adjustment of $5.6 million annually, equal to 2.0% of GDP. However, as the RMI entered into the new Compact period, the former structural deficit which was first revealed in FY19 reemerged. Coupled with the loss of SEG a significant adjustment is required. A reduction in the work force in administrative services and education is required coupled with a wage freeze through FY30 to restore a fiscal balance. GDP falls by 3.2% with losses in both employment and household incomes, which generates a significant out-migration.

**Palau impact**. In the case of **Palau**, the nation continues to enjoy access to Head Start and other Federal education programs, which were replaced (cashed out) by the SEG in the FSM and RMI. The modeled adjustment to the new Compact period thus only entails a reduction in CTF drawdowns sufficient to ensure achievement of sustainable perpetual status. This amounts to a $5 million adjustment equivalent to 1.5% of GDP. The adjustment modeled assumes a freeze on civil service recruitment, no award of annual increments and a 2% real reduction in purchases of goods and services, as well as government transfers. All this has only a minor impact on GDP which is projected to fall by 0.4%, with similar minor impacts on employment, household incomes, and induced out-migration.

# Adjusting to Potential Compact Economic Assistance Renewal

## *COMPACT RENEWAL*

**FSM and RMI Compact renewal scenarios.** For the FSM and RMI Compact renewal assumes a further 20-year period 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, in the modeled projection it is assumed that the totality of the annual US appropriations would be contributed to each CTF at the start of each year while the distributions would proceed during each year by mutual agreement for each expenditure type: replacing sector grants, disaster assistance, SEG, audit, and any others. Under such an assumption the benefit of delayed expenditures or even unspent funds would enable the respective CTFs to benefit—on average—through investment returns. At an infinitesimal cost to the US Treasury, a significant benefit would accrue to the CTFs, strengthening their sustainability.

**Palau Compact renewal scenario**. In the case of Palau, the original Compact structure differed from the FSM and RMI. To place all three FAS on a structurally equivalent basis the Compact renewal scenario for Palau was modeled to equate the structure 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 $15 million annually consistent with the average ratio of CTF contributions for the FSM and RMI. As for the FSM and RMI the totality of the annual US appropriations would be partially inflation-adjusted and deposited into the COFA Trust Fund at the beginning of each year. Distributions available to Palau would be fully inflation-adjusted.

**FSM Compact renewal enables significant improved growth potential**. Continuation of Compact sector grants at existing levels issues in a new period and potential to develop a public sector development strategy. Under the new circumstances 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 no longer be relevant. For the FSM the Compact renewal scenario envisages the large national government structural surplus would be transferred to the state governments in a planned and increasing way allowing for absorptive capacity constraints to be overcome. Further, an annual sustainable drawdown from the FSMTF, after setting aside a reserve for climate events and resilience, would provide additional resources to pursue the public sector growth strategy. The outcome is that FSM GDP is projected to increase by 3.4% in FY24 and be maintained at an average of 1.0%, thereafter through FY30. This is an improvement over the amended Compact period where growth stagnated for 20 years. Reflecting the additional projected growth, employment and household incomes increase and outmigration is held at bay.

**RMI Compact renewal ensures economic and fiscal stability**. In the case of the RMI, Compact renewal does not release additional funds. Unlike the FSM, the RMI did not set aside its surplus revenues from sovereign rents into the RMICTF, but rather let expenditures rise to match the increasing fiscal envelope. In fact, the emergence of a growing structural deficit in FY19, but subsequently masked by the large volume of COVID related grants, comes home to roost as the new Compact period comes into force and requires adjustment and contraction. After a short period of fiscal consolidation and economic contraction, over the period FY25-FY30 the economy is projected to close at 0.8% compared to 1.3% during the amended Compact period, FY04-FY19. In the case of the RMI the impact of Compact renewal does not enable adoption of the public sector led growth strategy outlined for the FSM, as all resources have already been drawn on. Rather Compact renewal ensures economic and fiscal stability. Better performance would require reform and development of an improved policy environment with donor support.

**Palau Compact renewal supports growth with resources for infrastructure**. While it is anticipated that the Palau economy will have recovered to levels existing before COVID-19 by the start of the new Compact period, the pre-COVID levels, FY18-FY19, were at a low point of the cycle. It is thus anticipated that the Palau economy will recover not only from COVID-19 but also continue to grow through FY30 as the tourism economy returns to full capacity. The Compact renewal scenario will enable Palau to maintain government at existing levels and provide greater resources for infrastructure, which will be severely limited due to the high debt to GDP levels. The projections indicate that GDP growth will average 4.9% through the end of FY30 and that Compact renewal would contribute 0.6% of that growth. Employment and household incomes follow similar patterns and migration is held in check.

## *TRUST FUND ISSUES*

**GSUSA constructs model to analyze trust fund performance**. The GSUSA has prepared a Trust Fund stochastic simulation model utilizing Monte Carlo techniques to investigate the robustness of the funds to meet the needs of the FAS as they enter the new Compact period. The model simulates the ability of the funds under the current provisions of the Compacts (COFA rules) to meet the criteria to replace the annual grants streams with a high degree of confidence. The GSUSA model also investigates a SAFER rule (sustainability adjustment for enhanced reliability) that is designed to achieve a high degree of performance. Both rule sets are analyzed against a set of criteria that measure performance: sustainability of the fund corpus, ability of distributions to attain the target, and lack of volatility. A combined performance indicator comprised of the 3 elements is constructed and scores are measured on the interval 0-100. A score of 95 is considered sufficient to achieve perpetual status with only a small probability of trust fund failure.

**Compact renewal enables Trust Funds to grow to sustainable levels**. Without Compact renewal the FSMCTF under the COFA rules performs poorly attaining a score of only 55 and it clearly fails to meet its purpose. This outcome can be improved by implementation of the SAFER rule and the score improves to 83, but still short of the desired 95 level. For the RMI the trust fund condition is considerably better. Under COFA a score of 92 is achieved and 95 under SAFER. For Palau the result for the existing trust fund falls somewhere in between the FSM and RMI. Under the existing COFA rules the Palau fund achieves a score of 61 and 88 under the SAFER rule. With the modeled Compact renewal assumptions the FSMCTF scores 95, the RMICTF exceeds 98, with the Palau COFA TF scoring 97.

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# COMPACT 101: STRUCTURAL FEATURES, TRENDS AND PREPAREDNESS FOR THE END OF COMPACT ECONOMIC ASSISTANCE

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# 1 COMPACT 101: STRUCTURAL FEATURES, TRENDS AND PREPAREDNESS FOR THE END OF COMPACT ECONOMIC ASSISTANCE

This chapter describes the structure and timing of the initial and subsequent Compact economic assistance periods for each FAS, followed by a timeline of key trends during the Compact periods.

The Compact of Free Association status represented the choice each FAS made in order to terminate its status as a territory 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 ultimate achievement of self-reliance. The FSM and RMI Compact provisions are similar as they were negotiated in a similar timeframe and passed into US law together. 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 8 years after the Compacts for the FSM and RMI. Each FAS is addressed sequentially throughout this report.

This chapter also includes a description of the actions taken by each affected party to prepare for the end of the funding under the respective Compacts and the roles of multilateral and bilateral donors.

## FSM Compact Structural Features

### *FSM Initial Compact Period (FY87 to FY03, "Compact I")*

The FSM Compact entered into 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.

The Compact and its subsidiary agreements were approved as an "Executive Agreement of the United States containing international obligations." Within the US government the Compact is treated as a treaty obligation that required 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. As of February 2019, the FSM had diplomatic relations with 92 countries. The FSM has typically been within the top three countries in the UN with respect to coincidence of votes with the US.

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" now describes the 17-year period from FY87-FY03. During this initial period, most funding was provided under section 211(a) as unrestricted 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 $15.3 million were provided for energy, communications, marine surveillance, health and medical programs, scholarships, and education/health block grants. One-time payments totalling $8.1 million were also provided in FY87 for: the US Coast Guard facility in Yap, communications hardware, and maritime surveillance support. Finally, the legislation implementing the Compact provided $20 million in initial financing for the FSM Investment Development Fund in FY87 to support private-sector lending. This $20 million partially compensated the FSM for the loss of tax and trade incentives that the US Congress removed from the negotiated Compact. 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 and some of the one time payments provided during the initial Compact economic assistance 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%, (The 7% cap 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%.

Funds provided through the initial Compact were backed by a "full faith and credit" committiment of the US government. In the US law approving the Compact, Congress authorized and approported funds to cover Compact commitments for the full period. Therefore, Compact funds were not subject to annual appropriations processes.

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

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

At the onset of FY01 the FSM entered negotiations with the US to extend economic assistance pursuant to section 231 of the Compact. Four key outcomes from the negotiations include:

1. The parties agreed to the creation of a FSM 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 not guaranteeing the level the FSMCTF would reach, or the level of distributions it would support, the intent was to provide a smooth transition and a perpetual fund that would support the FSM, thus ending the need for annual US budgetary support. 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. Initial deposits of $30 million from the FSM and $16 million from the US were anticipated to be available on 1 October 2003. But the FSM deposited $30.3 million exactly one year late on 1 October 2004, and the U.S. chose await the FSM contribution and delayed its initial deposit of $16 million until 5 October 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 to the accountability provisions attached to transfers during the amended Compact period. The amended Compact revised the "Fiscal Procedures Agreement" (FPA), basing it heavily on the "Common Rule" that applies to federal grants to

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.

US states, territories, and local governments. The parties agreed on revisions to the FPA and to create a Joint Economic Management Committee (JEMCO), which would have 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 initally specificed sectors: education, health, private sector development, public sector capacity building, environment, and public infrastructure. A seventh sector was created by mutual agreement pursuant to section 211to allow sector grants to cover the costs of enhanced reporting and accountability (ERA). Such ERA expenditures are limited to 2% of total annual grants. By action of the JEMCO, and consistent with the "sense of the Congress" expressed in the amended Compact act, 30% of section 211 sector grant funding has been dedicated to public infrastructure.
4. The FSM agreed during the negotiations to a "cash-out" provision for education in which the FSM has foregone several US federal programs that had supported Head Start (pre-K), primary, and secondary education in the FSM. The reason that US officials provided at the time was that the programs were not well-suited to the circumstances in the FSM and that the cost of those programs, converted to annual grants, would provide more flexibility and improved outcomes. The amount authorized 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) with the authorization partially adjusted for inflation for the period FY05-FY23. The amount was provided as an authorization for appropriation and left to the US Department of Education (DOE) to request annual budget allocations in the annual appropriation process. Had the designated amount been both authorized and appropriated, the nominal value would have grown from $12.23 million in FY05 to an estimated $15.7 million in FY23. However, US DOE did not request authorized annual partial inflation adjustments, and with two cuts that resulted from US government-wide periods of sequestration, the FY23 level of the SEG is projected to be $11.1 million[1].

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 FSM states. The US and FSM signed documents to implement the amended Compact on 25 June 2004.

The funding structure of the amended Compact contains four funding streams for the FSM and a fifth that accumulates in the CTF:

i. **Sector grants**. These started at $76.2 million, including $0.2 million for the Disaster Assistance Emergency Fund (DAEF), in FY04 to FY06, and were followed by 17 sequential annual reductions of $800,000 each year (referred to as the "decrement") to reach a specified value of $62.6 million in FY23. However, since sector grants are adjusted annually by two-thirds of the change in the US GDP deflator, the nominal level of the sector grants actually provided has been relatively stable. Sector grants started at $76.2 million in FY04, peaked at $81.7 million in FY13, and are projected to be $81.4 million in FY23.

ii. **Supplemental Education Grant**. The SEG, as described above, started at $12.23 million in FY05 and is projected to be $11.1 million in FY23.

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

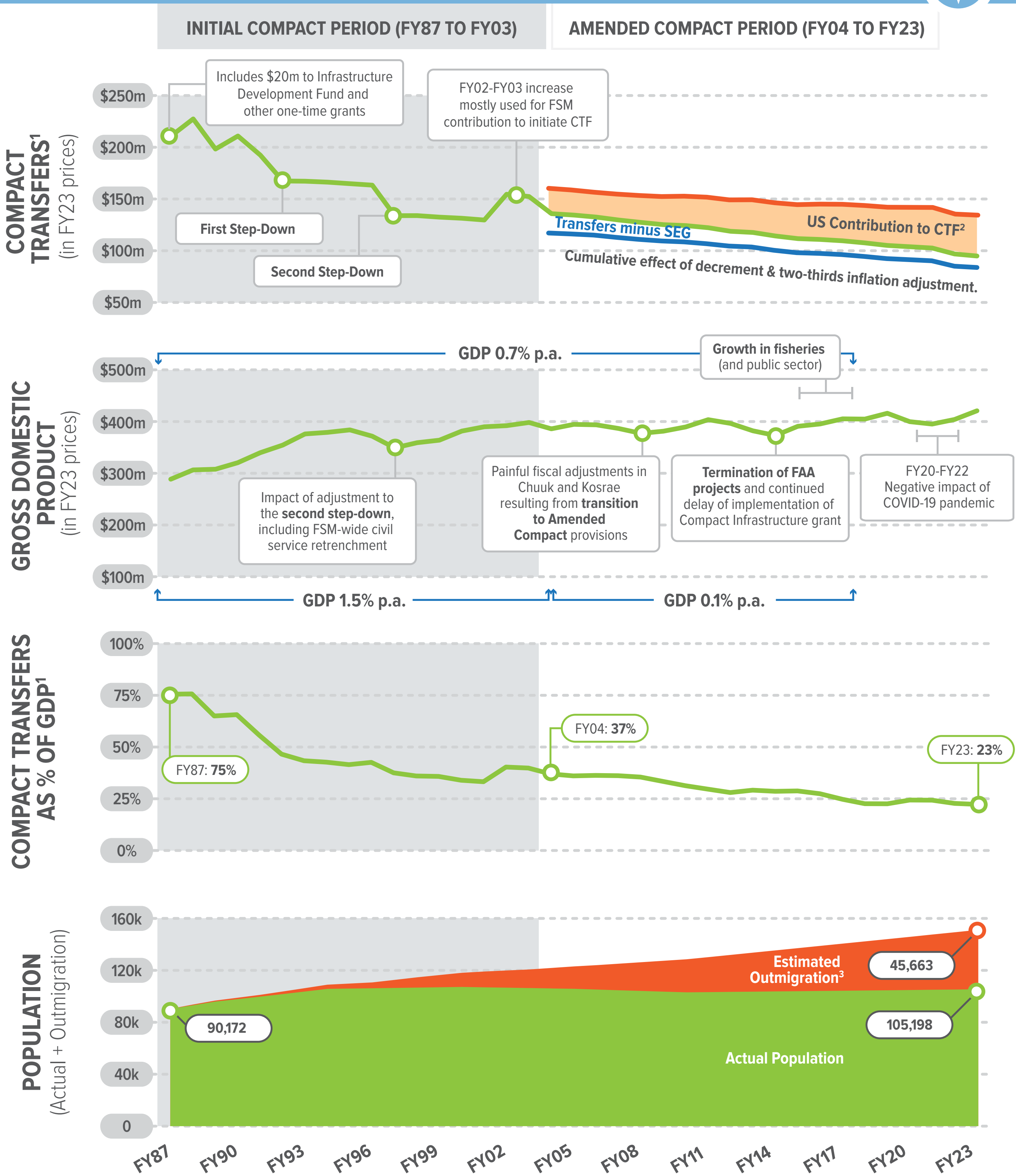
iv. **Disaster assistance fund**. Since 2004, the US and FSM have each contributed $200,000 annually to a Disaster Assistance Emergency Fund which is intended to support disaster responses. Annual contributions (adjusted partially for inflation) are expected to reach $260,000 from each contributor in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

v. **The Compact Trust Fund**. The FSMCTF, created at the outset of the amended Compact period, received an initial US 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 in sector grants; additionally, the contribution increases as a result of the partial inflation adjustment. The FY23 US contribution to the CTF is projected at $38.5 million.

Congress authorized and appropriated funds to cover amended Compact commitments in its implementing legislation. Compact funds were not subject to the annual appropriations process.

[1] It is reported that the US DOE will adjust the SEG funding level by FY23 such that that year's appropriation will reflect consistency with the mandated inflation adjustment. If so, the figures in this report require upward adjustment. For the FSM, the FY23 figure is estimated to be not $11.1m but $16.3m.

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 are shown in the blue line with SEG removed to allow for comparison across Compact periods.
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.

Under current terms of the amended Compact, all five funding streams are scheduled to terminate at the end of FY23. Thereafter, the FSM would receive annual distributions from the FSMCTF, pursuant to a distribution policy to be adopted by the CTF committee within a resticted set of rules. The result could be potentially severe finacial impacts on the FSM. For example, if the FSM were to receive FSMCTF distributions at the maximum allowed level, it would cause significant volatility in annual distributions, including a 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 (FY87-FY03) and under the amended Compact period (FY04-FY23). All values are in FY23 prices.
- The second chart shows real GDP from FY87-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, which is expected to continue through the FY19 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 on Compact transfers has declined from very high levels during the initial Compact period to a projected level of 22.6% of GDP at the end of the amended Compact period.
- The fourth chart shows the gradual—but mounting—effect of cumulative emigration from the FSM to the US. FSM's population is expected to have grown 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 counting children born to FSM Compact migrants overseas.

### FSM Reliance on Total US Assistance as of FY23

US Compact transfers and on-budget federal programs and services support a significant share of FSM government operations, GDP, and employment. In the absence of this US support, the FSM economy would be much smaller and employment much lower, while direct emigration to the US would be far higher.

Total projected on-budget US support in FY23 is $125.3 million, comprised of $82.7 million in compact grants, scheduled to end after FY23; $11.1 million in SEG grants, scheduled to end after FY23; and $29.9 million of other on-budget federal programs and services, not scheduled to end.

This total US contribution represents 31% of government revenues and supports about 25% of FSM GDP and 21% of employment.

Other valuable off-budget areas of US support also benefit the economy but are not readily quantified. For example, the FSM benefits from US postal services and Federal Deposit Insurance Corporation (FDIC) deposit insurance, both of which end after FY23. Losing US postal services would increase costs for FSM consumers and businesses, while losing FDIC insurance could potentially sever correspondence banking relations with foreign banks and have serious implications for the delivery of financial services. Modeling the dollar impact on public services, businesses, and households of these and other US services is beyond the current capability of the GSUSA macroeconomic modeling framework.

While the focus of this report is on the impact of the expiring Compact and SEG grants and the transition to trust fund proceeds, the continuation of ongoing US programs past FY23 without interruption greatly benefits the economy. If this $29.9 million in FY23 US support ended, GDP would fall by an additional 13% and result in additional job losses of 2,780 positions, about 16.4 percent of total employment in FY23. The impact on migration would be exceptionally large, resulting in 18,638 new migrants to the US, or 17.7% of the population. In practice, actual induced migration due to fiscal shocks would likely be spread over several years, and not all primary job earners or dependents may migrate.

### Current State of Preparedness: 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]."

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

## INITIAL COMPACT PERIOD
FY87-FY03

## AMENDED COMPACT PERIOD
FY04-FY23

### RECURRENT FUNDING

**Initial Compact Period**

- 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**

- 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
- $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 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 $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 Compact Period)

- 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 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 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 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) ($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.

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 Compact's economic provisions or for negotiations that renew economic assistance 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 FSM Trust Fund (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 non-renewal of Compact assistance scenario. However, the states are not by their own means prepared to manage the impacts of a fiscal shock resulting from non-renewal of Compact economic assistance and the FSM as a whole is not prepared to mitigate the greater impacts associated with any further reduction in US support than modeled in the non-renewal scenario.

# RMI Compact Structural Features

## *RMI Initial Compact Period (FY87-FY03, "Compact I")*

The RMI Compact of Free Association entered into 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.

The Compact and its subsidiary agreements were approved as an "Executive Agreement of the United States containing international obligations." Within the US government the Compact is treated as a treaty obligation that required 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. As of July 2019, the RMI had diplomatic relations with 95 countries. The RMI has typically been within the top three countries in the UN with respect to coincidence of votes with the US.

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" now describes the 17-year period from FY87 to FY03. During this initial period, the majority of funding was provided under section 211 as unrestricted 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 are referred to as "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 annually for Kwajalein Atoll, acknowledging US military facilities at the atoll. Additional annual transfers totalling $7 million were provided for energy, communications, marine surveillance, health and medical programs, scholarships, and education/health block grants. One-time payments totalling $3.7 million were also provided in FY87 for communications hardware and marine surveillance support. Finally, the legislation implementing the Compact provided $10 million in initial financing for the RMI Investment Development Fund to support private- sector lending. This $10 million partially compensated the RMI for the loss of tax and trade incentives the US Congress removed from the negotiated Compact.

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 RMI Compact Trust Fund (RMICTF) created under the amended Compact.

Most of the specified annual transfer levels provided during the initial Compact economic assistance 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%. (The 7% cap 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%. Funds provided through the initial Compact were backed by a "full faith and credit" commitment of the US government. In the US law approving the Comapct, Congress authorized and approported funds to cover Compact commitments for the full period. Therefore, Compact funds were not subject to annual appropriations processes.

In addition to economic assistance and annual funds to the RMI government to secure land in Kawajalien Atoll for US military use, the Compact (section 177) provided $150 million to settle outstanding claims from nuclear testing. US Congress provided additional funds during the Compact I period related to nuclear testing.

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

### *RMI Amended Compact Period (FY04-FY23, "Compact II")*

At the outset of FY01, The RMI entered into negotiations with the US to extend economic assistance 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 not guaranteeing the level the RMICTF would reach, or the level of distributions it would support, the intent was to provide a smooth transition and a perpetual fund that would support the RMI , thus ending the need for annual US budgetary support. 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. Initial deposits of $30 million 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 that totalled $5 milllion 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 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 the end of FY23, or approximately 5% of the projected value of the RMICTF at that time.
2. The US insisted on significant changes to the accountability provisions attached to transfers during the amended Compact period. The amended 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 also agreed to create 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—were required under section 211 to be awarded to six initially specified sectors: education, health, private sector development, public sector capacity building, 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 several US federal programs that had supported Head Start (pre-K), primary, and secondary education in the RMI. The reason US officials provided at the time was that 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. The amount authorized 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), with the authorization partially adjusted for inflation for FY05-FY23. The amount was provided as an authorization for appropriation and left to the US Department of Education (DOE) to request annual budget allocations in the annual appropriation process. Had the designated amount been both authorized and appropriated, the nominal value would have grown from $6.1 million in FY05 to an estimated $9.5 million in FY23. However, US DOE did not request authorized annual partial inflation adjustments, and with two cuts that resulted from US government-wide

periods of sequestration, the FY23 level of the SEG is projected to be $5.6 million[2].

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 structure of the amended Compact contains four funding streams for the RMI and a fifth that accumulates in the CTF:

i. **Sector grants**. This funding started at $35.2 million in FY04, including $0.2 million for the Disaster Assistance Emergency Fund (DAEF), and was followed by 19 sequential annual reductions of $500,000 each year through FY23 (referred to as the "decrement") to reach a specified value of $27.7million in FY23, after accounting for an annual increase of $2 million that started 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 started at $35.2 million in FY04, peaked at $37.5 million in FY14, and are projected to be $36 million in FY23.

   Notably for the RMI, only $26.9 million in FY23 sector grants is scheduled to end. The remaining $9.1 million in FY23 of sector grants continue to be authorized and appropriated through the term of the US-RMI Military Use and Operating Rights Agreement (MUORA). In additon to grant funds the amended Compact provided annual payments to the RMI to secure defense sites in the Kwajalein Atoll. These payments are projected to be $23.4 million in FY23 and continue to be authorized and appropriated through the term of the MUORA.

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

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

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

v. **The Compact Trust Fund**. The RMICTF, created at the outset of the amended Compact period, received an initial US 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 to the CFT is projected at $21.4 million.

Congress authorized and appropriated funds to cover amended Compact commitments in it's enactment legislation. Therefore, Compact funds were not subject to the annual appropriations process.

Under terms of the amended Compact, all five funding streams are scheduled to terminate at the end of FY23, except the approximately 25% of the sector grant stream ($9.1 million) that carries on under terms specified in the terms of the MUORA and is dedicated to Kwajalein, with its timing matched to that of the MUORA. Aside from the Kwajalein grant stream, the terms of the amended 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 a restricted set of rules. The result could be potentially severe financial impacts. For example, if the RMI were to receive RMICTF distributions at the maximum allowed level, it would cause signifcant volatility in annual distributions, including a high probability of one or more years of zero distributions.

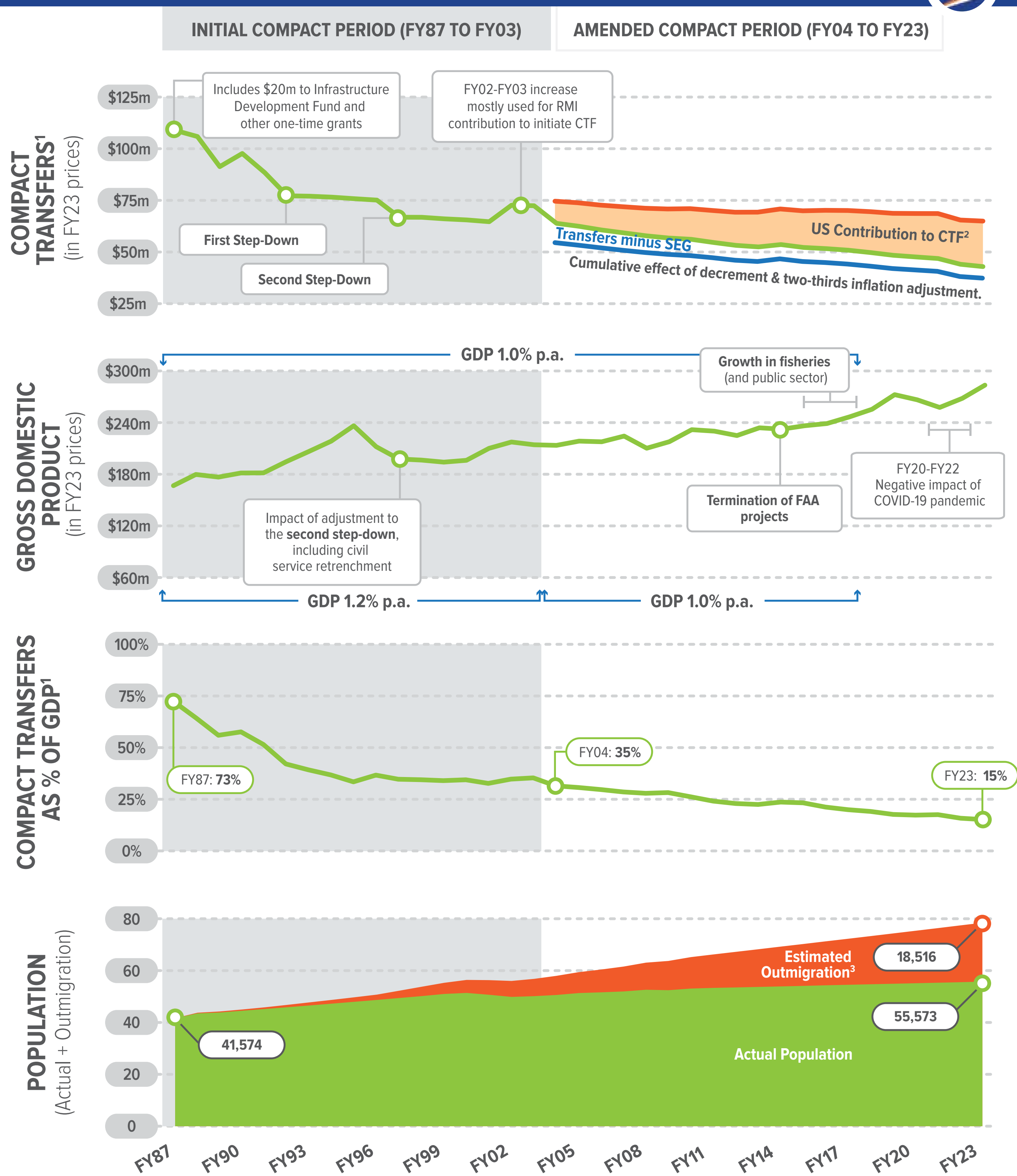
### *RMI Compact Timeline: Trends over both Periods (FY87 to FY03 & FY04 to FY23)*

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 (FY87-FY03) and under the amended Compact period (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 the RMI has achieved moderate but positive economic growth over the FY87 to FY18 period, which is expected to continue through the FY19 to FY23 projected period. This real growth was achieved while the RMI received declining real transfers through the Compact.

[2] It is reported that the US DOE will adjust the SEG funding level by FY23 such that that year's appropriation will reflect consistency with the mandated inflation adjustment. If so, the figures in this report require upward adjustment. For the RMI, the FY23 figure is estimated to be not $5.6m but $8.1m.

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 are shown in the blue line with SEG removed to allow for comparison across Compact periods.
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.

- 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 very high levels during the initial Compact period to a projected 15.2% GDP in FY23 –at the end of the amended Compact period.
- The fourth chart shows the gradual—but mounting—effect of cumulative emigration from the RMI to the US. 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 an estimated 22,638 by the end of FY23, not counting children born to RMI Compact migrants overseas.

### *RMI Reliance on Total US Assistance as of FY23*

US Compact transfers and on-budget federal programs and services support a significant share of RMI government operations, GDP, and employment. In the absence of this US support the RMI economy would be much smaller and employment much lower, while direct emigration to the US would be far higher.

Total projected on budget US support in FY23 is $59.1 million, comprised of $26.9 million in compact grants, scheduled to end after FY23; $5.6 million in SEG grants, scheduled to end after FY23; and $26.6 million of other on-budget federal programs and services ($17.5 million), and Compact grants related to Kwajalein not scheduled to end ($9.1 million).

This total US contribution represents 48% of government revenues and supports 23% of RMI GDP and 13% of employment.

Other valuable off-budget areas of US support also benefit the RMI economy but are not readily quantified. For example, the RMI benefits from US postal services, which end after FY23. Losing US postal services would increase costs for RMI consumers and businesses. Modeling the dollar impact on public services, businesses, and households of these services is beyond the current capability of the GSUSA macroeconomic modeling framework.

While the focus of this report is on the impact of the expiring Compact and SEG grants and the transition to trust fund proceeds, the continuation of the ongoing US programs past FY23 without interruption benefits the economy. If this $16.9 million in support ended, GDP would fall by an additional 11.1% and job losses increase by about 1,734 positions, about 16.2% of total employment. The impact on migration is exceptionally large, resulting in nearly 9,361 new migrants to the US, or 16.8% of the population. In practice, actual induced migration due to fiscal shocks would likely be spread over several years, and not all primary job earners or dependents may migrate.

### *Current State of Preparedness: RMI*

The RMI named a Chief Negotiator, the Minister of Foreign Affairs, and a negotiating committee staffed by the Ministry of Foreign Affairs and select government officials and outside counsel.

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 for the government 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 effectively manage a shock of the magnitude of the base adjustment scenario. Fortunately, the magnitude of reforms that the non-renewal of Compact assistance scenario would force would not be unprecedented and would result in only a minor economic impact.

The RMI is not prepared to mitigate the greater impact associated with any further reduction in US support than modeled in the non-renewal scenario.

## Palau Compact Structural Features

### *Palau Initial Compact Period (FY95 to FY09)*

The Palau Compact of Free Association came into force on 1 October 1994, at the start 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 vote was not achieved, a 1992 amendment to the Constitution reduced the 75% approval requirement to 50%. Thus, the Compact was approved on 9 November 1993 by 68% of Palauan voters in the eighth UN-observed plebiscite, as a sovereign act of self-determination.

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

| INITIAL COMPACT PERIOD<br>FY95-FY09 | COMPACT REVIEW AGREEMENT PERIOD<br>CRA Stopgap Funding<br>FY10-FY17 | COMPACT REVIEW AGREEMENT PERIOD<br>CRA Fully Authorized<br>FY18-FY24 |
|---|---|---|
| **RECURRENT FUNDING** | | |
| • Annual Budgetary Support:<br>» $12m FY95 to FY98<br>» $7m FY99 to FY04<br>» $6m FY05 to FY09<br>» $2m for scholarships<br>» $631k for surveillance and referrals<br>» $150k for communications<br>• Audit costs funded through OIA Federal Services Account. | Annual Stopgap Funding:<br>• $13m annual special appropriation<br>• Audit costs funded through OIA Federal Services Account. | • Annual Budgetary Support: $24.574m transferred in FY18 for use as follows:<br>» $13.1m in FY18<br>» $8.1m in FY19<br>» $3.3m in FY20<br>• Infrastructure Maintenance Fund: $2m annually FY18-FY24.<br>• 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)<br>• $36m in FY95 for infrastructure<br>• $28m in FY95 for energy grant<br>• $5.5m in FY95 for military options<br>• $1.5m in FY95 for communications<br>• $667K in FY95 for surveillance, referrals and scholarships | | • $20m in FY18 for infrastructure projects |
| **TRUST FUND** | | |
| • $66m contribution in FY95<br>• $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<br>• $10m in FY19<br>• $14.8m in FY20<br>• $15m in FY21<br>• $15m in FY22<br>• $15m in FY23<br>• $15m in FY24 |
| **ACCOUNTABILITY PROVISIONS** | | |
| • Section 231(a) requires an official National Development Plan (NDP)<br>• Section 231(b) requires an Annual Report to the president of the US on implementation of the plan and use of Compact funds.<br>• Section 432 Compact Review after 15th, 30th, and 40th years. | | • CRA Section 4(e) created Economic Advisory Group (EAG)<br>• 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.

The Compact and its subsidiary agreements were approved by the US as an "Executive Agreement of the United States containing international obligations." Within the US government the Compact is treated as a treaty obligation that required 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. As of July 2019, Palau had diplomatic relations with 89 countries. 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.

Title II of the Palau Compact describes the economic assistance for the 15-year period from FY95 to FY09. The US provided unrestricted budget support, targeted support for specific sectors, funds to establsih the Palau Compact Trust Fund, federal services, and committed to constructing a road system. During this period, most funding was provided under section 211(a) as unrestricted budgetary support. Palau's Compact designated $12 million annually for FY95 to FY98, $7 million annually for FY99 to FY04, and $6 million annually from FY05 to FY09 for this budget support. During the latter two periods Palau was authorized to distribute $5 million annually from the Palau Compact Trust Fund (CTF) to supplement its budget. Palau chose to forgo that $5 million distribution for the initial three years from FY99 to FY01, before beginning its annual allowed draw of $5 million from the CTF in FY02. The US provided a total of $70 million to the CFT in FY 95/FY97.

Additional annual US transfers for a total of $2.781 million were provided for communications, marine surveillance, health and medical programs, scholarships, and education/health block grants. One-time payments were provided in FY95 for infrastructure ($36 million); energy ($28 million), military impact if the US designated and used defense sites ($5.5 million), communications ($1.5 million), and for surveillance, referrals and scholarships ($667,000). In addition to the funding for infrastructure, the US committed to construct a road system that became the ring road on Babeldoab island at a cost to the US of $149 million.

Most of the specified annual transfer levels provided during the initial Compact economic assistance 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%. (The 7% cap 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%. Funds provided through the initial Compact were backed by a "full faith and credit" commitiment of the US government. In the US law approving the Compact, the Congress authorized and approported funds to cover Compact commitments for the full periord. Therefore, Compact funds were not subject to annual appropriations process.

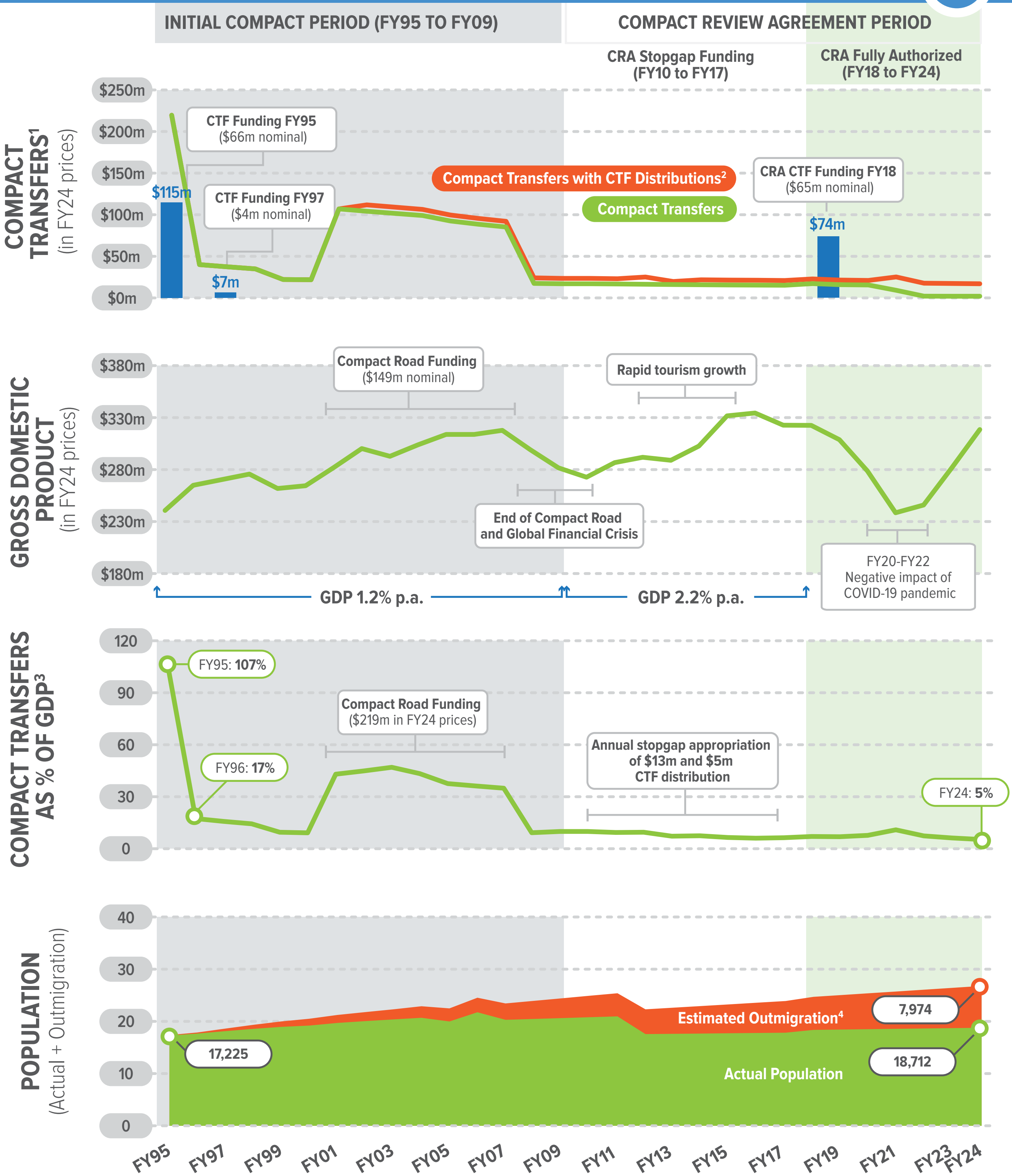
Figure 5 provides a summary comparison of the features of the initial Compact period and the Compact Review Agreement period for Palau.

### *Palau Compact Review Agreement Period (FY10-FY24)*

The Palau Compact requires a review of Compact effectivenss on the 15th, 30th, and 40th anniversaries of the Compact. 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 mandated 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 negotiation outcomes in the 3 Sept. 2019 Compact Review Agreement (CRA) include:

1. The parties agreed that the originally projected 12.5% annual growth rate for Palau's CTF was not met and warranted redress. The review process established the objective of the US "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% nominal annual growth for the period ending on 50th year of the Compact, and used the new target for subsequent calculations.
2. The US insisted on changes to the accountability provisions for transfers during the CRA period.

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.

However, the new oversight requirements in Palau were significantly lighter than in the amended Compacts for the FSM and RMI. In the end, agreed to create an "Economic Advisory Group" (EAG) to monitor Palau's economic progress and put forth recommendations that would, set the agenda of annual economic consultations. As of March 2022, the EAG had not been established or met. If it does meet, it will likely report considerable progress by Palau toward the original Compact fiscal and economic policy objectives.

3. In addition to funding to directly increase the value of the CTF, a revised schedule of distributions was agreed to through FY24.

Following delayed US Congress action to approve the CRA, it was implemented in December 2017; a subsequent bilateral amendment to the agreement entered into force 18 Sept. 2018. All CRA funds were transferred to Palau at the end of FY18. Only the infrastructure maintenance funding stream continues, at $2 million annually through FY24, contingent on Palau fullfilling its quarterly matching requirements.

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

i. **Stop-gap support**. For FY10-FY17, the US Congress provided annual appropriations of $13.147 million to total $105.176 million, prior to Congress approving the CRA in FY 2018.

ii. **Budgetary support**. A total of $24.574 million (including $2.47million provided through an FY18 stop-gap discretionary appropriation) was provided in FY18 to support spending and as a supplement to agreed upon annual distributions from the CTF for the years FY18 to FY20 (after which, Trust Fund distributions of $15 million are the only source of budgetary support).

iii. **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.

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

v. **Compact Trust Fund**. A total of $65.25 million was deposited into the fund at the end of FY18 to supplement the CTF's ability to achieve its original goal.

Congress authorized and appropriated funds to cover the full CRA commitments in FY18, thus the funds were not subject to any subsequent annual appropriations process.

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 FY19 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, which is expected to continue through the 30-year period from FY19 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 (including distributions from the CFT) has declined from moderately high levels during the initial Compact period to a projected level of 5.3% of GDP at the end of the CRA period.
- The fourth chart shows the gradual—but mounting—effect of cumulative emigration from Palau to the US. 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 an estimated 7,974 by the end of FY24, not counting children born to Palau Compact migrants overseas.

## *Palau's Reliance on Total US Assistance as of FY24*

US CRA transfers, ongoing CTF disbursements, and on-budget federal programs and services support a significant share of Palau's government operations, GDP, and employment. In the absence of this US support, the RMI economy would be smaller and employment lower, while direct emigration to the US would be higher.

Total projected on-budget US-sourced support in FY24 is $39.3 million, comprised of $2 million in CRA grants, scheduled to end after FY24; $15 million in ongoing CTF distributions; and $22 [computed, but 14.9 on Sims ROP tab] million of other on-budget federal programs and service.

This total US-sourced contribution represents 28%

of government revenues and is equivalent to 13% of Palau GDP.

Other valuable off-budget areas of US support also benefit the Palau economy but are not readily quantified. For example, Palau benefits from US postal services which potentially end after FY24. Losing US postal services would increase costs for Palau consumers and businesses. Modeling the dollar impact on public services, businesses, and households of this and other services is beyond the current capability of the GSUSA macroeconomic modeling framework.

While the focus of this report is on the impact of the expiring CRA grant and continued distributions from the CTF, the continuation of the ongoing US programs beyond FY24 without interruption benefits the economy. If this $22 [computed, but 14.9 on Sims ROP tab] million in FY24 US support ended, GDP would fall by additional 3.6% and job losses increase by 171 positions. This would result in 231 additional migrants to the US.

### *Current State of Preparedness: Palau*

Palau and the US are engaged in the "Second Compact Section 432 Review" to review and potentially renew economic assistance beyond FY24. Palau has created an officially designated Compact Review Committee, chaired by the Minister of Finance, but that Committee has held no formal meetings with US officials. The President of Palau, H.E. Surangel Whipps, Jr., met in Washington, DC, in August, 2021, with the Secretaries of the three key US departments—Defense, State, and Interior. In those meetings, the President expressed that the offer provided to Palau in December 2020 was inadequate and unacceptable. He also expressed a need for the parties to negotiate in a manner which would first define mutual goals and objectives, which would include a mutual review of the Compact relationship to-date (pursuant to section 432), and to ensure any assistance to Palau reflects the "updated value" of Palau in the context of global security realities now existent. Subsequent to that DC visit by the President, the Minister of Finance has undertaken only minimal technical discussions with the US government. From January 2021 the US has made it clear to Palau that the new administration in the US would settle on its approach to the FAS Compact renewal negotiations as a part of its larger Indo-Pacific Strategy

Reforms under implementation to mitigate the impact of COVID-19 may also provide a means for adjusting to reduced funding scenarios. The impact of COVID-19 and the need to develop an economic and fiscal response has absorbed the Palau policy and legislative agenda. With support from the ADB under a Policy-Based Loan (PBL), Palau has developed a program of reforms to assist in stabilizing the nation's fiscal and economic situation and to develop long-term instruments to fulfill and reduce debt service obligations as the economy recovers. The reforms to implement a modern tax regime, reforms to Social Security, and the private sector regulatory environment would enable Palau to better adjust to different funding scenarios.

## Current State of Preparedness of the USA, multilaterals and bilaterals

### *USA*

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 period from 2019 to the present, 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, the RMI, and Palau until they are mutually dissolved.

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 4, the consequences of letting the existing terms of each Compact prevail are significant for each nation. Alternatively, the benefits to an extension of US funding are shown in chapter 5. 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. In March 2022, the US President appointed a

Special Presidential Envoy for Compact Negotiations.

### *Major multilateral donors: World Bank, ADB, and the European Union*

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 US funding risks faced by the FSM and the RMI after FY23 contributed 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 World Bank 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.

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 ADB 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.

Dating back to 1996, ADB has a history 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 Bilateral Donors*

Japan aids all three FAS. Infrastructure projects remain the largest share of support, but Japan also provides support for sector projects, equipment purchases, and scholarships. Indirectly, Japan funds UNDP for support to the FAS in disaster preparation and to support operating costs under the Australia 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. Japan has no direct mechanism 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 Compact 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 of 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 Compact adjustment.

China is an important development partner for the FSM. The focus of the program is large infrastructure 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 only 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 FAS 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. Australia has no direct mechanism to provide budgetary support in the event of a major fiscal adjustment and officials from their FSM embassy that covers all three FAS indicated they have received no requests related to the potential FY23/FY24 Compact 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.

In 2021, the three FAS announced their intention to withdrawl from the Pacific Island Forum, but in February 2022, the three nations paused their withdrawl to await PIF reform actions.

# 2

# FAS ECONOMIC STRUCTURE AND PERFORMANCE

# 2 FAS ECONOMIC STRUCTURE AND PERFORMANCE

**Analysis of the FAS economies set the stage for the impact of the Compact scenarios discussed in subsequent chapters**. This chapter serves two purposes. Firstly, it provides a brief overview of each of the 3 FAS, the structure of their economies and economic performance before the impact of COVID-19[1]. The second purpose is to provide an understanding of the reasons for the divergent impact of COVID-19 on the 3 FAS economies. The impact of COVID-19 on the FSM and RMI economies has not been significantly different to the normal volatility in growth experienced during the economic cycle. However, for Palau the impact has been devastating. The background provided here on the FAS economies coupled with the next chapter on the economic impact of COVID-19 sets the stage for the subsequent analysis of the main focus of this report: the impact of the two Compact scenarios on the FAS.

## FSM Economic Structure and performance

### *Economic Structure*

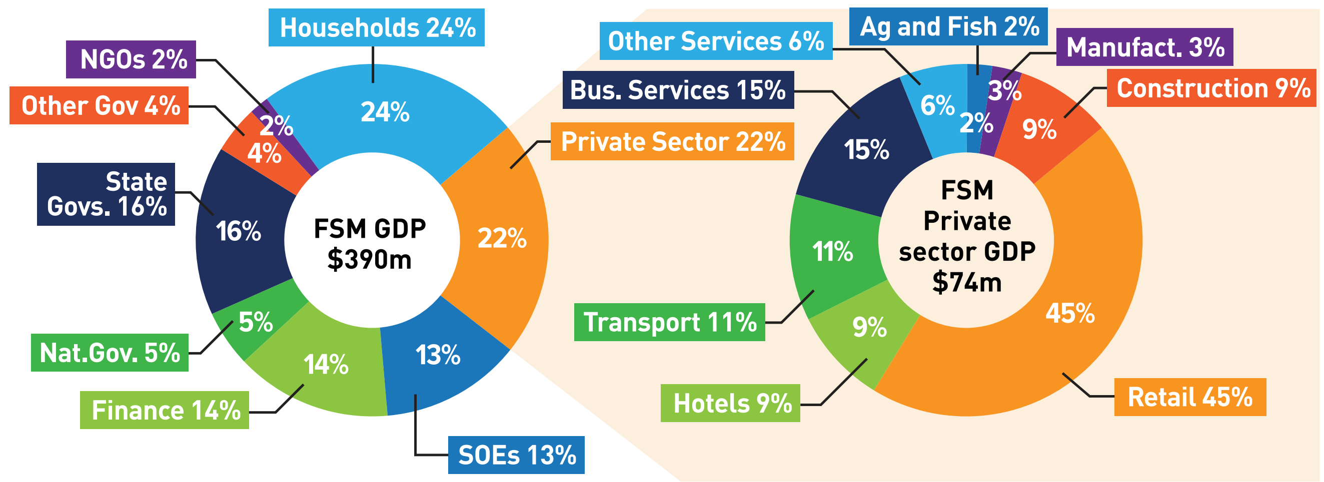
**The private sector is small and underdeveloped in the FSM**: Figure 7 indicates the structure of the economy by institutional sector and the composition of the private sector by industry. The private sector represented an average of 22% of GDP during the FY17-FY19 period. The private sector is smaller than the FSM's two sister FAS, the RMI and Palau, where it represents 33%and 47% of GDP, respectively. The government sector, comprising national, state, municipal and agencies represents 25%, smaller than the RMI and Palau, where the government represents 30% and 28%, respectively. Despite the national and state government bureaucracies, the share of government in GDP is lower in the FSM than in the RMI. However, the FSM has relied on the public sector as the major engine of growth.

**The household and informal sector is relatively large in the FSM reflecting the slower rate of economic growth and transformation of the economy**: As an indirect measure of development of the modern economy, production of the household sector in both informal and non-marketed or subsistence production in the FSM represents a large 24% compared with 13% in the RMI and 10% in Palau.

**The small private sector provides services to other sectors in the economy and is dominated by retailing**: The FSM has been unable to develop those industries in which it is presumed to have a comparative advantage: agriculture, fisheries, and tourism. See Figure 7. In contrast, fisheries represents 37% of RMI private sector activity, and in Palau the tourism economy is 38% of private sector activity. The private sector in the FSM is largely comprised of services providing support to the public sector. The largest private sector activity is retail, representing 45% of private sector GDP, with the next largest being business services and transport. During the business cycle the private sector growth has typically mirrored that of the public sector, though this correlation did not hold during the COVID-19 pandemic period during which private sector performance was more deeply affected.

[1] See also recent GSUSA Economic Reviews of FSM, RMI and Palau, FY18 for an in-depth analysis of economic structure and performance.

Figure 7: FSM Institutional Structure of the Economy, FY17-FY19, 3-Year Average

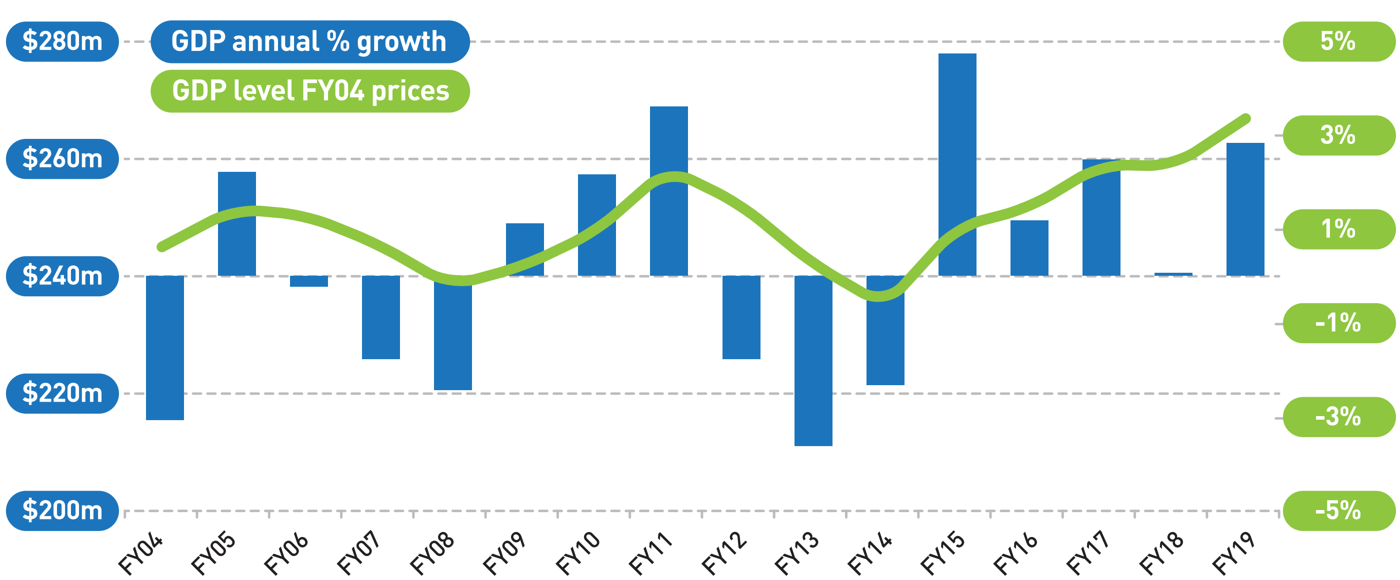



## *Economic performance*

**Failure to develop a competitive private sector has resulted in weak economic growth**: The FSM's economic performance has been weak during the amended Compact period, with annual real growth averaging 0.3% from FY04 to FY19, see Figure 8. This is below the FSM's sister FAS, the RMI which grew by an average 1.4% (FY04-FY19), and Palau which grew by an average 0.6% (FY01-FY19). The weak performance in the FSM reflects the natural disadvantages such as the small size of the country and its remote geographical location common to the other FAS, but also results from an uncompetitive private sector policy environment, and a failure of the economy to foster new private sector industries in areas of potential comparative advantage. 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, the economy has been in a perpetual state of minimal growth.

**Significant divergence in state level economic performance and income levels has occurred**: A critical

Figure 8: FSM GDP Level (FY04 Prices) and Annual % Growth:
FSM economy averges 0.3 percent annual growth between FY04 and FY19

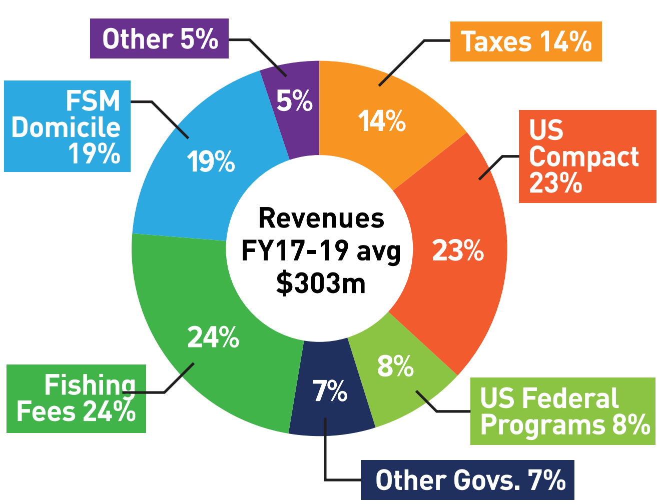


characteristic in the development and political economy of the FSM is income growth and income differences between the four states. GDP per capita levels are also widely divergent with Pohnpei at $3,700 in FY19, Yap at $3,100, Kosrae at $2,400, and Chuuk at $1,400. The difference puts Kosrae at 35% below Pohnpei, while Chuuk is 61% below Pohnpei.

## *Fiscal structure*

**Sovereign rents have grown rapidly and now represent close to half of all FSM revenues**: Figure 9 indicates the structure of revenues by type. In more developed countries, tax revenues represent the vast majority of government revenues, but in the FSM taxes represent only 14% of total revenues. The tax regime is based on an outmoded regime inherited from Trust Territory days that lacks buoyancy and is ripe for reform. The most important sources of revenue are grants, at 38% of the total, but they are either fixed in nominal terms or decline due to the lack of indexation of the Compact sector grants. The economy remains highly dependent on foreign assistance from its donor partners: U.S. Compact grants and federal programs, multilateral, and other bilateral grants. Taking grants and certain taxes together, over half of revenues are inelastic with respect to GDP. The major buoyant source of revenues, which has grown very rapidly in the last few years, is sovereign rents: fishing fees derived from Parties to the Nauru Agreement and implementation of the Vessel Day Scheme (24% of revenues), and the FSM domicile for Japanese corporations (19% of revenues).

**Figure 9: FSM National and State Governments Revenue Sources, FY17-FY19 Average**
Major revenue sources comprise Compact grants and soverign rents, while taxes are minor




**The structure of government expenditures is evenly balanced between the normal functions of government**: Figure 10 provides a broad picture of government expense by function, averaged over the FY17-FY19 period. Public services are relatively evenly spread across the normal functions of government. Two sectors, education and health, are predominantly funded through the Compact and delivered at the state level; they represent 19% and 16% of expenditures, respectively, but remain relatively small despite the focus of the amended Compact. Public administration at 31% is the largest share of government spending. Economic affairs has a small share at 5%, but investment in capital projects is high, at 21%. The high proportion of investment in capital assets, despite the collapse in the use of the infrastructure grant, largely reflect recent spending on public projects from national government funds, although World Bank ICT projects and FAA airport improvements are included. The implied investment capital to output ratio (ICOR), given the weak performance in the economy, indicates a low level of efficiency and productivity of investment.

**Public expenditure levels at the national and state governments have diverged as revenues accruing to the national government have grown rapidly while state revenues have languished**. The average level of expenditure for FY04-FY06 was $151 million, with the national government responsible for 33% and the remainder being spread over the four states. Since that time, the proportions have changed greatly; he national government now directs more than half of all expenditures. During the same period, state government expenditures in total have grown by 5% in nominal terms while national government expenditures have grown by 145% in nominal terms. Given that service delivery predominantly takes place at the state level, the implications for service delivery are profound.

## *Fiscal Performance*

**Fiscal balance has been maintained by the four state governments over the last decade; however, service delivery has been severely constrained at the state government level**: The FSM government comprises four state governments and a national government, with much of the responsibility for public service provision—including education, health, and public safety—held primarily 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 have maintained fiscal balance since FY09, see Figure 11.

Figure 10: FSM National and State Governments, Expenditures by Function, FY17-FY19 Average
Allocation of expenditures to capital assets is high given the low performance of the economy

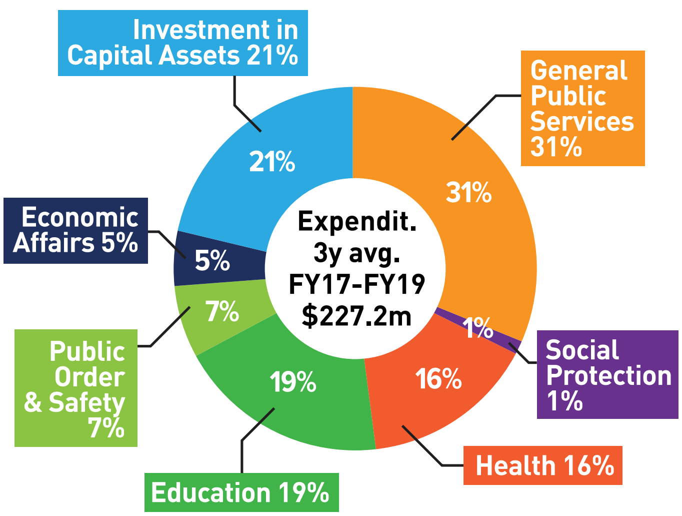
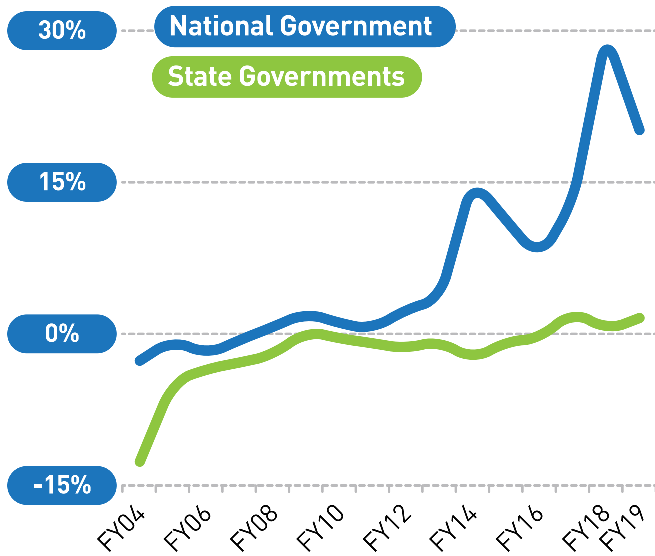



Figure 11: FSM Fiscal Balance National and State Governments, Percent GDP, FY04-FY19
State governments maintain fiscal balance while national runs large surpluses




**National government runs large fiscal surpluses**: 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 steadily from 5% of GDP at the start of the amended Compact, to an average of 21% of GDP - FY15-FY19, with minimal volatility. In FY19 receipts from fishing licenses were $73 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 national revenue base spikes periodically. In FY18 and FY19, for example, it averaged 24% 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 FY15-FY19, this large structural surplus averaged 19% of GDP, peaking at almost 30% in FY18.

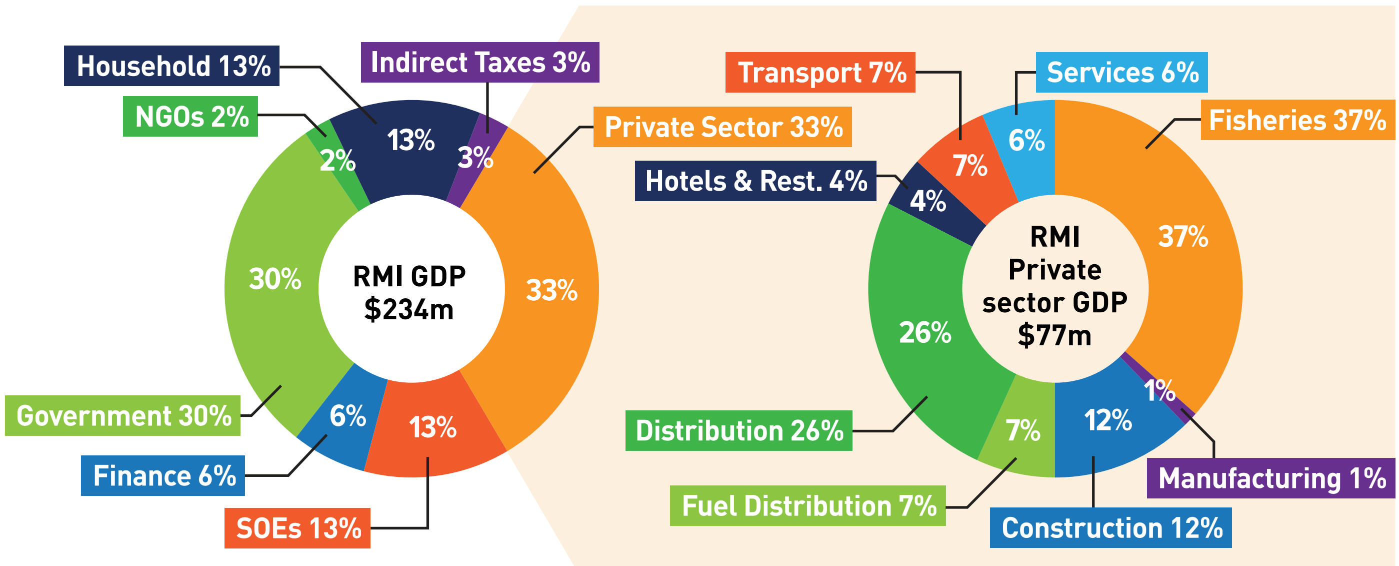
**Large fiscal surplus has supported rapid growth in the nation's FSM Trust Fund**: The large increase in resources has been utilized in two major ways. Firstly, and most importantly, the FSM has created a national trust fund (FSMTF) and increased its holdings of uncommitted funds. About two-thirds of the additional resources have been allocated to the fund or remain unspent. At the end of March 2021, the FSMTF is estimated to be close to $350 million, a significant—and impressive—achievement. The national government is committed under a series of public laws to adding about $24 million annually to the fund; however, during the COVID-19 pandemic period, a portion of these funds has been diverted into the economic stimulus package and tourism sector mitigation relief fund.

# RMI Economic Structure and performance

### *Structure of the economy*

**The RMI private sector is small as a share of GDP but has grown significantly**. Figure 12 indicates the structure of the RMI economy by institutional sector, with a further detailed indication of the composition of the private sector by industry. The private sector represented an average of 33% of GDP during the FY18-FY20 period. The size of the private sector falls between the RMI's two sister FAS, the FSM and Palau, which have the private sector at 22% and 47% of GDP respectively. The RMI's government sector, comprising national, local and agencies, represents 30% of GDP, compared with 28% in Palau and 25% in the FSM. As an indirect measure of development of the modern economy, production of the household sector in both informal and non-marketed or subsistence production in the RMI averaged 13%, compared with 24% in the FSM and 10% in Palau. Palau clearly has the most developed

**Figure 12: RMI Institutional Structure of the Economy, FY18-FY20, 3-Year Average**
Private sector is small in the RMI but fisheries is the largest segment




and modern economy with a relatively large private sector, whereas the FSM has a large informal sector. The RMI, on the other hand, has greater integration into the cash economy than the FSM, but has relied upon the public sector as its major engine of growth.

**The fisheries export sector is the largest component of the private sector, with other industries providing services to the domestic economy**. Figure 9 also disaggregates the structure of the private sector by industry. The largest industry is fishing, which is comprised of offshore purse seine fishing, near-shore reef fishing, and onshore fish loining. Overall, fishing represents 37% of private sector activity. Construction is also a significant driver of private sector economic activity, representing 12%. The transport, hotels and restaurant sectors are relatively small, representing 11% and providing services to a small number of visitors and tourists–in addition to onshore services to fishing fleets. Distribution (retail and wholesaling) activity is large representing 26% of private sector activity and it is dependent on the overall level of demand in the economy.

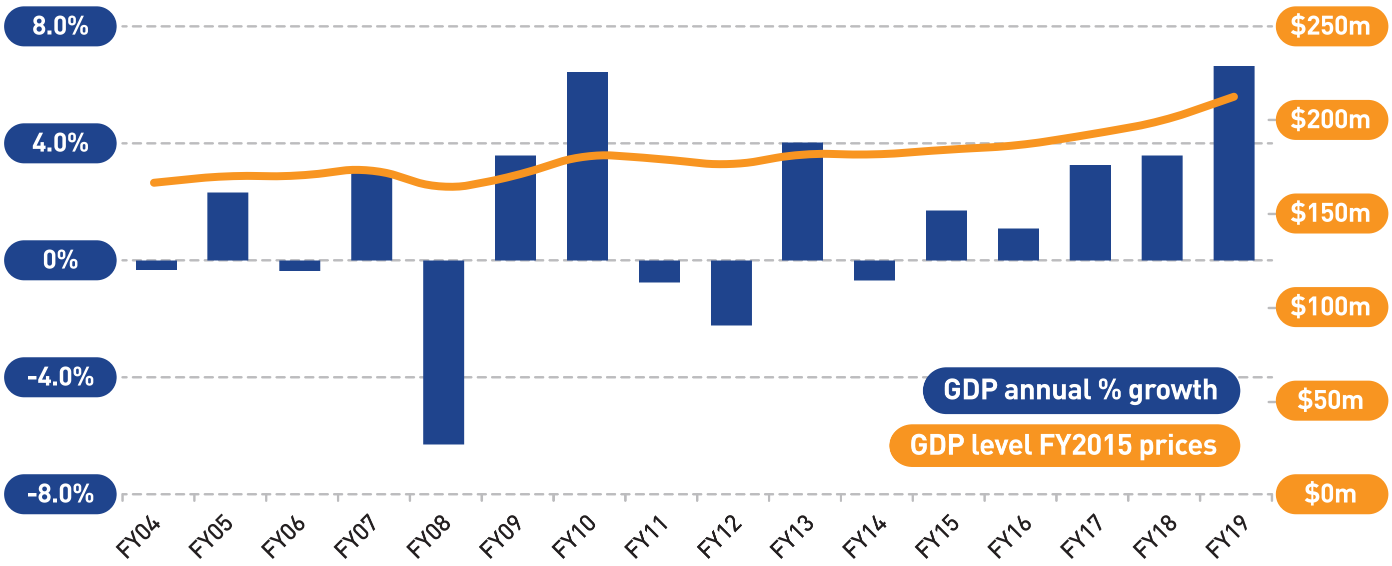
### *Recent economic performance*

**Economic growth in the RMI has been modest during the amended Compact, averaging 1.4% annually with high volatility**. The RMI's economic performance from FY04 to FY19 has been modest, with real economic growth averaging 1.4%, as Figure 13 reflects. It compares to Palau, which grew by an average 0.9%, but considerably more than the FSM, which grew at an annual average of 0.3% over the same period. The RMI's low average growth during the period reflects high volatility between periods of strong growth in fisheries, construction, and services, against periods of substantial contraction. The main drivers of growth during the amended Compact have been fisheries, private services, including finance, and public sector services. Public administration, education and health have all been forces of growth supported by disbursement of the Compact sector grants in education and health.

**From FY15-FY19 economic growth increased, attaining an average of 3.0%**. During the first half of the amended Compact, through FY14, economic growth was weak, averaging 0.9% per annum. However, during FY15-FY19, the economy grew more rapidly, with an average growth of 3.0%, which reflected growth in fisheries, construction, shore-based services to fishing fleets and financial services. It was further boosted by the general boom in sovereign rents, fishing royalties, and fees from the shipping registry, which increased the fiscal envelope and allowed growth in public administration.

**Private sector growth outperforms public sector.** The provision of government services grew modestly with little variation by an average of 1.3% per annum matching the average rate in the economy. The private sector, however, performed far better averaging 2.4%, but with considerably greater volatility. The large swings in the rate of growth for the overall economy thus reflect the even greater volatility in the private sector.

**Figure 13: RMI GDP Level (FY15 Prices) and Annual % Growth**
RMI economic growth averges 1.4 percent annual growth during the amended Compact




## *Fiscal Structure*

**External grants represent the largest share of revenues while tax effort is low, reflecting an outmoded regime.** Figure 14 indicates the structure of revenues by type, at the start of and end of the amended Compact. In more developed countries, tax revenues represent the largest element of government revenues, but in the RMI tax effort is low and has fallen from 29% of total revenues to only 22%. The tax regime is outmoded, inherited from Trust Territory days and requires reform. It lacks buoyancy—or growth in relation to economic activity. The most important sources of revenue are grants that have also fallen as a share of revenue from 65% at the start of the amended Compact to 48%. This amount is either fixed in nominal terms or declines, reflecting the lack of full indexation of the Compact sector grants. The RMI economy remains highly dependent on foreign assistance from its donor partners: U.S. Compact grants, federal programs, multilateral, and third country grants.

**Sovereign rents have grown rapidly in recent years and enabled rapid growth in expenditures**. Taking grants and taxes together, over two-thirds of total revenues are inelastic with respect to GDP. The major growing source of revenues over the last few years is sovereign rents. This element includes fishing fees derived from Parties to the Nauru Agreement (PNA), implementation of the Vessel Day Scheme (VDS), and revenue from the ship registry. These sources, which once represented 3% of revenues have grown to represent 28%.

**The provision of economic services has grown significantly, reflecting increased subsidies to SOEs and the outer atolls**. Lastly, in the discussion on fiscal structure Figure 15 displays the allocation of government expense by function. The two major functions--public administration and education--both indicate a reduction despite the priority attached to education in the amended Compact and by the RMI government itself. Health services, however, indicates a small increase in share, reflecting the importance of improving health outcomes in the RMI under the Compact and by the government. The main area of increase in service delivery has been economic affairs, which reflects the large growth in subsidies and transfers, especially to SOEs and the copra subsidy to outer island growers. The growth in subsidies and transfers reflects both a high political priority and a corresponding weak SOE management.

## *Recent fiscal performance*

**Revenues fell as a share of the economy in the first ten years of the amended Compact, but grew rapidly with the growth in sovereign rents**. During the first ten years of the amended Compact, revenues declined as a percentage of GDP, reflecting the inelastic and outmoded tax regime and static nature of Compact grants in nominal terms. The FY14-FY20 period reflected growth in a new form of revenue—fishing royalties arising out of the VDS from the PNA—resulting in a 10% increase in the share of overall revenues.

**Payroll has declined as a share of GDP, but expenses on subsidies and transfers has doubled**. Current expenses have displayed a largely reactive position with respect to current revenues. The decline in the revenues/ GDP ratio during the initial 10 years led to a tight fiscal position that constrained expense. However, as the revenue base expanded with the increase in fishing fees, expenses also expanded. Within current expenses, discipline has been maintained over payroll, which declined in relation to GDP, falling from an average of 25% at the start of the amended Compact to 21% during the last three years. While the use of goods and services has been largely constant, the main area of expansion has been in subsidies to the large SOE sector and transfers to NGOs and households, which have doubled from 12% to 24% of GDP. On the capital side, grants have been the main source to cover expenditures, which, as with current expenses, have risen and fallen in tandem.

**Fiscal policy in the RMI has been driven by revenue availability**. The fiscal deficit -- in essence the difference between current revenues and expenses since the capital account is largely balanced -- was largely in balance through the period. Fiscal policy in the RMI has been driven by revenue availability and the stage of the economic cycle. During the initial period through FY14, budget discretion was severely limited and expenses were forcibly constrained. Thereafter, with the boom in revenues, expenses grew unconstrained given the availability within each year's fiscal envelope. The failure to create a fiscal reserve during the period when the fiscal envelope was expanding carries a dramatic lesson for RMI policy makers going forward.

## Palau Economic Structure and performance

### *Economic Structure*

**Private sector represents half of the economy, but government remains substantial**. Figure 16 indicates the structure of the Palau economy by institutional sector and the composition of the private sector by industry. The private sector represented an average of 47% of GDP during the FY17-FY19 period. The size of the Palau private sector is larger than in the RMI and the FSM, with their private sector representing 33% and 22% of the economy respectively. The government sector in Palau, comprising national, state and agencies, represents 28%, compared with 30% in the RMI and 25% in the FSM. As a measure of development, production of the household sector in both informal and non-marketed or subsistence production in Palau averaged 10%, compared with 13% and 24% in the RMI and FSM, respectively.

**Tourism-related activities dominate the private sector.** Figure 16 also breaks out the structure of the private sector by industry. The large tourism sector is reflected in the accommodation, restaurant and transport industries with some production occurring in other sectors such as tourist related retail operations. Overall tourism activity represents about 38% of private sector

**Figure 14: RMI Revenue by Type, FY04-FY06 Compared with FY17-FY19**
Grants dominate revenues but with large contribution from soverign rents

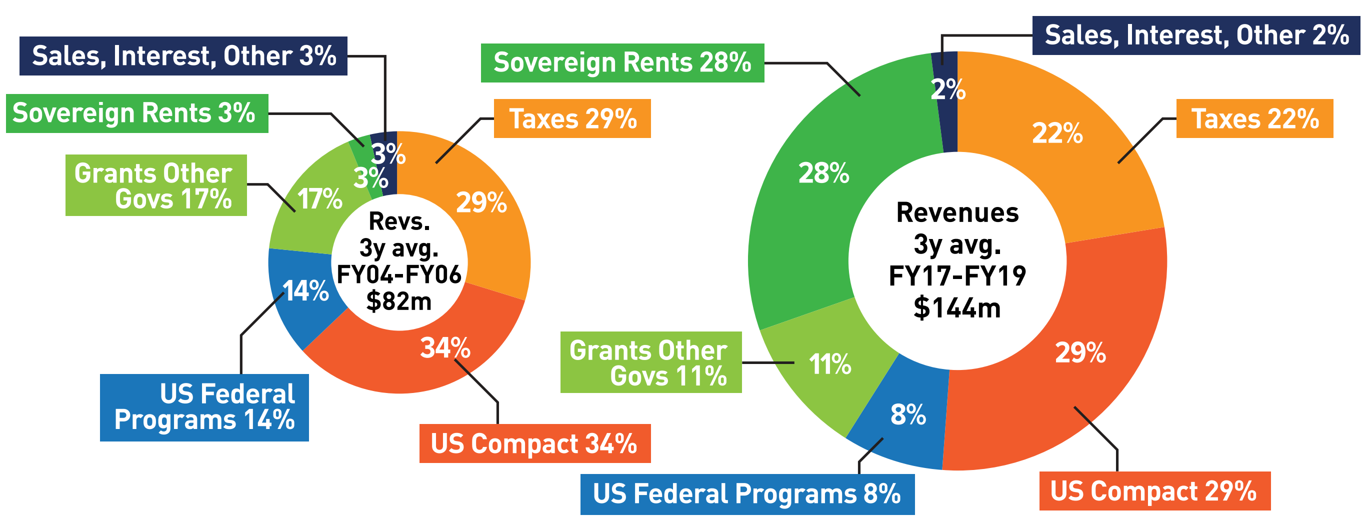
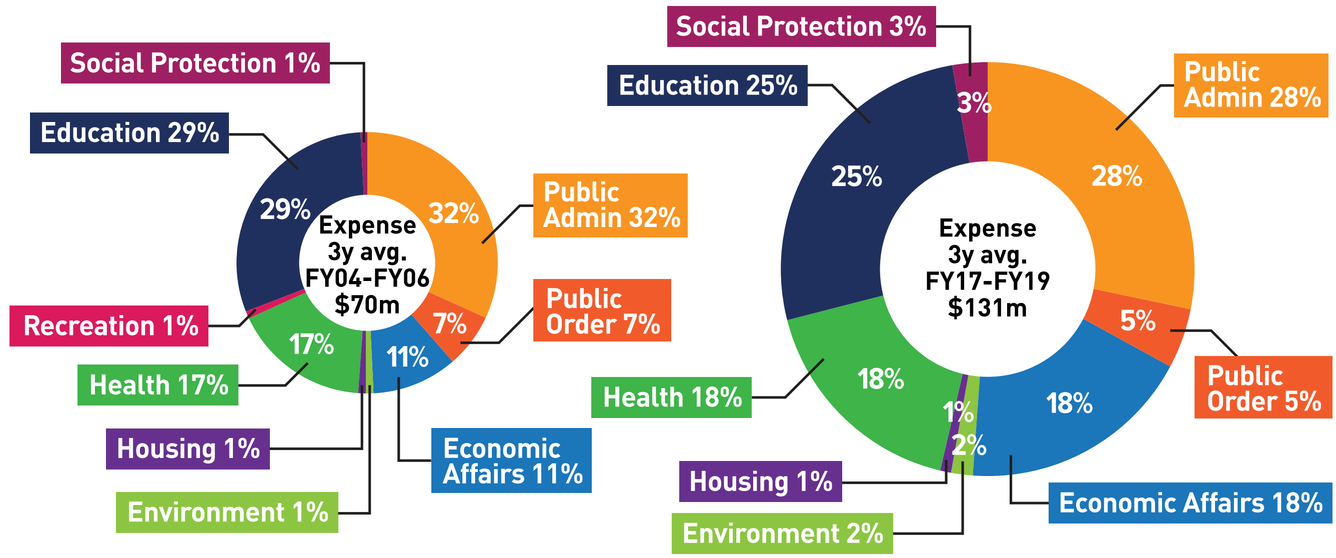


**Figure 15: RMI Expenditures by Function, FY17-FY19 Average**
Public administration, education and health dominate delivery of public services




activity. Construction is also a major driver of demand representing 10% of the private sector. While the retail segment is large at 32% servicing the local population, the remainder of private sector activities is small.

## *Recent economic performance*

**Palau's economic growth has been modest and comparable to that of the RMI and FSM**. Palau's economic performance during the pre-COVID period FY01-FY19, has been modest, with real economic growth averaging 0.6% during the period, see Figure 17. This is comparable and about halfway between Palau's sister FAS, the RMI, which grew by an average 1.2% growth, and the FSM, which grew at an annual average of 0.1%. 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, information communication technology, and the construction industry.

**Figure 16: Palau Institutional Structure of the Economy, FY17-FY19, 3-Year Average**
Private sector is largest in the economy with tourism biggest industry

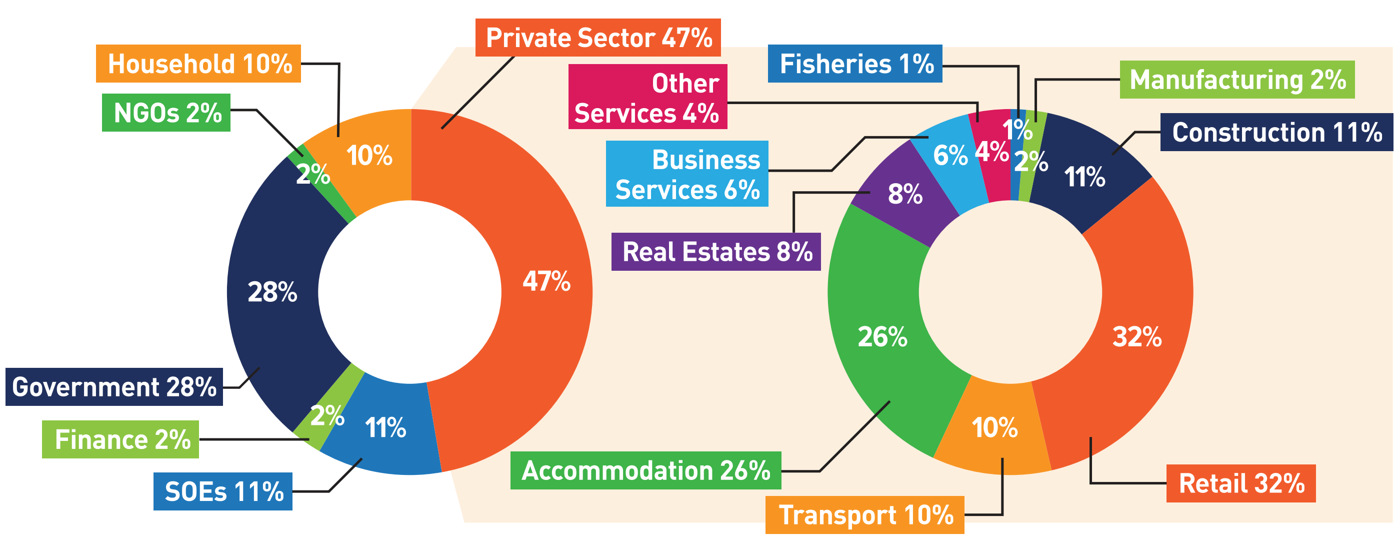


**Figure 17: Palau GDP Level (FY15 Prices) and Annual % Growth**
Palau economy averges 0.6 percent annual growth between FY00 and FY19 with a high degree of volatility

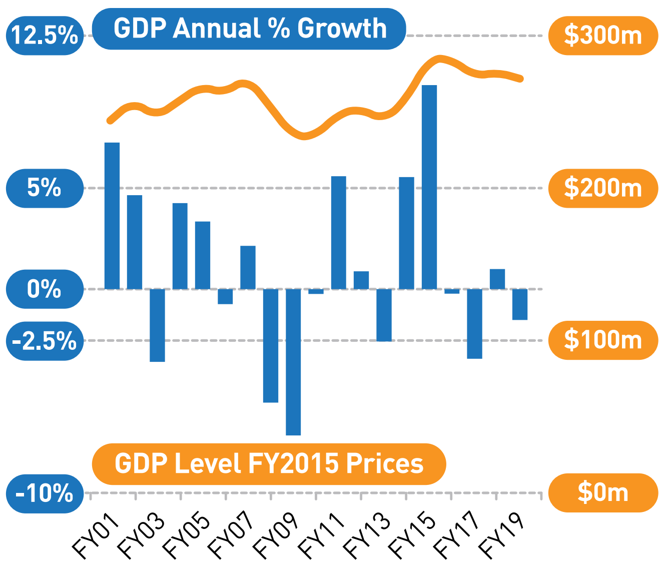
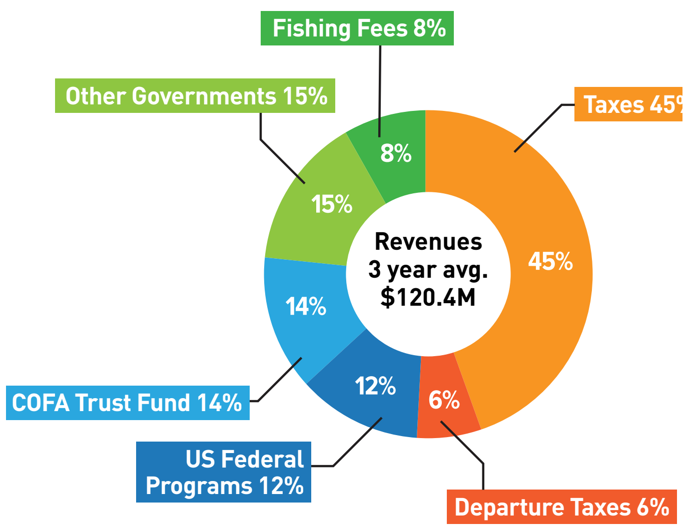



**Figure 18: Palau Revenue Sources, FY17-FY19 Average**
Taxes are major compent of revenues but grants are large




**During the last 20 years economic growth has been highly volatile**. During the period from FY01 through FY05, the economy grew by an average 3.1%, which reflected a combination of the construction of the Compact Road and tourism. This was followed by a period of contraction as the road project came to an end, and because of the impact of the global financial crisis in 2008 and 2009 on tourism; overall GDP declined by an average 2.5% during FY06-FY10. From that point Palau underwent a tourism expansion phase, growing by an average of 3.7%. But that came to an end after FY15 and the economy stagnated through FY19 as visitor arrivals contracted to a level only 6% above the FY05 level. While Palau's relatively high level of Gross National Income (GNI) of $16,745 per capita in FY19 places it in the World Bank's high-income category, economic growth performance has been modest and highly volatile.

## *Fiscal Structure*

**Significant reliance on grants has resulted in an inelastic revenue trend**. Figure 18 indicates the structure of revenues by function. While the major component of revenue is taxes at 41%, it is a relatively low proportion of overall revenues. This provides some insulation of the revenue base from declines in economic activity, but also leads to a lack of buoyancy with respect to economic growth, as many of the other sources such as grants are fixed in nominal terms.

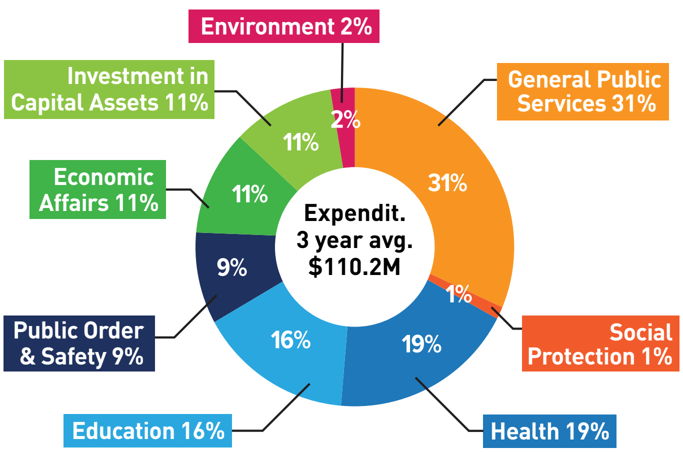
Clearly, the economy remains highly dependent on foreign assistance from its donor partners: U.S. Compact grants, federal programs and other country grants represent a total of 38% of total revenues. Fishing fees have grown to 7% but not to the extent of that in the FSM and RMI.

**Administration expenses are high in Palau compared with health and education**. Figure 19 provides a broad picture of government expense by function. Just over a third of expense, 36%, is allocated to social services in education and health. This compares with the FSM at 36% and RMI at 46%. In Palau, a significant proportion of expense, 31% is allocated to general administration.

## *Fiscal Performance*

**Tax effort has increased in recent years with additional taxes on tourism**. After a long period of a relatively unchanged tax effort, taxes began to rise as a share of GDP after the tourism boom of FY15. This was largely due to increases in tourism-based taxes, such as the Pristine Paradise Environment Fee, coupled with increases in taxes on tobacco. An additional important component has also been the increase in fishing fees, arising out of the Vessel Day Scheme from the Parties to Nauru Agreement. While small compared with the other two FAS, fishing fees rose from close to zero in FY05 to nearly $10 million in FY19.

**Figure 19: Palau Expenditures by Function, FY17-FY19 Average**
Administration is the largest component of expenditures




**While payroll has been held in check Palau has failed to maintain a good level of infrastructure investment**. Current expense has displayed a largely static relationship to GDP through FY14 but fell during the tourism boom years through FY17 as GDP grew rapidly. However, as economic growth weakened, expense continued to grow and expanded as a share of GDP through FY19. Within current expense, payroll has declined in relation to GDP, falling from an average of 19% at the start the 2000s to 15% during the three years FY17-FY19. Use of goods and services has been largely constant while transfers to other components of government, NGOs and households has risen. On the capital side, both capital grants and expenditures on fixed assets have decreased as a share of the economy, indicating a potentially worrisome lack of spending on public infrastructure.

**Palau runs fiscal surplus during the tourism boom years**. The fiscal deficit (in essence the difference between current revenues and expense since the capital account is largely balanced) was largely in balance through FY14. Since then, Palau ran significant surpluses as the tourism industry expanded rapidly but returned to balance as the tourism industry boom came to an end in FY19. Palau has displayed a significant degree of discipline in execution of the annual budget and during the FY14-FY19 period achieved significant savings, which enabled the accumulation of a significant fiscal reserve.

# 3

# THE IMPACT OF COVID-19 ON THE ECONOMIES OF THE FAS AND OUTLOOK THROUGH THE REMAINDER OF SCHEDULED COMPACT GRANT ASSISTANCE

# 3 THE IMPACT OF COVID-19 ON THE ECONOMIES OF THE FAS AND OUTLOOK THROUGH THE REMAINDER OF SCHEDULED COMPACT GRANT ASSISTANCE

**The FAS economies are projected to have recovered from the COVID-19 pandemic by FY24, but will operate from a lower base than anticipated before the pandemic**. In the last chapter, we reviewed the structure and performance of the FAS economies before COVID-19. In this chapter we look at the direct impact COVID-19 had on these small economies and what it will mean as they enter a new Compact period after FY23 in the FSM and RMI and after FY24 in Palau. The assumptions of the study are that, by the end of FY23 the economies will have reopened to the outside world and be well on their way to full recovery. However, the economies will operate from a lower base than anticipated in the original projections presented in January 2020[1].

## The Federated States of Micronesia

**Projections are based on the core assumption that travel limitations will remain in force though much of the first half of FY22**. As we expect that travel restrictions will not be lifted until mid-FY22, the full force of the COVID-19 pandemic will be felt throughout FY21 and well into FY22. These projections have assumed that in FY22, production levels of the affected sectors recover by one-half of their normal levels and are fully recovered by FY23. This reflects the FSM's slow roll-out of the vaccination program and cautious reopening of the economy to the outside world. However, the assumption that travel restrictions are lifted by mid-FY22 may be optimistic, as the FSM restricted arrival flights in February 2022 due to increased COVID cases in Guam. The FSM economy relies very little on tourism and visitor arrivals; nevertheless, the projected economic consequences of the COVID-19 pandemic are significant. Further details of the economic impact of COVID-19 on the FSM economy can be found in a recent Economic Issues Paper prepared by GSUSA[2].

### *Mitigation*

**At the onset of the pandemic, the FSM initiated a Tourism Sector Mitigation Relief Fund**. In April 2020, shortly after the onset of the pandemic, the FSM President initiated an economic stimulus package, and the FSM Congress initiated a tourism sector mitigation relief fund (TSMRF). The TSMRF was initially credited with a $1 million congressional appropriation to support tourism operations that were adversely affected by the pandemic. In addition, approximately $9 million normally earmarked for the FSM Trust Fund as of April 2020 through the remainder of FY20 were diverted to the TSMRF. Further, the TSMRF also received $0.5 million from the FSM NORMA project development fund and $3 million (out of $6 million) from the ADB's Pacific Disaster Resilience Program. In total, the FSM secured almost $15 million for the TSRMF.

[1] Graduate School U.S.A., The Economic Impacts of the End of Compact Grant Assistance in the Freely Associated States, Econ-MAP, Economic Issues Series, Honolulu, January 2020.

[2] Graduate School U.S.A., Economic Impact of the COVID-19 Pandemic and Policy Assessment of the Federated States of Micronesia, EconMAP, Economic Issues Series, Honolulu, June 2021.

**FSM received a large donor response to develop a health response framework**: At the onset of the crisis, the national government initiated an FSM COVID-19 Response Framework to prepare the nation with a series of steps to mitigate the impact should the FSM become subject to the virus. Donor support for the program was immediate and strong, with the US providing the majority of health-related grants: $7.7 million under an OIA TA from the US CARES Act, $7 million of unspent Compact sector grants, plus a series of other, smaller federal program grants from the CDC and other US agencies totaling about $29 million. Further health related funding of $2.5 million was available from the World Bank and $5.0 million from the ADB.

**CARES Act unemployment benefits generated significant benefits to affected FSM workers**: As with the other Freely Associated States, FSM citizens were made eligible for unemployment support from the US government under the US CARES Act.

Initial funds of $36 million were awarded and despite some technical issues related to the drawdown process, that full amount remains available to the FSM. In the modeling framework the projected counts of unemployed workers are multiplied by the CARES Act unemployment benefit rates to generate the impact on household incomes.

**ADB grants FSM $14 million to support HEALS program**. The ADB supported the FSM's Health and Livelihoods Support Program (HEALS), a sub-program of the CPRO with a $14 million grant to support businesses and "low-income and vulnerable households" affected by the pandemic. ADB also granted a further $6 million to replenish the FSM Disaster Relief Fund.

## *Economic Impact*

**The FSM economy is projected to contract by 5.1% over FY20 and FY21 compared with FY19.** The economic impact of COVID-19 on the FSM economy is shown in Figure 20. Projections indicate the COVID-19 pandemic will cause a 3.9% drop in GDP in FY20 and a further 1.2% reduction in FY21-a combined reduction of 5.1% over the two-year period. This contrasts with a May 2020 economic impact assessment that projected a reduction in GDP of 4.9 and 2.0% in the two years, respectively[3]. The reduced level of impact results mostly from the positive impact of FSM-managed mitigation and stimulus programs.

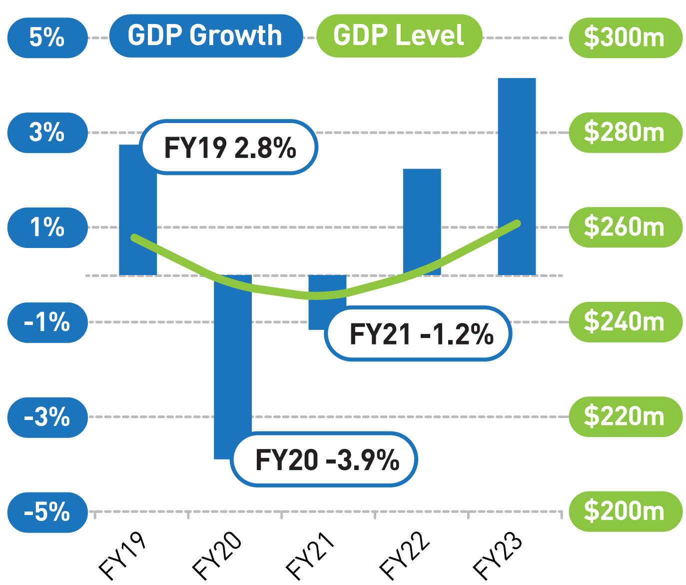
**Mitigation programs have helped reduce the impact on GDP, but not as much as may have been generally anticipated**. Given that the various mitigation efforts did not directly impact production levels in the worst-affected sectors of transport and tourism, their effect on measured GDP is not as great as may have been anticipated. The added stimulus added to aggregate demand and, indirectly, to some additional output in the economy when spent. This is not a critique of the programs as designed and implemented. In fact, programs aiming to protect the disposable income of affected households are preferable to programs designed to purely protect measured GDP. Similarly, programs to address national health system vulnerabilities are meritorious despite their import-intensive character.

[3] Graduate School U.S.A., Assessing the Impact of COVID-19 on the FSM Economy, EconMAP Technical Note, June 3, 2020.

## *Impact on Private and Public Sectors*

**Private sector GDP is projected to contract by 12.7% during FY20 and FY21**: Figure 21 indicates the impact of the pandemic on private and public sector GDP. The public sector is projected to decline only incrementally in FY20 and then grow slightly in FY21, with some contraction through FY23. The main COVID-19 impact has been on the private sector: a large reduction of 7.9% is indicated for FY20 and a further reduction of 4.8% is projected in FY21. Overall, a 12.7% loss in cumulative value-added is projected for the private sector, which is 4.3% less than the 17% loss projected without the mitigation programs.

Figure 20: FSM Projected GDP Level and Growth
Economy worst hit in FY20 with recovery postponed till FY22



## *Fiscal Impact*

**State governments are projected to maintain fiscal balance during the COVID-19 pandemic**: National and state government fiscal outcomes are projected in Figure 22. The state governments are assumed to operate on a balanced budget rule and adjust to the annual fiscal drag implicit in the amended Compact and the COVID-19 cyclical downturn to attain fiscal balance. That said, there may be short-term deviations such as a surplus in FY20 and deficit in FY21 where the fiscal outturn is worse than budgeted and there is a lag in response.

**Sovereign rents are projected to return to normal levels during the pandemic and remain stable through FY25**: The national government has achieved large fiscal surpluses in recent years, averaging 16% of GDP from FY15 through FY19. In FY19, an unusual level of corporate tax receipts from the FSM domicile for major Japanese corporations resulted in a large fiscal surplus. For FY20, sovereign rent revenues return to normal levels from the FSM domicile industry and fishing royalties. The impact of the COVID-19 pandemic on domestic taxes is minor and domestic revenues (excluding grants) are projected to remain stable.

**The overall impact of COVID-19 on the fiscal position of the national government is projected to be minor**: On the expense side, the major additional funding need of the national government has been financing the Tourism Sector Mitigation Relief Fund. However, drawdown of funds has been limited due to the number of firms enrolled. Discretionary national government expenditures on legislative projects rose to a record $28 million in FY19. In the current study a level of $14 million in legislative projects has been projected through FY25. In FY20, a fiscal surplus of $24 million is projected and the surplus rises to $27 million in FY21, due to accumulated reserves of unspent grants. As unspent funds are drawn down in FY22 a reduced, but stable fiscal surplus of $19 million on average is projected through FY25.

**Figure 22: FSM State and National Government Fiscal Deficit**
Natonal government continues to run large fiscal surpluses during COVID-19

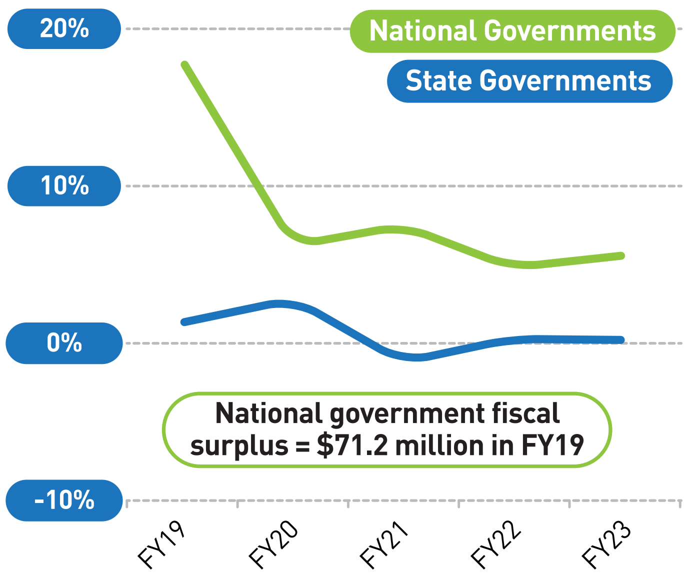
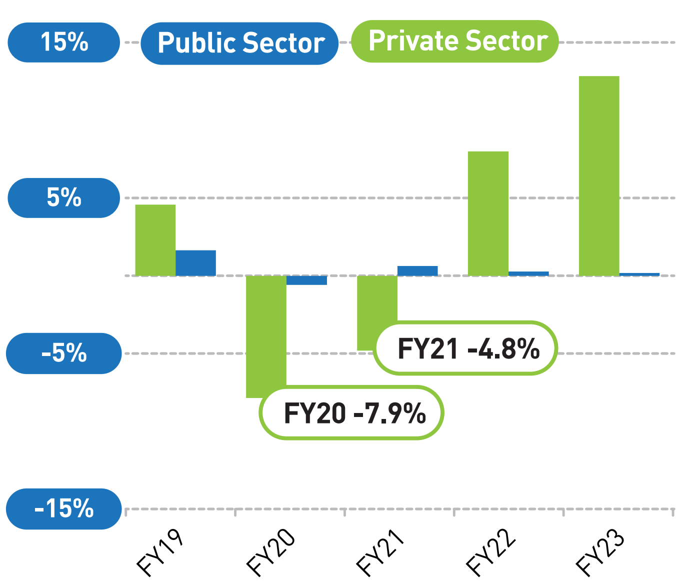



**Figure 21: FSM Projected Private and Public Sector Growth**
Private sector GDP contracted by 12% over FY19-FY21




## *Conclusion*

**Strong government action coupled with generous support from the donor community to secure the FSM's financial needs has left the economy well positioned for recovery**. At the onset of the COVID-19 pandemic, when matters were highly uncertain, the need for financing was unclear. The FSM was spared any outbreak of COVID-19 and donors provided sufficient resources for health needs. The US CARES Act supported the unemployed with generous funding and the ADB CPRO provided resources for low-income households and the vulnerable in the population. The FSM's own stimulus program supported the small tourism industry. The combination of these factors has ensured the financial stability and security of the FSM economy. With implementation of the vaccination program, albeit at a slower than desired rate, the FSM economy is well positioned for recovery.

# The Marshall Islands

**Projections are based on the core assumption that travel limitations will remain in force though the remainder of 2021 and that full recovery will not be attained until FY23**. In the previous chapter, we indicated that the structure of the RMI economy is heavily dependent on the public sector, and substantially dependent on fisheries activity and sovereign rent receipts. The economy relies little on tourism and visitor arrivals; nevertheless, the projected economic consequences of the COVID-19 pandemic are significant. In this section, we report on the FY20 experience and attempt to estimate the likely impact of the COVID-19 pandemic on the economy through the remaining years of the amended Compact period to FY23 drawing on a recent work by the Graduate School USA. These projections have assumed that in FY22 production levels of the affected sectors are recovering but still only operating at one-half of their normal levels. Full recovery is only attained by FY23.

## *Mitigation*

**RMI Response and Preparedness Plan sets framework for COVID-19 mitigation**. In June of 2020, the government of the RMI prepared a $42 million RMI Coronavirus (COVID-19) Preparedness and Response Plan that has been extended several times and now stands at $63.3 million. Expenditures have been planned for a series of activities: (i) health response $25.8m, (ii) assistance to households $11.2 million, (iii) support to outer island governments $13.2 million, (iv) private sector support $8.3 million and (v) miscellaneous items $4.8 million. The Preparedness Plan has been funded through grants from RMI's donor partners including the ADB, US, EU, IOM, World Bank, China,Taiwan, Japan, and with a small contribution from the RMI of 2.2 million.

**RMI has been the beneficiary of a large donor response to support the Response and Preparedness Plan**: The main funding sources of the Plan are the US government, which has contributed a total of $18.4 million and ADB, with a total contribution of $23.6 million. US resources include support under the CARES Act for unemployment benefits, $3.9 million under an OIA TA grant, plus a series of other, smaller federal programs from CDC, etc. totaling a further $3 million. Further health-related funding was available from the World Bank ($2.5 million) and the European Union ($2.7 million).

**ADB takes a lead role in funding the mitigation effort**. The lead donor for the mitigation program has been the ADB with a program totaling $23.6 million. Of the total, $6 million through the Disaster Resilience Program (DRP), $16 million through the COVID-19 Pandemic Response Option (CPRO), $1 million in grants under the Asia Pacific Disaster Response Fund, and $0.6 million in Health-related TA. The DRP and CPRO take the form of budgetary support designed primarily to cover funding shortfalls in financing of COVID-19 impact mitigation projects and programs specified under the Preparedness Plan.

**CARES Act unemployment benefits generated significant benefits to affected RMI workers**: In common with the other Freely Associated States, RMI citizens were made eligible for unemployment support from the US government under the US CARES Act. Initial funds of $7.9 million were awarded.

## *Economic impact*

**The total economic impact of COVID-19 over FY20-FY21 is projected to be a 5.9% reduction in GDP**. COVID-19 struck halfway into FY20, in March 2020, but the full fiscal year impact was modest. GDP fell by an estimated 2.6%, which is no greater than the normal ups and downs of the RMI's economic cycle (see Figure 23). A further GDP reduction of 3.3% projected for GDP in FY21, bringing the total impact of COVID-19 to 5.9% over the two years. The sector which contributed most to the reduction was transport; it includes shore-based support to fishing fleets, provisioning of vessels in Majuro port, and airport operations. The sector is projected to have declined by 41%. The small hotel and restaurant sector, reflecting travel restrictions, is projected to contract enormously by 72%. The construction sector is projected to have declined by 12%, but despite travel restrictions on key skilled personnel, large cutbacks have been avoided. Lastly, the fishing sector is projected to decline 12%.

**Impact of the crisis has been uneven: the public sector is projected to expand modestly while the private sector has experienced a large contraction**. Figure 24 indicates the impact of the pandemic on the private and public sectors. While the public sector is projected to remain largely unchanged, the brunt of the COVID-19 impact is on the private sector. It recorded a relatively small reduction of 3.8% in FY20, in part reflecting the closure of the loining plant; in FY21 a larger reduction of 7.4% is projected. Over the two years, a very sizeable loss in output of 11.2% has been projected for the private sector, while the public sector remained largely unaffected. The impact on the private sector was

**Figure 23: RMI Projected GDP Levels and Growth**
GDP falls by 5.9% percent over the FY19-FY21 period

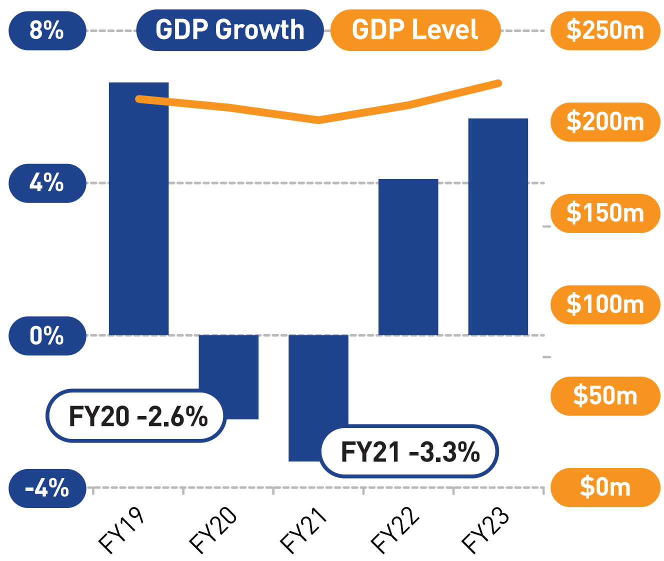
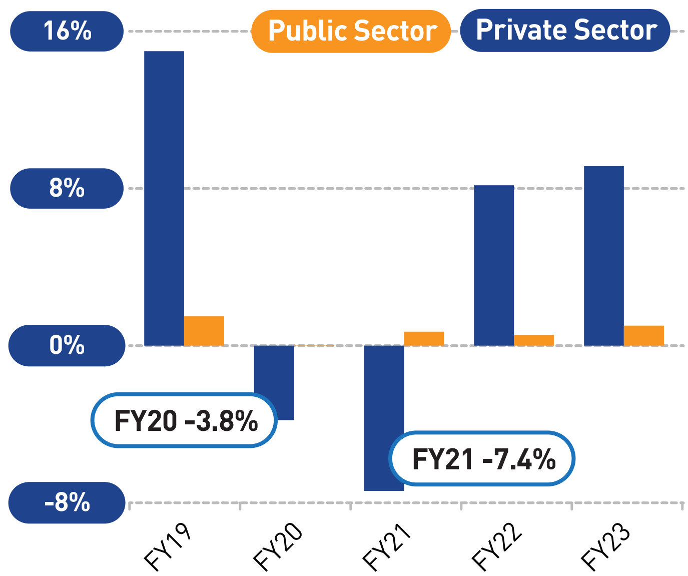



**Figure 24: RMI Projected Private and Public Sector Growth**
Large 10.9 percent reduction in private sector GDP over the FY19-FY21 period




painful. Even within the private sector, the impact on certain sub-sectors is particularly strong, strengthening the ongoing case for well-targeted mitigation efforts.

## *The fiscal impact*

**The anticipated fiscal deficit for FY20 turned into a large surplus**. In FY20, the RMI recorded a large fiscal surplus of $12 million or 5% of GDP (see Figure 25). This did not reflect fiscal adjustment to projected revenue shortfalls during COVID-19, but rather large inflows of donor grants and mitigation programs that supported the domestic economy and resulted in strong revenue growth. Government expense contracted due to travel restrictions and, while capital expenditures rose substantially, they were funded through capital grants. The overall outcome was a large fiscal surplus.

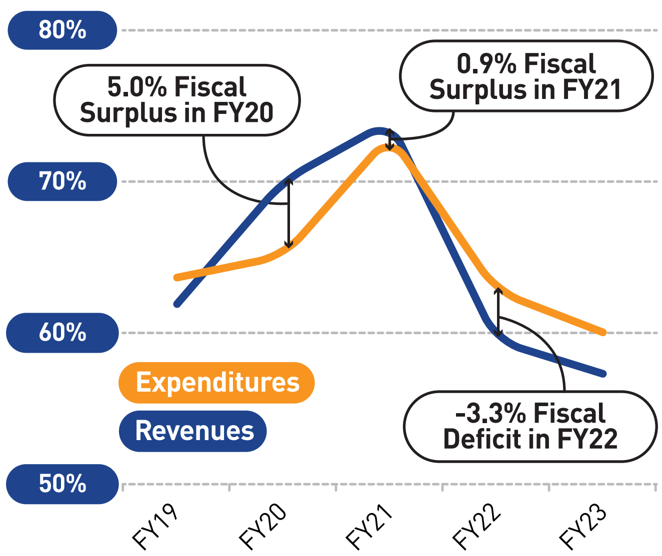
**Both grants and COVID-19-related expense are set to rise strongly in FY21**. Tax revenues are projected to fall by 0.5% in FY21, reflecting the contraction in the economy. However, grants are projected to rise to record levels with an additional $11 million projected, in large part through the receipt of the ADB CPRO (COVID-19 pandemic Relief Option) grant of $16 million. On the expenditure side, use of goods and services is projected to increase significantly, by 24%, due to additional grant-funded COVID-19 impact mitigation costs. Other expenses, including transfers to households and support to the private sector, will rise rapidly, from $19 million to $28 million, with COVID-19-related needs. Finally, capital expense is projected to fall slightly, reflecting project design and implementation bottlenecks arising from travel restrictions.

**FY21 is projected to have a modest fiscal surplus of 1.4% of GDP**. With expenditures rising more rapidly than revenues, the fiscal outlook is expected to deteriorate but remains in surplus. After a record surplus of 5% of GDP in FY20, the projections indicate a reduced surplus of 1.4% in FY21. FY22 will see further funding of expenditures from prior COVID-19 related grants, resulting in a projected fiscal deficit of 3.5% as reserves are drawn down. These trends will continue in FY23 but with a reduced deficit of 2.5% of GDP. By the end of FY23 all of the prior buildup of COVID-19 funds will have been fully utilized.

## *Conclusion*

**Donor resourcing in FY20 and FY21 secured the nation's financial position during COVID-19, but masked the underlying structural deficit that was developing in FY19**. At the onset of the COVID-19 pandemic, when matters were highly uncertain, the need for financing was unclear. The RMI was spared any outbreak of COVID-19 and sufficient resources for health needs were funded through donor sources. The US CARES Act supported the unemployed with generous funding and the ADB CPRO provided resources for low-income households and the vulnerable population. The combination of these factors ensured the financial

Figure 25: RMI Revenue and Expenditures, % GDP
CPRO restores fiscal balance in FY21




stability and security of the RMI economy during the pandemic. However, as of FY19, past expansionary fiscal policies had left the nation with a structural fiscal deficit. The large infusion of donor funds in FY20 and FY21 masked the underlying fiscal position. As existing donor funds are drawn down, the FY19 structural deficit is likely to re-emerge, requiring adjustment as the nation enters a new Compact era.

## Palau

**While COVID-19 devastates the tourism sector and the economy contracts by 23%, donor-funded mitigation effort helps reduce the burden.** The previous chapter indicated that the structure of the Palau economy is heavily dependent on tourism but also remains dependent on a large public sector significantly funded by donor grants. The impact of COVID-19 has devastated the private sector, but without both a large source of external revenues and the COVID-19 mitigation effort, it could have been far worse. As it is, the economy is projected to have fallen by 23% and the private sector by 39 in FY20-FY21, although the non-tourism domestic economy and government have managed to keep operating at normal levels. This section will review of the impact of the COVID-19 pandemic on the economy through the remaining years of the CRA period until FY24.

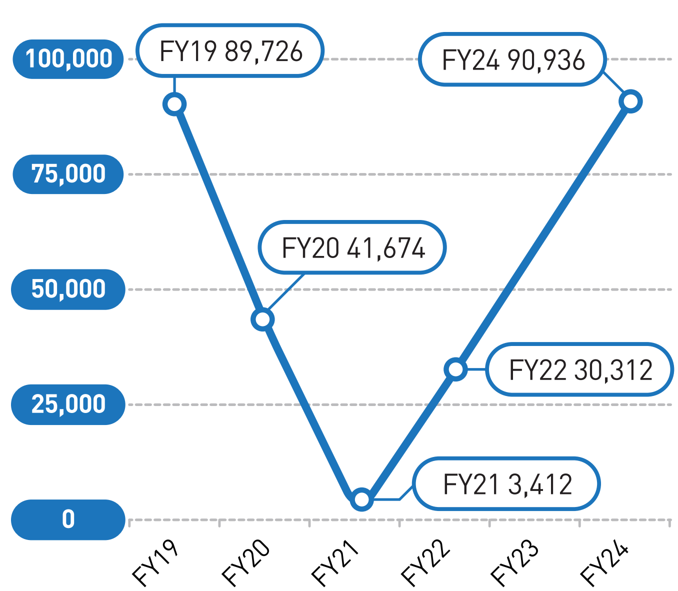
### *Impact on the tourism sector*

**After a favorable FY20 start, Palau's tourism industry collapsed after the arrival of COVID-19**. The first four months of the FY20 fiscal year were favorable, with visitor arrivals reaching 32,255 and Palau was on track to attract 116,000 visitors by the end of FY20. Following the emergence of COVID-19, tourism numbers dropped by half in February, and by the end of March had collapsed. By the end of the FY20 the total number of recorded visitors was 41,674, a 54% reduction from FY19, see Figure 26.

**Sealed Corridor fails to reignite a tourism recovery as Taiwan experiences a COVID-19 delta outbreak**. For the first six months of FY21, travel restrictions remained in place and apart from the occasional emergency workers, and military personnel there were no recorded visitors. However, in April, Palau instigated a "sealed corridor" or "bubble" with Taiwan, permitting travel between the countries and the potential of a slow recovery in the tourism industry. However, no sooner had the agreement been reached than Taiwan experienced an outbreak of COVID-19 in mid-May and the sealed corridor promptly closed. Initial hopes for the beginning of a tourism recovery ended and no significant number of visitors would arrive in FY21.

**Palau attains a very high rate of vaccination**. At the start of 2021 Palau was able to participate in the US operation "warp speed" and commence vaccinating its population. By mid-year Palau had vaccinated

Figure 26: Palau Projected Visitor Arrivals
Visitors projected to disappear during the COVID-19 pandemic with full recovery not projected befor FY24



an exceptionally high proportion of its population according to the Ministry of Health, greater than in any other US state, territory or FAS. In the second half of the year boosters became available although the update of boosters was lower than the initial doses. In July Palau loosened its travel requirements allowing travelers to enter provided they were fully vaccinated, tested negative and underwent a period of restricted movement after entry.

**After a sizeable outbreak of COVID-19 in early 2022, the disease had largely burnt itself out and Palau has attained "herd" immunity against existing variants**. Palau remained free of COVID-19 until December when a first case of community transmission was reported. This rapidly built into a large outbreak maxing out with 371 positive cases reported on January 28th or 2.5% of the population. Thereafter, the number of daily cases declined sharply such by the end of March the outbreak had large burnt itself out. In total 4,014 cases had tested positive, 23% of the population with 6 fatalities. With high rates of vaccination and a large number of prior cases Palau has attained "herd" immunity against the existing COVID-19 variants. It thus represents a safe place to visit and host travelers. Recovery will no longer depend on the COVID status of Palau but rather on the willingness of travelers to visit.

**Full recovery of the tourism economy projected by FY24**. Following projections of international travel from the International Air Transport Association (IATA)[4], in FY22 Palau visitor numbers should attain a level of 34% of the pre-COVID-19 FY19 level, experience further increases in FY23, and full recovery in FY24.

## *Mitigation programs*

**The CROSS Act provides support to the private sector to mitigate the impact of COVID-19**. After the emergence of the pandemic, Palau initiated a series of mitigation programs designed to assist both affected private sector businesses and households. In April 2020, the President of Palau signed into law the Coronavirus One-Stop-Shop Act (CROSS). A total of $20 million was appropriated for an eight-month period, through the end of January 2021. The law provided an unemployment program for workers who lost their jobs, a temporary jobs program for a limited number of individuals, relief to the private sector through a loan program disbursed by the National Development Bank of Palau (NDBP), and a lifeline utility service program for low-income households.

**CROSS Act extended throughout FY21**. By the expiration of the CROSS Act at the end of January 2021, the program turned out to have spent only $10 million. The program was extended under the new administration through the remainder of FY21, to be financed out of the remaining funds. However, the structure of the program was to be altered with Palauans to fall under the temporary jobs program and the foreign work force in Palau to return to their former employers. Foreign work force employees were expected to work 20 hours weekly at the minimum wage of $3.50 an hour, with a cost saving from the original $400 per month in unemployment benefits to $280.

**The US CARES program provides an important lifeline for Palauans made unemployed by the pandemic**: In addition to the Palau CROSS Act, the citizens of the Freely Associated States are eligible for certain unemployment benefits under two US-funded facilities. Other CARES Act assistance was provided by US Interior and the CDC.

**ADB provides critical funding to support government operations and the cost of the CROSS Act**. In addition to its own mitigation effort, Palau has used concessional donor loan financing. The Asian Development Bank has been the major supporter through a series of loan facilities: the Palau Disaster Resilience Program (DRP) for $15 million, the COVID-19 Pandemic Response Option (CPRO) for $20 million and a Policy Based Loan (PBL) of $55 million. The PBL, also known as the RISES program (Recovery through Improved Systems and Expenditure Support), involves the commitment of the national government to implement a series of fiscal and economic reforms. The first tranche conditions of the loan, subprogram 1, were fulfilled, and Palau received $25 million for budgetary support anticipated to fund the government through the end of FY21 and well into FY22. The second tranche, or sub program 2 of $30 million will require passage of a further set of deeper and more demanding reforms and will hopefully provide Palau with sufficient resources to fund government operations through FY22/23 and until the recovery of the economy is well underway.

## *Economic Impact*

**In FY21 Palau experienced the full force of the collapse in the tourism industry; and the economy contracted by 23% in FY20-FY21**. The outlook for the Palau economy is projected in **Figure 27**. After a reduction of 9.7% in FY20, the economy is projected to fall an additional 14.3% in FY21 as the full force of the collapse in the tourism economy is felt without the benefit of 4-5 months of pre-pandemic economic

[4] Brian Pearce, Outlook for Air Transport and the Airline Industry , IATA, November 24, 2020.

**Figure 27: Palau Projected GDP Level and Growth**
Total reduction in GDP of 21 percent anticipated

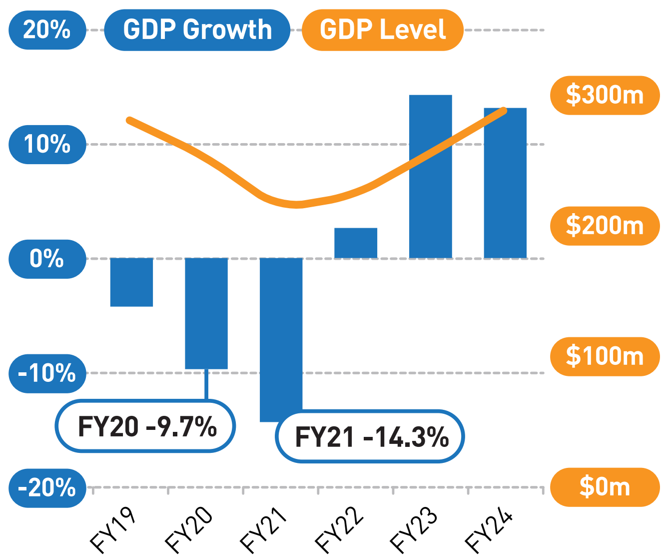
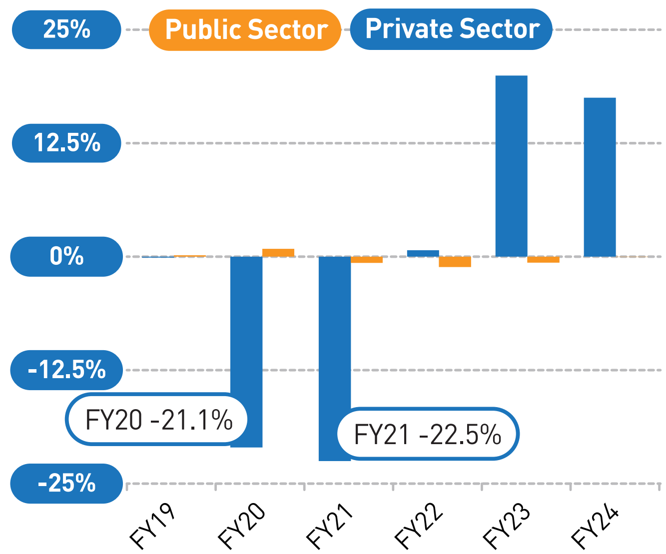



**Figure 28: Palau Projected Private and Public Sector Growth**
Total reduction in private sector contributions to GDP of 33% anticipated




activity that moderated the FY20 decline. The drop in FY21 reflects the disappearance of visitors throughout the entire fiscal year after the demise of the sealed corridor with Taiwan, and a reduction in the level of construction activity, but assumes the continuation of the mitigation programs including both the CROSS and CARES Acts provisions.

**The economy is projected to start a slow recovery in FY22, with full recovery by FY24**. In FY22 it is assumed that the process of a slow and gradual recovery commences and visitors to Palau achieve a level of 30,000 (34% of the level for FY19 before the pandemic). However, it is assumed that the stimulus provided through the U.S. CARES act and its subsequent acts are no longer available but that a reduced need for the CROSS Act provisions remains. It is further assumed that the construction industry reverts to trend after earlier projects close out and contracts by 23%. The partial recovery in the tourism industry leads to growth in the economy of 2.6%. In FY23 visitor numbers are projected to increase to 61,000, 68% of the FY19 level, and the economy is projected to grow by a healthy 14%. By FY24 the tourism industry is projected to have returned to the FY19 level and the economy is projected to be 2.6% above the depressed level of FY19.

**Private sector experiences the brunt of the impact of the pandemic**. Figure 28 indicates the impact of the pandemic on the private sector. While the public sector is projected to remain unchanged—due to donor financing to maintain basic services—the brunt of the COVID-19 impact is felt by the private sector. In FY20, it saw a large reduction of 21.1%, reflecting the collapse of the tourist economy after the end of March and indirect effects on secondary industries. In FY21, a further reduction of 22.5% is projected, reflecting the full impact of the reduction in tourism. Overall, a massive loss in output of 38.9 has been projected for the private sector.

### *Fiscal Impact*

**The accumulated fiscal deficit resulting from COVID-19 is likely to reach $76 million or 33% of GDP by the end of FY22**. The fiscal results are shown in Figure 29. In FY20, Palau recorded a fiscal deficit of $25 million—10% of GDP. In FY21, the gap is projected to widen, with the deficit rising to $37 million, or 17% of GDP. Again, even in FY22 a significant deficit of $14 million, 6% of GDP, remains. It does not finally disappear until FY24. The nascent recovery is not sufficient to eliminate the need for deficit financing. In total, an accumulated deficit of $76 million or 33% of GDP is likely to result during the FY20-FY22 period.

### *External debt and debt service*

**External debt/GDP ratio is projected to rise rapidly to nearly 90% of GDP to finance the impact of the COVID-19 global pandemic but will decline as the economy recovers**. As a result of the COVID-19 global pandemic, the need for external borrowing is projected to rise rapidly in the short term (see Figure 30). External

**Figure 29: Palau Revenues and Expenditures, %GDP**
Palau experiences large fiscal deficits during COVID-19

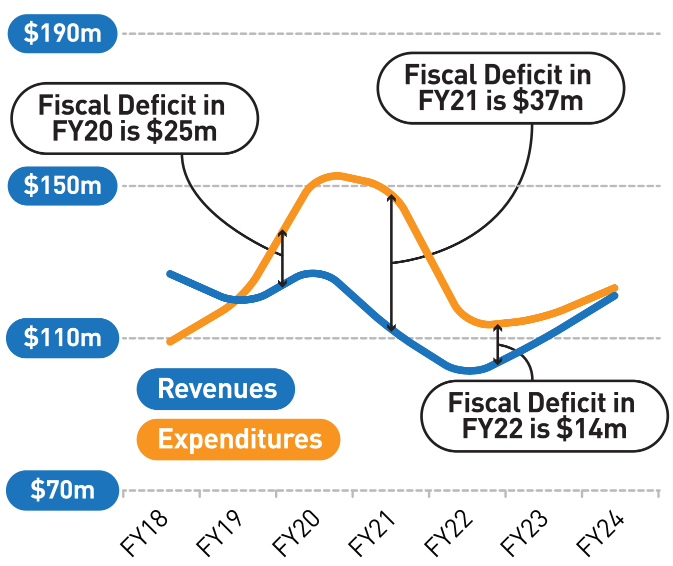
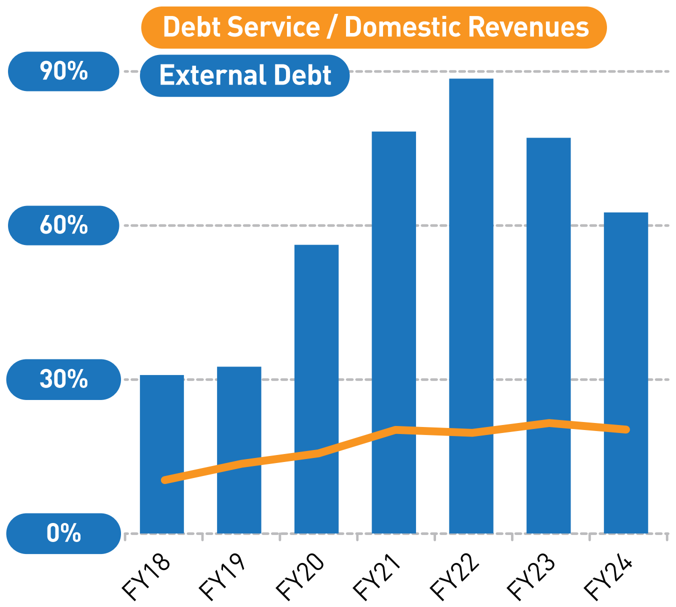



**Figure 30: Palau External Debt and Debt Service, % GDP**
External debt rises to high levels before recovery




debt rose from a level of 33% to GDP in FY19 to 56% in FY20 and is expected to reach almost 90% of GDP by the end of FY22. While the rise in the debt/GDP ratio is projected to attain record levels, much of the increase is due to the decline in GDP. After peaking in FY22, the ratio declines rapidly to 63% by FY24 as the economy recovers. While much of the rise in external debt, $95 million, is due to COVID-19, Palau has also borrowed for other purposes: the Taiwan Housing Loan (HLDP) loan of $15 million, an ADB Policy Based Loan for PPUC of $10 million, and $15.4 million for the second ADB internet fiber project. In all, recent additional non-COVID borrowing totals $40 million.

**External debt service is projected to rise significantly but should not result in a high risk of debt stress, provided Palau implements offsetting fiscal measures.** Debt service follows a similar but less extreme pattern. From representing 10% of government domestic revenues before the crisis in FY18, debt service, including SOE payments, rises to 22% in FY23 and declines thereafter as the economy recovers. Removing the SOE component including on-lent loans, national government debt service is projected to stabilize at around 10% of domestic revenues in FY23-FY26. After a period where debt service has been a minor component of the national budget, it will end up consuming a significant but manageable proportion. While the level of debt Palau will incur is large by historical standards, it should not, given fixed low interest rates and the concessional nature of the debt, pose a high risk of debt stress. Return of growth in the economy, the tax reform initiative, and careful monitoring of expenditures will enable Palau to maintain fiscal and economic stability in the years ahead.

## *Conclusion*

**Palau has incurred a significant debt overhang that will reduce the nation's ability to fund critical public services and inhibit future borrowing, investment, and development**. While a series of donor mitigation programs have supported the nation, households and the private sector during COVID-19, this support has been provided largely through loan finance. Palau will thus emerge from the crisis with a large debt overhang, at its height 90% of GDP, just as it is enters a new Compact period. Palau will also incur significant debt service obligations, which will reduce the nation's ability to fund critical public services. The large debt overhang will also reduce the nation's capacity to incur future debt liabilities, thus limiting the ability to fund public infrastructure and future productive capacity. These constraints place special needs on economic and fiscal policy as Palau enters a new Compact period in FY25.

# 4

# MODELING THE IMPACT OF NON-RENEWAL OF COMPACT ECONOMIC ASSISTANCE

# 4 MODELING THE IMPACT OF NON-RENEWAL OF COMPACT ECONOMIC ASSISTANCE

This chapter outlines the potential impacts of reductions in funding provisions if no actions are taken to renew the economic assistance associated with the amended Compacts for the FSM and RMI after FY23, and the CRA for Palau after FY24.

The "**Non-Renewal of Compact Assistance Scenario**" assumes the FSM and RMI each move to a regime outlined in its amended Compact and its implementing law. This regime has two key features—both resulting in a downward fiscal adjustment. First, the FSM and RMI would transition from sector grants funded by annual US appropriations to annual distributions drawn down from their respective CTFs. In this projection, rather than have the "maximum" allowed CTF distribution each year, the model assumes the initial level of annual CFT distributions is set to be sustainable (with a high degree of confidence). After the initial, one-time downward adjustment, distributions would thereafter be adjusted annually to fully offset the impact of inflation with some potential for further rules-based upward or downward adjustments based on CTF investment performance. The second key feature of the Non-Renewal of Compact Assistance Scenario is the assumption that SEG funding would cease as currently scheduled.

The Palau Compact did not have a "cash-out" feature for federal education programs. Therefore, its Non-Renewal of Compact Assistance Scenario involves just one downward fiscal adjustment, specifically, an initial distribution from the Palau CTF which is reduced from its current nominal fixed level to achieve Palau's goal of a perpetual fund in a sustainable manner (with a high degree of confidence) and thereafter adjusted to fully offset the impact of inflation with some potential for further rules-based upward or downward adjustments based on CTF investment performance.

**Scenario analysis utilizes economic models developed by the GSUSA for each FAS.** The chapter is divided into three sections—one for each FAS. The analysis utilizes a modelling framework, developed by GSUSA, which adopts a modelling system based on the economic sector accounts of the three economies and programming techniques similar to those utilized by the International Monetary Fund[1].

For the purposes of this study, the GSUSA team estimates the sustainable distribution from each Compact Trust Fund. These estimates utilize a "Sustainability Adjustment for Enhanced Reliability" method hereafter referred to as the SAFER method. The methodology is described in other published works by the team. Using a statistical method called Monte Carlo analysis, the median value of each trust fund at the end of FY23 or FY24 is projected and a SAFER estimated distribution for FY24 or FY25 is computed.

## The Federated States of Micronesia

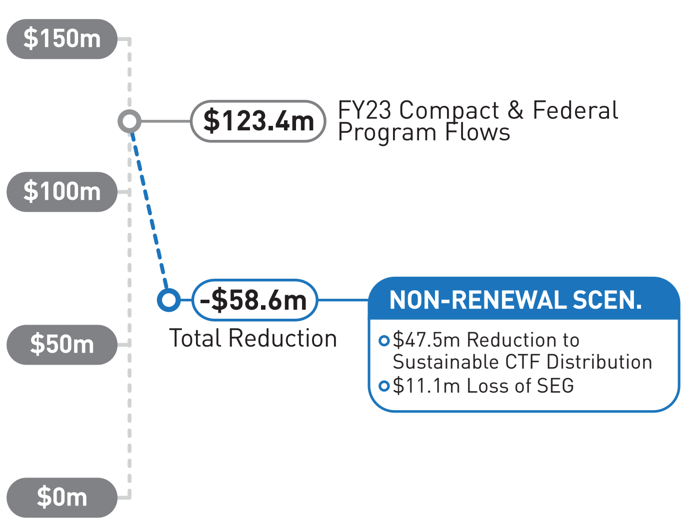
**Sustainable draw from the FSMCTF in FY24 is estimated to be $36.0 million, $47.5 million below the estimated grant level in FY23 which equates to a fiscal**

[1] See recent GSUSA Economic Reviews of the three FAS for a discussion of the models.

**shock of 11.3% of projected FY23 GDP**. The Compact non-renewal adjustment scenario predicts what will take place in the FSM if no actions are taken to renew the economic assistance provisions of the FSM Compact. Under the terms of the amended Compact, the level of ending Compact sector grants projected for FY23 equals $83.5 million. Absent a renewal of Compact economic assistance, in FY24 that distribution amount plus full inflation during FY23 could be covered by a distribution from the FSMCTF, though it would require a greater-than-average investment return during FY23 or an immediate draw from the CTF's buffer fund. Instead, for this study, the GSUSA team posits an immediate adjustment to sustainable distributions by applying the SAFER method. With the median projected FSMCTF value of $1.17 billion at the end of FY23 the SAFER estimated annual distribution would be just $36.0 million to support FSM government operations and capital investments. This sustainability adjustment in transfers to support FSM government operations and capital investments is specified in Figure 31 as a $47.5 million annual reduction, which equates to 11.3% of projected FY23 GDP.

**Loss of Special Education Grant adds another reduction equal to2.6% of GDP**. In the absence of a renewal to Compact economic assistance, the FSM will also lose the SEG grant. There was never any provision for the FSMCTF to replace this this grant. This reduction in support to education programs (mostly for pre-K) in the FSM is specified in Figure 4.1 as $11.1 million annually equating to 2.6% of projected FY23 GDP.

**Figure 31: FSM Non-Renewal Scenario: Required Adjustments**
Components and Magnitudes




*Note: Sustainable distribution from the CTF ($35.1m in FY23 prices) is assumed to be available.*

**The total adjustment thus required under the non-renewal scenario is $58.6 million, or an extraordinary fiscal shock equivalent to 13.9% of projected FY23 GDP**. The analysis under the Compact non-renewal scenario assumes a "status quo" FSM policy environment. The FSM national government polices described in Chapter 2 are assumed to continue: (i) allocation of 2/3rds of the structural fiscal surplus to the FSM Trust Fund with the remaining 1/3rd supporting a large outlay on congressionally identified projects and use of goods and services, and (ii) the FSM Trust Fund is not used to offset reduced grants. Further, US federal programs and services not scheduled to terminate after FY23 are assumed continue uninterrupted.

**Full brunt of adjustment falls on the state governments**: As the national government only spent $3.3 million from Compact sector grants and the Special Education Grant in FY19, the impact of the Compact non-renewal scenario on national government recurrent operations is negligible. The Compact non-renewal scenario assumes—for the purpose of modeling and to avoid the necessity of predicting the policy approach that the FSM national government would undertake—that nearly the full brunt of fiscal adjustment would be absorbed by the four state governments. Given the virtual inability of the state governments to raise taxes on their own or to finance their deficits through borrowing, they would have no alternative but to undertake an austerity program with deep expenditure cuts, such as:

i. A wage cut on all state-level civil servants of 20%. This might be introduced through a simple reduction in wages or through a 2-day reduction in the bi-weekly pay period.

ii. A Reduction-In-Force in state government civil servants of 30% in Kosrae, Pohnpei and Yap with a 40% reduction in Chuuk.

iii. The reductions in payroll numbers would be accompanied by a similar level of cuts in the use of goods and services.

**Spending on infrastructure would be maintained, but only through accelerated use of the pipeline of unused funds**: While the national government is largely unaffected by the loss of Compact grants, it is responsible for disbursing resources under the Compact infrastructure sector grant for state-based projects. Under the non-renewal scenario, funding for these projects will also be subject to a cut of $14.3 million from an FY23 annual level of$25.1 million. However, there is a considerable accumulation of unused FSM Compact infrastructure funds, amounting to over $200 million at the end of FY19. The non-renewal scenario has assumed that the use of this source of funds will steadily increase through FY30, temporarily offsetting the reduction in overall funding for infrastructure from the lower SAFER CTF distributions.

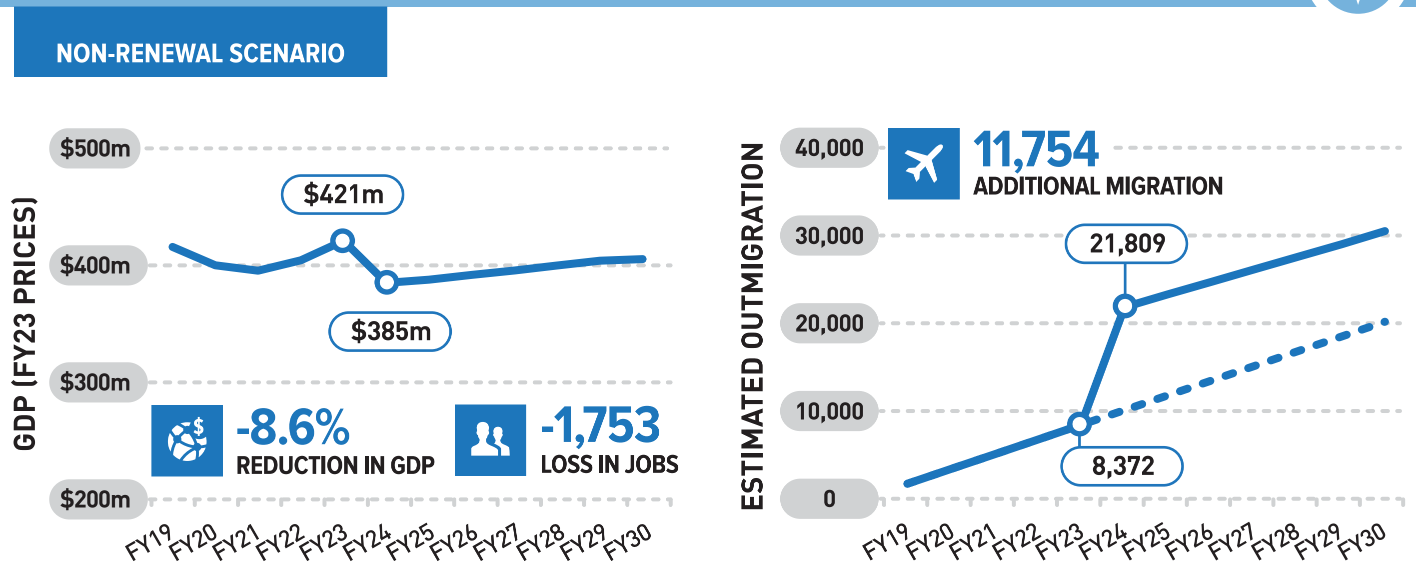
**FSM economy projected to contract by 8.6% under the non-renewal scenario**. Figure 32 illustrates the impacts of the non-renewal scenario on FSM GDP. While the overall FSM economy is projected to contract by 8.6%, the impact by FSM state is uneven. Chuuk and Kosrae are the most severely impacted, with declines in state GDP of 11.9% and 12.8%, respectively. Yap is projected to decline by 8.2% and Pohnpei by 6.2%; the smaller contraction in Pohnpei reflects its status as the seat of the national government. Most of the adjustment will be felt in the public sector, which contracts by 20.4% while the impact on the private sector is less adverse but still large at 5.1%. The total loss in jobs is greater than the impact on GDP, with a loss of 1,753 or 10.4% of the employed work force, primarily in the public sector. At the state level job loss is highest in Chuuk and Kosrae where employment declines by 18% and 15%, respectively. In Yap and Pohnpei the decline is less, 10% and 6%, respectively.

**Migration function reflects underlying trend and a component sensitive to employment prospects**: The simulation model incorporates a migration function that allows for trend migration and a component sensitive to economic and job conditions in the FSM. The migration function assumes an estimated trend that 1.6% of the population of the FSM—and its sister FAS nations—migrate to the US each year, regardless of economic or social conditions in the FAS. That rate reflects the long-term trend; however, migration to the US has risen during past periods of severe fiscal adjustment in specific localities, 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 (FY97-FY99), and during the large adjustments in Chuuk and Kosrae early in the amended Compact period (FY08-FY09).

Under the non-renewal scenario with large job losses, migration is projected at an extraordinary level. In addition to the baseline trend, the migration function is designed to indicate the implied level of migration associated with a certain level of job loss. The function assumes an employee who loses his or her job migrates with dependents. With a dependency ratio of 6.7 people per job, the impact on FSM migration would resulting in nearly 11,754 new migrants to the US, or 12% of the population (Figure 32). In practice, actual induced migration due to fiscal shocks would likely 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 a potential upper boundary.

The impact of projected out-migration—especially in the smaller FSM states—is both dramatic and threatening. At the state level, the largest states generate the greatest number of migrants to the U.S. However, the impact is more dramatic on the populations of the smaller states of Kosrae and Yap which are projected to decline by 20% and 14%, respectively. Kosrae has been particularly adversely affected by its past loss of population, such that the potential for a further fiscal shock presents a truly dramatic threat.

Figure 32: FSM Compact Non-Renewal Scenario: GDP, Jobs and Emigration



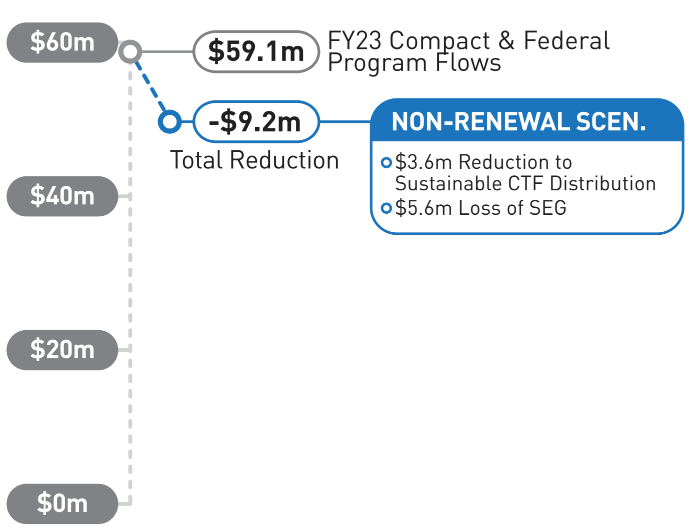
# The Marshall Islands

**The RMI CTF is projected to attain a value of $784 million in FY23—close but still below—the threshold to achieve sustainability with a high degree of confidence**. Under the terms of the RMI's amended Compact, the level of non-Kwajalein targeted Compact sector grants projected for FY23 is $27.6 million. Absent a renewal of Compact economic assistance, in FY24 that distribution amount can be covered by a distribution from the RMI CTF. Using the Monte Carlo method of statistical analysis, the median value of the RMI CTF at the end of FY23 is projected at $784 million, with a corresponding SAFER distribution of $24.0 million. This potential reduction in transfers to support government operations and capital investments is specified in Figure 33 as $3.6 million annually, which equates to 1.3% of projected FY23 GDP.

**Loss of Special Education Grant will result in a reduction in grant levels of 2.0% of GDP**. An additional decline in transfers will occur through the loss of the SEG. There is no provision for the RMI CTF to replace this loss of annual transfers. Figure 33 illustrates the potential reduction in support to the RMI's education programs—$5.6 million annually, starting in FY24, or a loss of 2.0% of projected FY23 GDP.

**The total adjustment required under the RMI non-renewal scenario is $9.2 million or 3.3% of GDP**. While considerably smaller than the FSM adjustment of 12% of GDP, it is still significant.

**Figure 33: RMI Non-Renewal Scenario: Required Adjustments**
Components and Magnitudes




**The economy is projected to recover by FY23, but the fiscal deficit incurred in FY19 re-emerges after COVID mitigation funds are depleted**. The non-renewal scenario projections through the amended Compact at the end of FY23 are based on continuation of the current RMI policy stance. The economy is projected to recover strongly in FY22 and FY23 after reductions in the COVID-19 years, FY20 and FY21, such that it will be 4.0% larger at the end of FY23 than the pre-COVID level in FY19. However, the picture of the fiscal position is the opposite. In FY20 and FY21, the economy ran significant surpluses supported by the large COVID-19 grants. In FY22 and FY23, the fiscal position is expected to turn negative, with deficits of 3.5% and 2.9% of GDP, respectively, as the grants run out and the original structural deficit that existed in FY19 becomes apparent again.

**Correction of the fiscal deficit that existed in FY19, combined with the fiscal impact of the non-renewal scenario requires significant fiscal adjustment in FY24**. In FY24, the economy thus needs to grapple with not only the impact of reduced funds incurred under the non-renewal scenario, but also the yet-unaddressed deficit that existed in FY19. To restore fiscal balance in FY24 and beyond, a significant set of adjustments are required, such as:

i. Reversal of 50% of the large increase in the use of goods and services to the level that existed before the rapid rise in sovereign rent revenues in FY15.

ii. Implementation of a 20% Reduction-In-Force in administrative services and education in FY24 with a continuing annual reduction of 5% in administration for FY25-FY30.

iii. A wage freeze through the remainder of the projection period FY24-FY30.

**The economy is projected to contract by 4.4% in FY24 due to non-renewal before it returns to the long-run trend rate of growth of 0.8% through FY30**. The impact on the RMI economy of these adjustments is shown in Figure 34. After the COVID years and projected recovery in FY22 and FY23, the economy is projected to decline by 4.4% in FY24 before resuming its steady state growth of 0.8%. The brunt of the reduction in GDP is felt by the public sector, which contracts by 9.5%, reflecting the modeled Reduction-In-Force in administrative services and education. Reflecting the cut in government's use of goods and services and the wage freeze, demand in the economy falls and the private sector contracts by 2.9%.

**The impact of the reduction in public services and fiscal adjustment is a loss of 668 jobs or 6.2% of the employed work force**. The majority of the job loss is incurred in the public sector, with a loss of 532 public servants or 9.1% of the total; 141 jobs are lost in the private sector or 3.2% of the total.

**Non-renewal scenario and fiscal adjustment induces a large additional 3,064 migrants or 6.4% of the RMI population**. Approximately 1.6% of the population in the RMI migrates to the US each year. This rate is mostly insensitive to the state of the local economy, although migration has risen during past periods of severe fiscal adjustment, such as during the large-scale civil service retrenchment required in the RMI by the second step-down of funding in the initial Compact period (FY97-FY98). Figure 34 indicates a baseline of migration accumulating during the period FY19-FY30: the addition of roughly 1.6% of the population annually. In the non-renewal scenario, each employee 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. Under the non-renewal scenario, the job loss from the private and public sectors is projected to induce an additional 3,064 migrants or 6.4% of the population above the normal trend migration rate.

## Palau

**Full recovery of the tourism sector and thus the economy is projected by the time Palau concludes the CRA period**. The projections in the prior chapter set the likely path Palau's economy may take for the remaining years of the CRA period, although—based on historical experience—it is subject to a high degree of variance. The base year for the non-renewal scenario examined in this chapter is FY24 when the recovery of the Palauan economy is complete by the time the post-CRA period starts in FY25. With full recovery from the massive impacts of the COVID-19 pandemic projected by the end of FY24, the fiscal impact of the non-renewal scenario is less dramatic than such a fiscal adjustment would have placed on a still-recovering economy.

**After recovery from COVID-19, the tourism economy is projected to expand rapidly from its weak pre-pandemic position**. The Palauan tourism sector was operating at low levels of hotel occupancy and visitor arrivals in FY19 before the COVID-19 pandemic; occupancy rates were 33% and visitors had fallen to 90,000, the lowest level since FY10. Our model assumes that occupancy rates will gradually return to normal levels, 55%, by FY30, with a projected recovery in visitors to 172,000. These assumptions impart a strong upward growth path in the tourism sector and the economy at the same time Palau enters the post-CRA period. There are thus two periods of recovery: (i) the recovery from COVID-19 during the remainder of the CRA period, and (ii) a broad tourism sector recovery during the early years of the post CRA period as the sector returns to normal levels of occupancy and profitability. For this study we isolate and focus on the impact of any adjustments to Compact economic assistance levels even if such impacts occur during a period of substantial tourism recovery and economic growth.

**Projections include adjustments to cover increased debt service resulting from COVID-19 associated debts**. Palau took on significant additional external concessional debt during the pandemic that requires servicing. Our model includes additional ongoing adjustments to cover debt service in addition to those

Figure 34: RMI Compact Non-Renewal Scenario: GDP, Jobs and Emigration

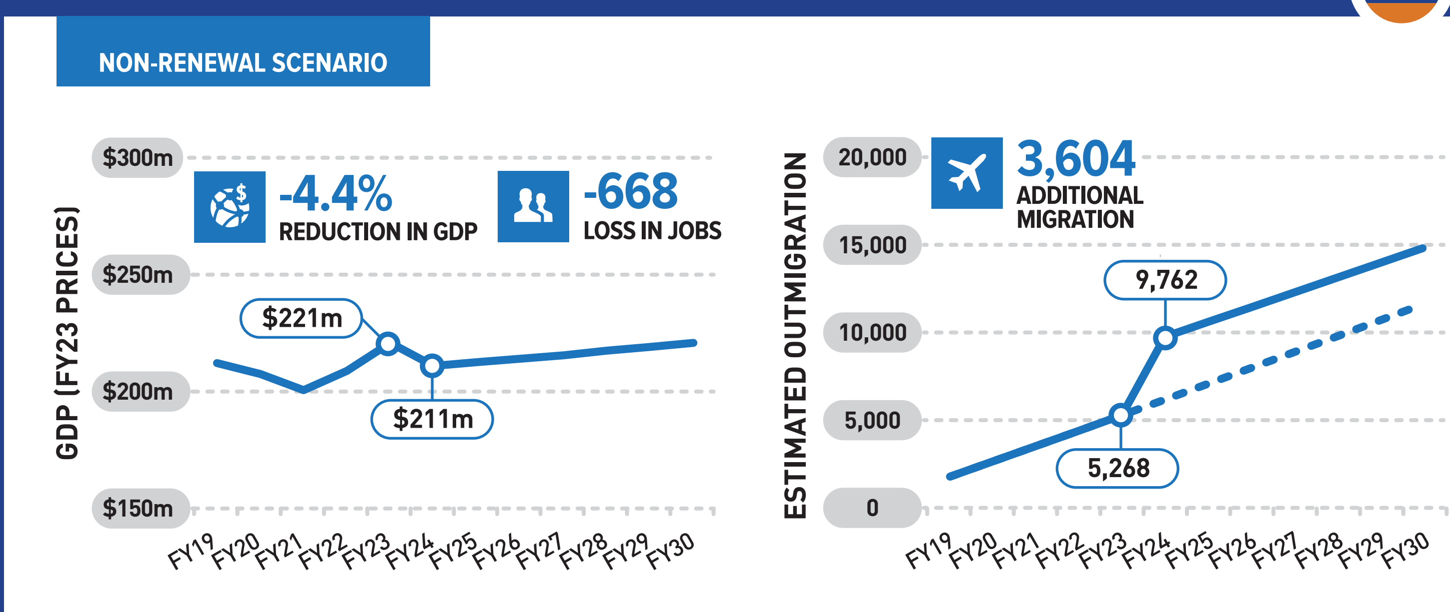
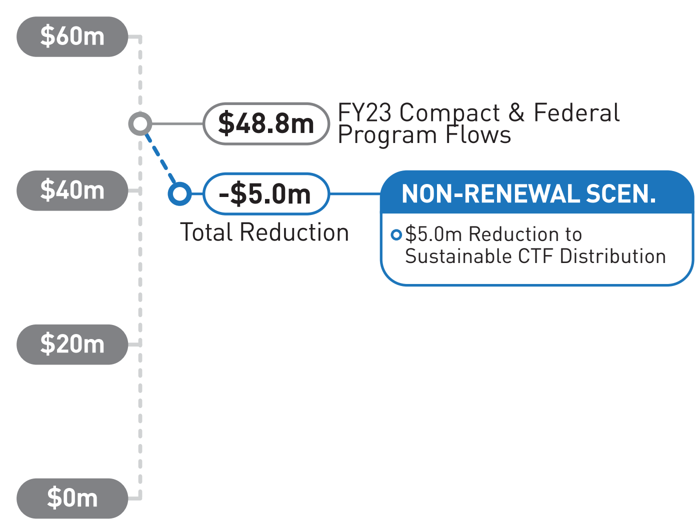


**Figure 35: Palau Non-Renewal Scenario: Required Adjustments**
Components and Magnitudes




arising from each Compact scenario. This is different for Palau as compared to the RMI and FSM, which are projected to have reduced external debt obligations due to the "grant only status" they operate under because of their lower level of GNI per capita.

**Palau faces modest adjustment under the non-renewal of compact assistance scenario although when coupled with increasing debt repayment the adjustment will be significant.** Compared with the two other FAS, Palau faces the least severe consequences of adjustment after its current period of Compact economic assistance ends after FY24. This is a result of Palau's lower reliance upon Compact assistance in relation to the size of its economy. Under the terms of the original Compact the level of distribution from the Palau CTF is limited to $15 million annually after FY23. Absent an amendment or renewal to Compact economic assistance, in FY25 that annual distribution will not be adjusted for inflation.

**Palau's COFA Trust Fund is projected to be $335 million at the end of FY24 and will support a sustainable distribution of $10 million**. Using the Monte Carlo method of statistical analysis, the median value of the Palau CTF at the end of FY24 is projected at $335 million, with a corresponding SAFER distribution of $10 million. This potential reduction in transfers to support government operations and capital investments is specified in Figure 35 as $5 million annually, which equates to 1.5% of projected FY24 GDP. The range of potential fiscal adjustments actions is broad: however, in this scenario the following assumptions are made[2]:

i. No new civil servants are hired to replace retirees, estimated to be a 2% annual decline,

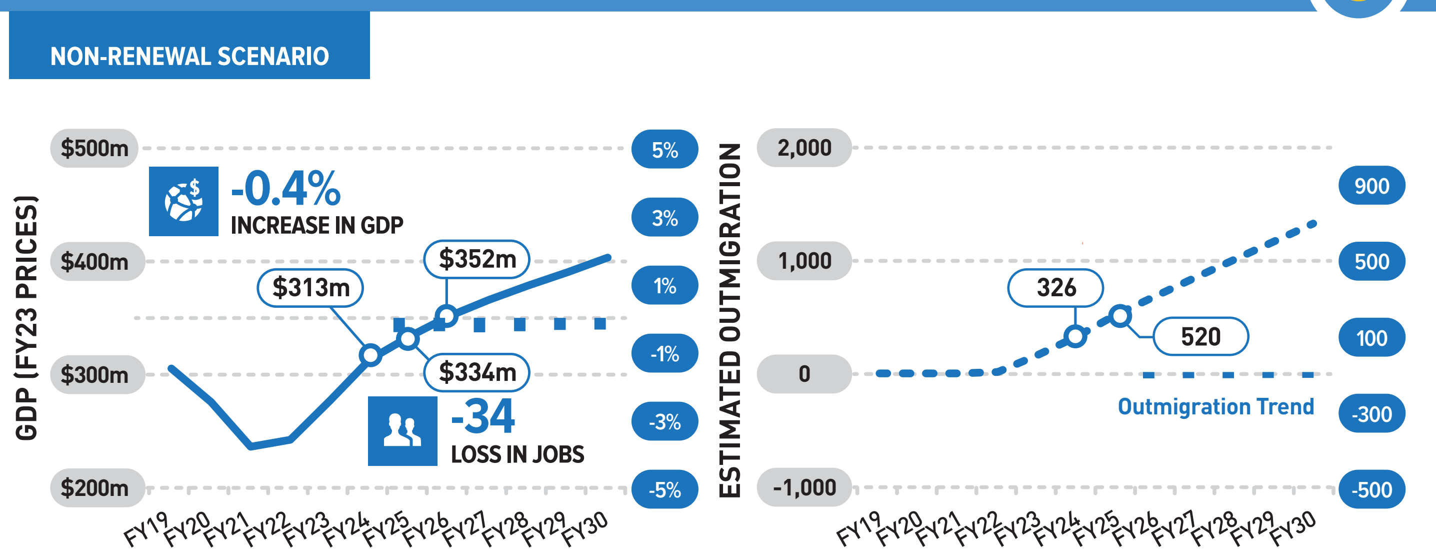
ii. Annual wage increments are not awarded, and

iii. A real cut of 2% is made on all purchases of goods and services, and transfers to government agencies, state governments and NGOs.

**The analysis presented is in comparison with the model trend**. In the analysis presented of the non-renewal scenario in this chapter and the Compact economic assistance renewal scenario of the following chapter, we compare them to the model trend. The

[2] The adjustments in this and following scenarios are determined to maintain a level of government deposits similar to that under the modeled trend

**Figure 36: Palau Non-Renewal Scenario: GDP, Jobs and Emigration**



model trend is that trajectory the economy might follow if Palau were to avoid the adjustment adopted in the non-renewal scenario. This implies that Palau would continue to draw down $15 million per annum from the COFA Trust Fund, effectively abandon its objective to create a perpetual fund, and at some point, risk the total collapse of the Fund. In the graphics the projections are presented in level form. However, in addition, the graphics show comparison to the model trend in percentage change terms. That percentage change from the model trend thereby isolates the impact of the adjustments under each scenario.

**The impact of the non-renewal scenario is a relatively small reduction in GDP of 0.4% and a loss of 34 Palauan jobs**. Figure 36 provides details of the impact of the non-renewal scenario on the economy, indicating both the underlying trend and difference to the non-renewal scenario. In FY25, GDP s projected to grow by 6.5%, which is 0.4% below the rate that results under the modeled trend. Thus, the impact of the non-renewal scenario is that same 0.4% decline with respect to GDP. This result may at first sight appear surprising. However, the economy is projected to be recovering rapidly from the pre COVID-19 tourism reduction. Visitor arrivals are projected to rise by 21% to 110,000 in FY26 above the pre-COVID level in FY19 of 90,000; this has a strong stimulative effect on the economy. The impact on the job market is similar: the stimulative impact of the economic recovery is far greater than the depressing effect of the Compact non-renewal scenario.

**Government reserves are projected to decline during the early stages of recovery, but to grow after FY27**. Government reserves are a measure of the need to finance the fiscal deficit after external debt obligations have been met. During FY20 and FY21, in the COVID period before recovery, the government secured a series of loans with the ADB to avoid the complete draining of its reserves. During the initial recovery phase and through FY27, government reserves are projected to decline as the level of economic activity is insufficiently strong to generate enough revenues to return the economy to fiscal balance. By FY27, the economy is back on a sustained growth path with occupancy rates approaching 47% and visitor arrivals approaching 137,000. From this point forward though the end of the decade, the economy continues to grow as visitors reach 172,000 and cash reserves grow. These results are based on limiting the real level of government at pre-pandemic levels and continuing to implement a prudent fiscal strategy.

# 5

# MODELING THE IMPACT OF COMPACT ECONOMIC ASSISTANCE RENEWAL

# 5 MODELING THE IMPACT OF COMPACT ECONOMIC ASSISTANCE RENEWAL

**Leaving behind the painful non-renewal scenario this chapter investigates the potential impact of Compact** economic assistance **renewal**. Chapter 4 described each FAS' plausible response to reduced Compact economic assistance without any modified development partner support and based on fiscal austerity to achieve fiscal balance. The forced adjustments outlined in Chapter 4 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. Now we look forward with optimism, using the GSUSA economic models to project the impact of a funded renewal of the Compact for each FAS.

**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**. At the outset of this chapter the potential impact of a Compact economic assistance renewal is described for each FAS economy. Clearly, continued Compact resources would improve economic and fiscal outcomes and avoid the cliff edge described in Chapter 4. Compact economic assistance renewal would also, if designed appropriately and funded sufficiently, establish perpetual trust funds that would secure flows of resources with a high degree of confidence and without need for an initial fiscal adjustment in FY24/FY25. While such a result would avoid fiscal shocks, the renewal would not by itself place each FAS on a higher economic growth trajectory.

**A better results scenario requires reform to FAS internal institutions and policies and/or a restructuring of the Compact economic assistance packages to enable greater financial support**. In addition to the basic Compact economic assistance renewal scenario, this chapter also considers the possibility of a further scenario combined with Compact economic assistance renewal that leads to better results. The "Better Results" scenario is based on either reform of internal institutions and policies within each FAS and/or a restructuring of the Compact economic assistance package to enable greater financial support than prevailed at the end of FY23/FY24. Attaining better results would require both commitment from each FAS and development partner support with projects and programs to support and reward institutional and policy reforms.

## Compact Economic Assistance Renewal

**For the FSM and RMI, Compact economic assistance renewal assumes a further 20-year period of annual support with the SEG also continuing**. Continued US support assumes that the US renews the amended Compact economic assistance provisions for the FSM and RMI at a level equivalent to the FY23 sum of the annual sector distributions, SEG, audit, and CTF contributions. Thus, the scenario assumes the FY23 level of US appropriation would continue. 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, capped at 5 %). However, in the modeled projection it is assumed that the totality of the annual US appropriations would be contributed to each CTF at the start of each year while the distributions would proceed during each year by mutual agreement for each expenditure type: replacing sector grants, disaster assistance, SEG, audit, and any others. Under such an assumption the benefit of delayed expenditures or even unspent funds would enable the CTF to benefit—on average—through investment returns. At an infinitesimal cost to the US Treasury, a significant benefit would accrue to the CTFs, strengthening their sustainability. The projected levels of the various distributions would be fully indexed for inflation, ending the 37-year period for the FSM and RMI of partial inflation adjustment combined with large periodic stepdowns (FY92 and FY97) or annual decrements (FY04-FY23). The model assumes these conditions would continue for the 20-year period from FY24-FY43.

**For the FSM, the better results scenario assumes a public sector-led growth strategy with substantial restructuring of domestic fiscal operations and for the RMI the creation of a Calibrated Development Assistance Distribution**. In addition to the base Compact economic assistance renewal scenario, two alternatives are outlined that lead to better results for the FSM and for the RMI. In the case of the FSM, it is assumed that the large structural surplus that exists at the national government plus resources in the FSM's own Trust Fund would be deployed to support development and institutional restructuring at the state government level. Increased transfers from the national to the state governments would form the basis for a public sector-led development strategy, at a minimum with potential for private sector growth as well. In the case of the RMI, no such fiscal surplus exists. However, the Compact Trust Fund for the RMI is sufficiently well resourced such that a stream of Calibrated Development Assistance could be distributed without endangering the long-run target to maintain a sustainable perpetual fund..

**For Palau, Compact economic assistance renewal is assumed to equate the structure of assistance to that of the RMI and FSM**. The structure of support under a Compact economic assistance renewal 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, during both the initial Compact and the CRA periods. The specific amounts modeled were chosen to equate the structure during the modeled Palau Compact economic assistance renewal period to that of the FSM and RMI. Operating distributions are assumed to be $15 million in FY24 prices with distributions for audit ($0.5 million) and infrastructure maintenance ($2 million) to continue at existing levels. Infrastructure is specified in proportion to the 70:30% operating distributions-to-infrastructure distributions 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 $15 million annually, or 63% above the sum of the other funding components. The 63% level, is derived from the average of FSM and RMI CTF contributions as a proportion of other FSM and RMI funding components. The topline contribution is adjusted for inflation using the two-thirds rule and deposited at the outset of each fiscal year into the CTF, while the distributions available to Palau annually would be fully inflation-adjusted from the FY24 baseline and distributed during each fiscal year.

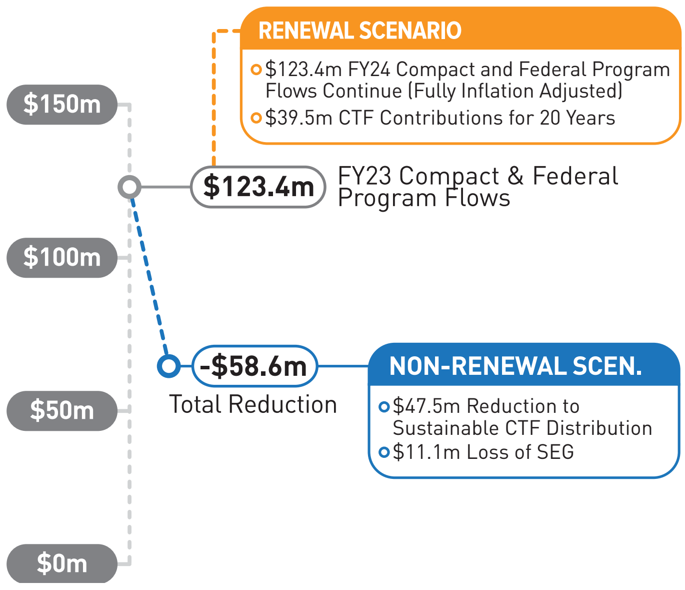
**Modeling does not consider the impact of climate events**. For all three FAS we do not account for the costs of achieving climate resilience. Credible institutions such as ADB and the World Bank are working to model—and insure against—the costs to nations to better prepare for climate events; however, 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% 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.

# The Federated States of Micronesia

## *Compact economic assistance renewal scenario*

**The Compact economic assistance renewal scenario allows government operations at the state level to continue without adjustment, but at the national level the renewal enables greater public spending**. In the FSM Compact economic assistance renewal scenario, sector distributions, including the SEG, are projected to continue at FY23 levels fully indexed and with no decrement. Figure 37 shows the FSM Compact economic assistance renewal scenario in comparison to the non-renewal scenario outlined in Chapter 4. In essence, the Compact economic assistance renewal scenario is a continuation of current levels of US assistance albeit fully indexed. The renewal scenario assumes the national government no longer needs to allocate resources from the fiscal surplus into the FSMTF. However, for precautionary needs, the corpus of the fund is allowed to accumulate without drawdown. Absent a need to set aside funds for an uncertain future the national government may maintain levels of legislative

**Figure 37: FSM Non-Renewal and Renewal Scenarios**
Components and Magnitudes




projects and other recurrent expenditures. The state level sees no change in fiscal regime and governments operate at the constrained level of funding existing at the end of the amended Compact.

**Full indexation of Compact economic assistance would release the economy from the fiscal drag experienced in the original and amended Compact periods**. In FY23 the fiscal drag imposed 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 without the fiscal drag. 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 annual economic growth of about 0.33%. The benefits of full indexation occur at the state government level.

The Compact economic assistance renewal scenario makes the following assumptions:

i. Government operations at the state levels remain unchanged.

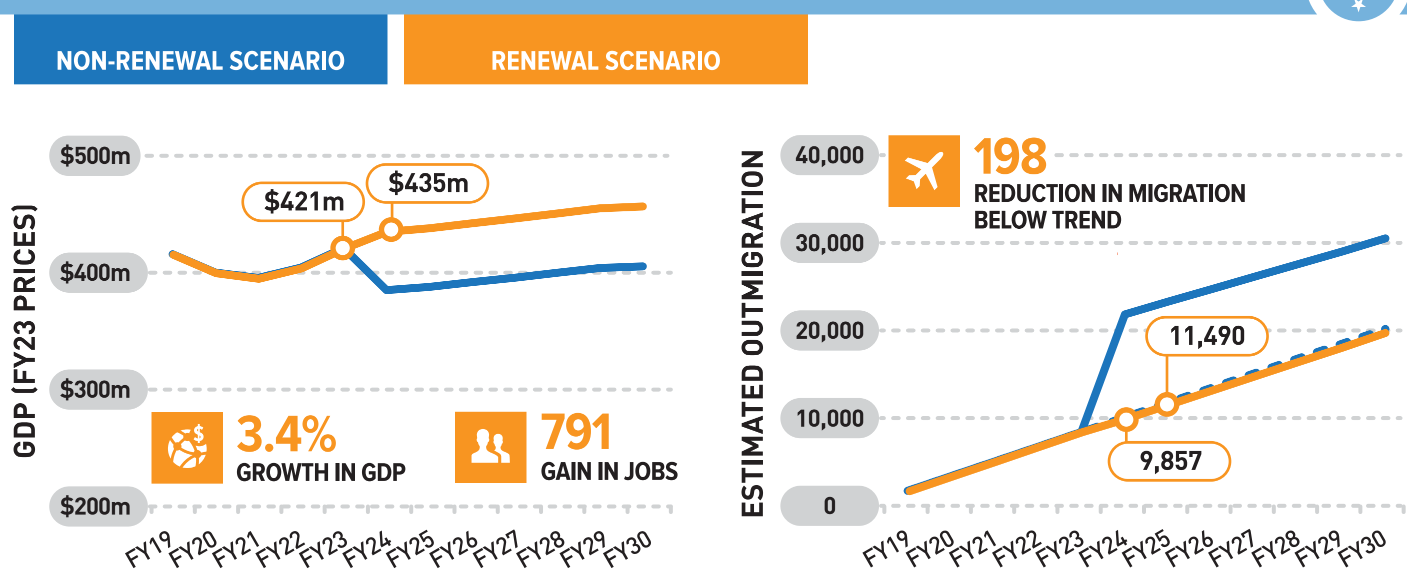
ii. The corpus of the FSMTF is allowed to accumulate.

iii. Expenditures on public congressional projects return to the FY20 level of $24 million in FY24 and are indexed for inflation thereafter.

iv. Expenses on professional services return to the average level in FY17-FY19 of $21 million and are indexed for inflation thereafter.

**The Compact economic assistance renewal scenario has a positive impact on the economy, jobs are created, and outmigration is reduced**. The Compact economic assistance renewal scenario and impact of these changes, together with the non-renewal scenario, is shown in Figure 38. GDP is projected to increase by 3.4% in FY24 and be maintained at an average of 1.0%, thereafter through FY30. This of course is a massive improvement over the non-renewal case where state governments required a large fiscal adjustment. The impact on the job market is also positive, with an additional 791 jobs created compared with FY23. Most of the jobs are created in the construction industry and other private services resulting from the higher demand in the economy. Finally, the impact on migration is

**Figure 38: FSM Compact Renewal Scenario: GDP, Jobs and Emigration**



positive; the additional jobs created stem the underlying trend in outmigration.

**Under the renewal scenario, the FSMCTF is expected to achieve sustainability and perpetual status**. If the described renewal of Compact economic assistance were to last for a 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 Compact economic assistance renewal scenario, the FSMCTF (using SAFER rules) achieves a score of 95.3% with no cases of zero distributions over the period FY24-FY63. In the absence of Compact economic assistance renewal, the FSMCTF would score 48% using COFA rules and 75% of cases result in at least one zero distribution year over the period FY24-63.

### *Better results scenario*

**A favorable Compact economic assistance renewal has the potential to radically alter the economic and political environment in the FSM**. In contrast to the Compact economic assistance renewal scenario outlined above, an alternative "better results" scenario exists that redeploys the national government structural surplus through a redistributive policy of public sector-led growth at the state level. Under such circumstance, the current revenue-sharing arrangements that exist between national and state governments would be subject to new dynamics. Arguments related to preparing for a fiscal "cliff" for the recent sustained growth of sovereign rents to remain within the national government would no longer be relevant. The structure of possible new revenue sharing arrangements with the state governments for a public sector-led growth strategy are outlined as follows:

i. Termination of further contributions by the national government to the FSMTF as the fund's most prominent objective, which is to provide a source of revenue to replace insufficient FSMCTF resources, would no longer be required.

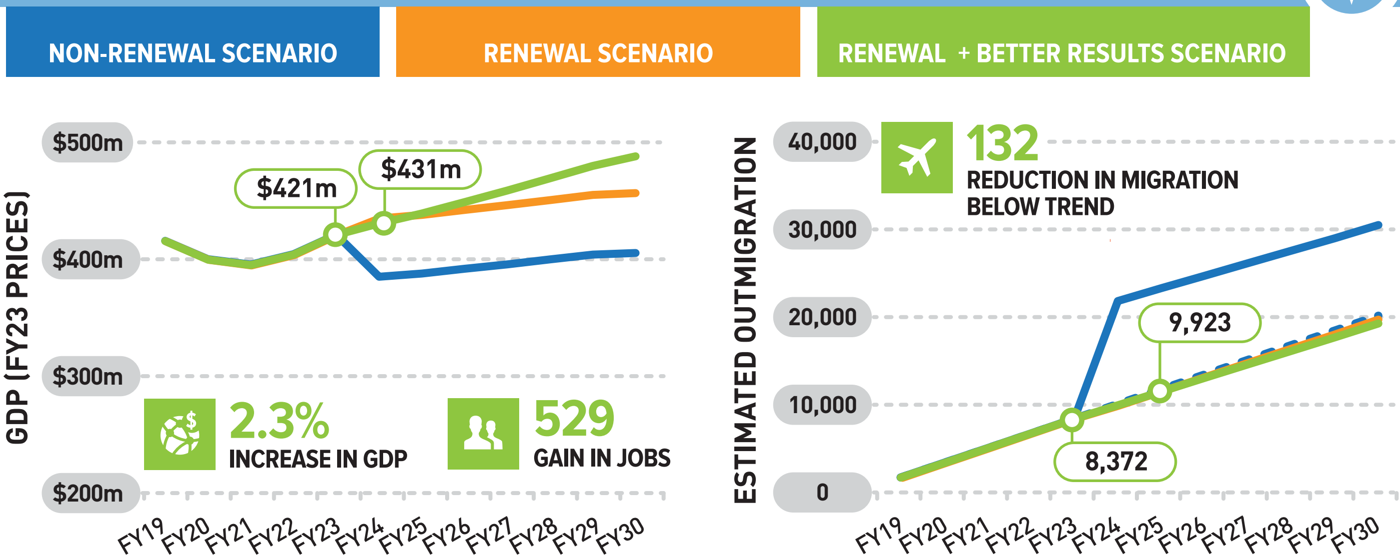
ii. Out of the FSMTF's projected $485 million in FY23, $100 million is set aside to support climate change and natural disasters.

iii. The remaining FSMTF corpus would provide a perpetual yield to be distributed to the state governments. Distributions would commence in FY24 at a low initial rate and increase through FY30 until the SAFER drawdown target was attained. In the interim, funds would be accumulated in the FSMTF.

iv. Expenditures on public congressional projects are restrained at the level of $14 million annually.

v. Out of the continuing national government sovereign rents, a target transfer to the state governments of $15 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.

Figure 39: FSM Better Results Scenario: GDP, Jobs and Emigration



**Additional funds for state government would reach 6.5% of GDP by FY30**. 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 transfers for the states would be close to $17 million and a further $19 million in drawdowns from the FSMTF, or 6.5% of the projected level of GDP. 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 state-level funding , the period under a Compact renewal could materially improve essential government services. 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.

**The FSM economy is projected to grow by an average of 2.1% during FY23-FY30 through adoption of a public sector-led redistributed growth strategy**. Figure 39 shows the impact of renewing the Compact economic assistance provisions and the benefits of internal fiscal redistribution on FSM's economy. The impact on GDP is favorable and the economy grows by 2.3% in FY24. This compares with the projected 8.6% reduction under the non-renewal scenario and the 3.4% growth under the base Compact economic assistance renewal scenario. The higher rate of growth under the renewal scenario reflects the assumption that FSM funds released at the national level result in an immediate increase in public expenditures. However, the rate of increase in FY24 cannot be sustained and economic growth slows to an average 1.0% during the remainder of the projection period. Conversely the gradual increase in funding under the better results scenario permits structural state-level changes and a high sustained growth of 2.1% over the period. Compared with the historical average during the amended Compact period this would be a monumental change. The pattern of impact on the state economies is not shown in the graphs, but the greatest beneficial impact would be on the smallest state, Kosrae, which is projected to grow by 3.1%, FY23-FY30. Chuuk, Pohnpei and Yap are projected to grow by 2.5, 1.8 and 2.3%, respectively.

**The better results scenario has a strong impact on employment, generating an additional 3,690 jobs over the period through FY30 or a 22% increase from the FY23 employed work force**. The impact on employment reflects a similar pattern to that of GDP, but the structure is different. In FY24 an additional 529 jobs are created in the better results scenario compared with 791 under the base renewal scenario. But over time the state-level redistributive policy has more employment potential. By FY30,the better results scenario results in 3,690 additional jobs while the base renewal strategy results in just 2,249 additional jobs. The distribution of the created jobs is different. Under the base renewal scenario, the jobs are created in the private sector, while under the better results case the jobs are focused in the public sector, reflecting the nature of the strategy. Clearly, the greater job creation under the better results scenario would have a greater long-term mitigating impact on outmigration.

**As transfers to state governments plateau, development strategy would need to switch to private sector-led growth**. The projections are based on a gradual increase in the volume of resources transferred to the state governments. In time the increasing source of funds would plateau, and the period of public sector-led growth would end. However, the radical shift in relation between national and state governments would place the FSM on a higher growth trajectory and with adoption of a more favorable environment for the private sector could be sustained into the future.

## The Marshall Islands

### *Compact economic assistance renewal scenario*

**Compact economic assistance renewal provides funding at pre-existing levels with full inflation adjusted, but the underlying fiscal deficit still requires adjustment**. . In the RMI Compact economic assistance renewal scenario, sector distributions, including the SEG, are projected to continue at FY23 levels—fully indexed and with no decrement. Figure 40 shows the RMI renewal scenario in comparison to the non-renewal scenario outlined in Chapter 4. However, a fiscal correction is still needed in FY24 due to the lingering imbalance inherited from the FY19 budget. The full range of adjustments, such as a Reduction-In-Force, under non-renewal are not required; the adjustment needed to restore fiscal balance is limited to the measures outline below:

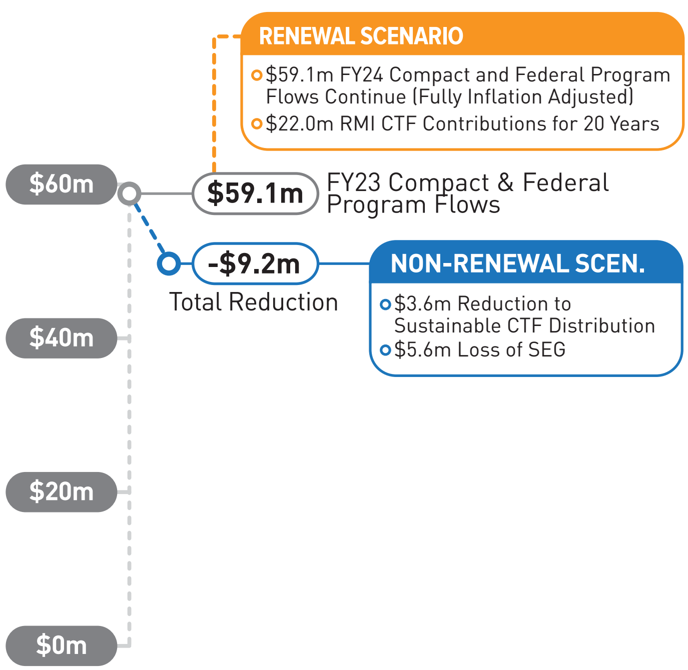
i. Reversal of 50% of the large increase in the use of goods and services to the level that existed before the rapid rise in sovereign rents in FY15.

ii. A wage freeze through the remainder of the projection period FY25-FY30.

**Full indexation of Compact economic assistance would release the RMI economy from the fiscal drag experienced in the original and amended Compact periods.** During the amended Compact period the fiscal drag imposed on the economy due to the decrement and lack of full indexation is estimated to be approximately 0.36% annually. 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 annual economic growth of about 0.33%.

**Compared with the base adjustment scenario Compact economic assistance renewal indicates a substantial improvement**. Figure 41 shows the impact of the renewal of the Compact on the RMI economy. Compared to the non-renewal scenario, the impact on GDP in FY24 is less adverse, but due to the pre-existing structural deficit the economy still needs to adjust. GDP under the renewal scenario is projected to decrease by 0.5% compared with a reduction of 4.4% under the non-renewal scenario, implying a significant gain of 3.9%. Over the period FY25 to FY30 under both the non-renewal and renewal scenarios, economic growth is close to 0.8% compared with 1.3% during the amended Compact period, FY04-FY19, indicating weak economic performance. The impact on employment in FY24 is considerably improved: only 107 jobs are lost under Compact economic assistance renewal compared with a reduction of 668 under non-renewal. Job growth over the period FY24-FY30, however, is projected to remain weak at 0.2% per annum, with 111 new jobs. The impact of the job loss in FY24 due to the need for fiscal adjustment is not negligible and 577 people are projected to migrate.

**Figure 40: RMI Non-Renewal and Renewal Scenarios**
Components and Magnitudes




**A better result will require a commitment to policy reform with donor support**. The analysis indicates that the impact on the RMI economy of Compact economic assistance renewal is an improvement on the non-renewal adjustment scenario. However, the gain is not large and projected performance in the renewal period is weak. The RMI has already absorbed the benefit of the increase in sovereign rents, largely from fishing fees, and has no pool of savings to provide resources for development or to offset fiscal shocks. Still, the benefit of a known future and the economic security resulting from Compact economic assistance renewal would likely cause changes in behavior and economic benefits that the model is unable to simulate. The results of the renewal scenario illustrate that better results will require a commitment to institutional and policy reform in the RMI coupled with development partner support to both capital projects and reform implementation.

**Under the renewal scenario the RMICTF is expected achieve a high degree of sustainability and perpetual status**. If the renewal of Compact economic assistance were for 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 economic assistance renewal, the RMICTF using SAFER rules achieves a score of 98% and there are zero cases of zero distributions over the period FY24-FY63. In the absence of a renewal, the RMICTF would score 90% using COFA rules and 23% of cases would have at least one zero distribution year over the period FY24-63.

### *Better results scenario*

**The strong performance of the RMI CTF indicates the potential for withdrawal of funds, provided such distributions do not degrade the value of the corpus below sustainability**. Reflecting a series of beneficial factors, the RMI CTF is projected to attain a value $784 million in FY23. These factors include a decision by the RMI (i) to devote a large proportion of Compact resources to the CTF during the amended Compact, (ii) to immediately allocate the annual decrement in Compact economic assistance to the CTF, (iii) to seek out additional funding from development partners, and (iv) dedicate $20 million of compensation from the US for the loss of Compact tax and trade incentives. The RMI CTF is already projected to be in a strong position in FY23 and achieve 89% of the value required for sustainability as defined by the SAFER rule, where a 95% score on the SAFER performance criteria is the notional goal.

Coupled with continuing allocations to the CTF during the FY24-FY43 period, the CTF is projected to achieve a very high degree of sustainability at the end of forty years ending in FY64, with a score of 98%. This high degree of sustainability suggests the potential for withdrawal of a certain amount of funds annually, provided this does not degrade the value of the RMICTF corpus below the 95% notional target.

**A $15-million calibrated development assistance distribution is modeled**. This study models the potential benefit of a calibrated development assistance distribution, which, in the RMI, could benefit from an estimated $15 million average annual distribution to support special projects. These projects could support non-recurrent spending or capital investments. This level of average annual distribution is calculated to be consistent with CTF sustainability. However, the actual value of this annual distribution stream would be continually calibrated—meaning distributions would be adjusted annually—to ensure the 95% target was maintained. In the event of investment returns that delivered the precise median expected results, the average $15 million distribution would prevail. If, however, the RMICTF faced early and/or persistent disappointing returns, the "calibrated distribution" would necessarily be reduced—with the funds thus remaining invested in the RMICTF—thereby fortifying the corpus in times of need.

**Application of the development assistance distribution stream could be associated with a donor-coordinated approach to provide a sound basis for performance and monitoring**. To gain maximum benefit, these supplemental/calibrated distributions could be allocated in a manner that supports RMI express priorities that are also consistent with the express findings of the RMI's multi-lateral and bi-lateral donor partners, including of course the US. The objective would thus be for the RMI to benefit from a donor-coordinated approach to the calibrated development assistance distribution stream, drawing in expertise from the international community where appropriate.

**The better results scenario allocates funds proportionately between non-recurrent and capital projects for model projections**. The better results scenario assumed the following use and allocation of the $15-million average distribution stream fully adjusted for inflation:

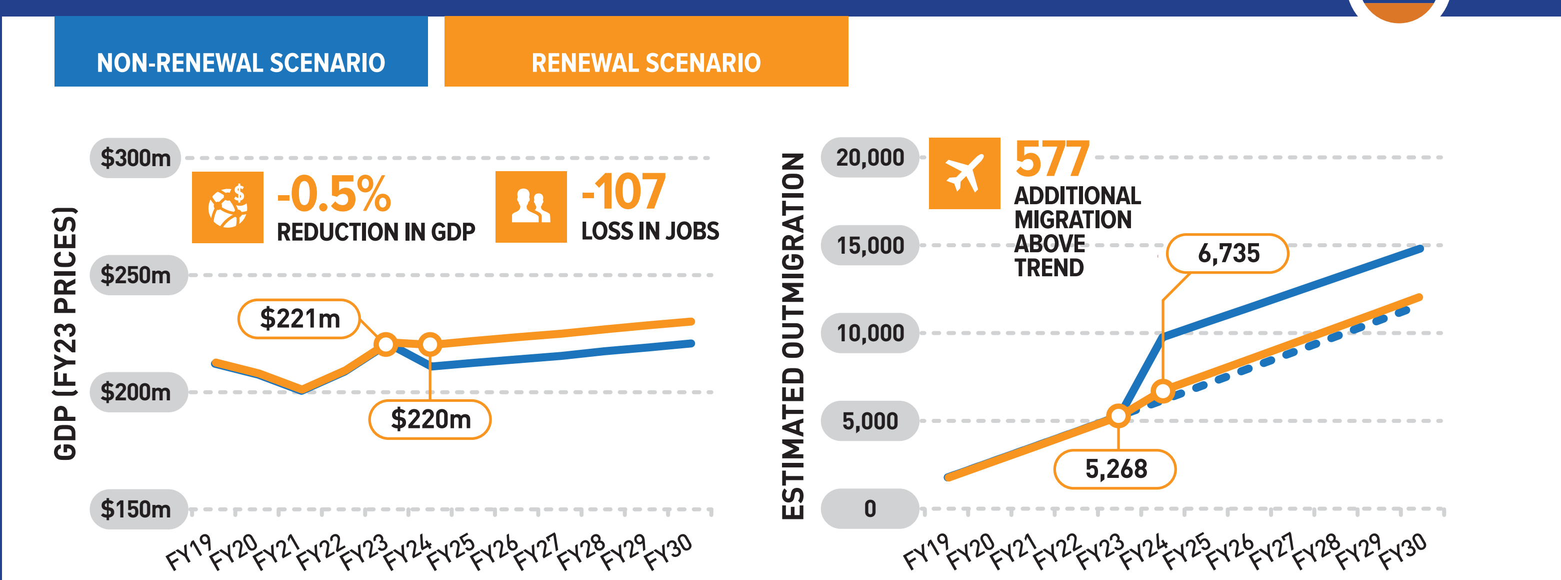
i. Funds are allocated on a 50:50 basis between non-recurrent and capital projects.

ii. Non-recurrent expenditures are divided also 50:50 between payroll and use of goods and services.

iii. Disbursement of the funds into well-designed projects will build up over a period of 6 years through FY30 when the program would presumably be well-developed.

**The better results scenario has a strong impact on GDP, job creation and reduction in out-migration**. The modeled results are shown in Figure 42. While the scenario assumes the same need for fiscal adjustment in FY24, the additional $15 million distribution stream is sufficient to turn the former negative economic growth result into a positive outcome of 0.8%, which is 1.3% above the basic renewal strategy. Through the remainder of modeled period GDP growth is projected to rise annually by 1.9%, which is an 1.1% improvement over the base renewal strategy. In FY24, 150 new jobs are created and a total of 1,847 new positions are generated above

Figure 41: RMI Compact Non-Renewal Scenario: GDP, Jobs and Emigration



the base renewal case by FY30. In terms of outmigration, the creation of jobs is sufficient to induce a projected reduction below the trend rate.

# Palau

## *Compact economic assistance renewal scenario*

**The Compact economic assistance renewal scenario for Palau considers continued US support to establish a perpetual Palau CTF and a further program of investment in infrastructure**. Figure 43 shows the Compact economic assistance renewal scenario in comparison to the adjustment scenarios outlined in Chapter 4. The program entails the following components:

i. CTF operating distributions are set at $15 million annually in FY24 prices.

ii. As noted, the level of infrastructure distributions is modeled at $6.5 million annually in FY24 prices so that the same 70:30 ratio for operating distributions to infrastructure distributions is established for Palau as exists already for the RMI and FSM.

iii. Specific distributions for infrastructure maintenance of $2 million and audit of $0.5 million.

iv. Annual contributions to the Palau CTF are set at $12 million in FY24 prices. This level of funds, 50%, is slightly below the 62% average ratio in the FSM and RMI, between sector distribution levels and CTF allocation.

v. Since the topline level of transfers from the US is presumed to maintain at two-thirds inflation adjustment, the trust fund contribution is modeled as the residual while allowing the other components to be fully inflation adjusted.

**Economic growth is projected to increase by 0.6% p.a. under the Compact economic assistance renewal scenario**. Figure 44 shows the potential benefits of such a renewal. As in all other scenarios, the projections assume a similar trajectory for fiscal balance as under the model trend. 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 4.9% per annum during FY24-FY30. In comparison with the modelled trend, this equates to a 2.0% increase in FY25 and a sustained average 0.6% annual improvement over the model period. This outcome is based on an improvement in the level of private sector activity of 0.7% per annum due to increased infrastructure spending, and additional resources for the public sector, which grows by 0.8% per year from FY24 to FY30.

**Compact economic assistance renewal provides a modest rise in employment and retention of Palauan jobs**. The additional hiring associated under the Compact economic assistance renewal scenario with modest expansion in public services adds an estimated 17 Palauan jobs in FY25 and rises to 105 Palauan jobs by FY30 compared with the model trend. Since most workers in the construction sector are foreign, the enhanced infrastructure program does not generate a significant increase in jobs for Palauans. As a result of the increases in both civil servants and construction

Figure 42: RMI Better Results Scenario: GDP, Jobs and Emigration

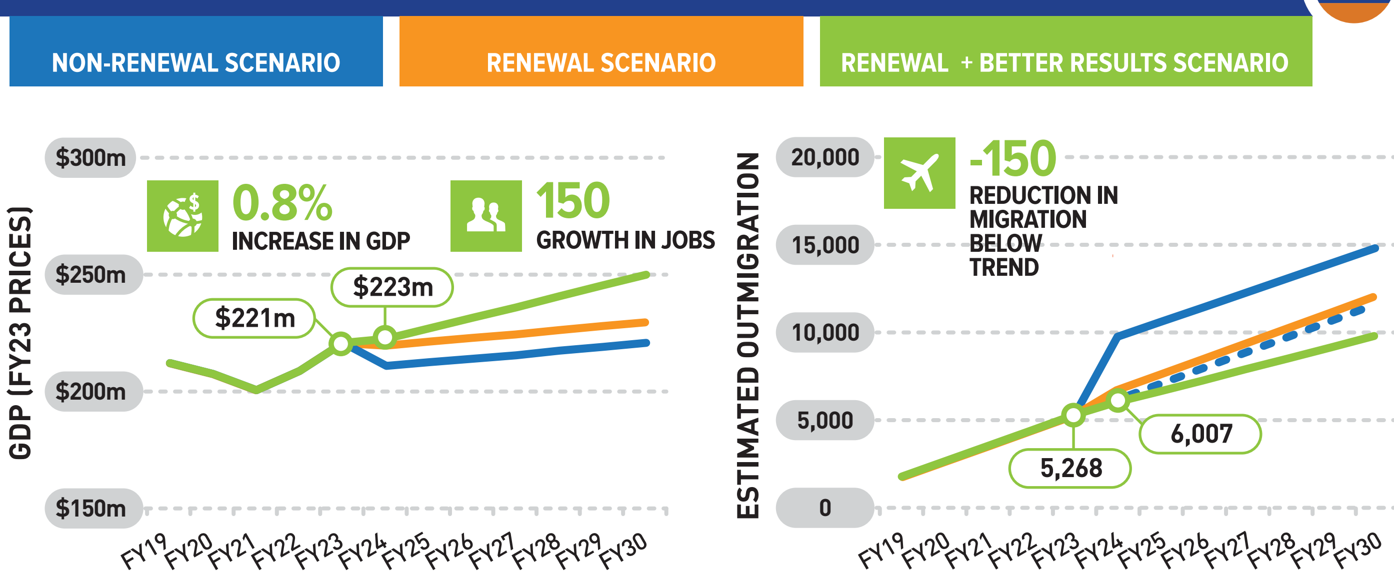
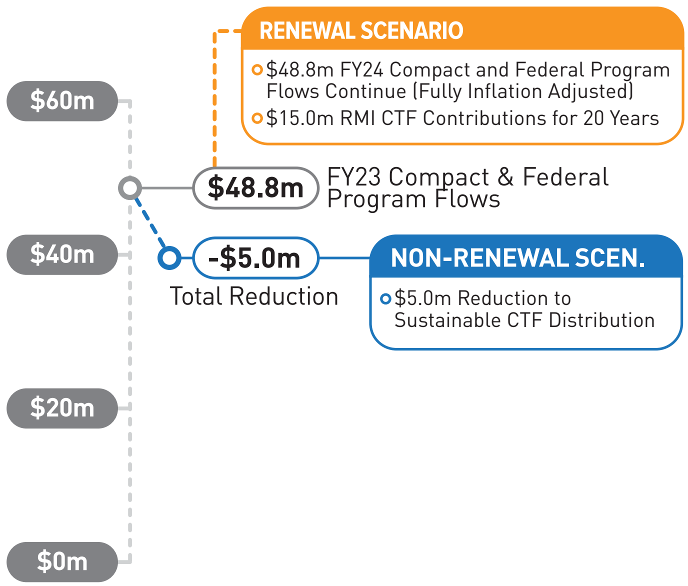


**Figure 43: Palau Non-Renewal and Renewal Scenarios: Required Adjustments**
Components and Magnitudes




workers, the overall labor market (both Palauans and non-Palauans) expands by an additional 422 jobs by FY30 or 3.4% of the size of the employed labor market. The projections show a small decrease of 36 fewer migrants in FY25 under the Compact economic assistance renewal scenario compared with the model trend.

**Additional infrastructure under the Compact economic assistance renewal helps strengthen the economy**. Public investment in infrastructure grows at the start of the projection period going into the COVID-19 period and helps sustain economic activity. However, from FY22 through FY25, a paucity of both private and public sector projects reflects the lack of demand for investment in the tourism industry and a lull in the public projects. From FY25 both private and public projects re-emerge as the economy gains momentum and demand for new tourism plant is felt. However, the significant impact of the renewal with additional infrastructure projects clearly help to lay the groundwork for economic expansion.

**Under the renewal scenario, the Palau CTF is expected to achieve a high degree of sustainability and perpetual status**. If the described renewal of Compact economic assistance were to last for a 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 economic assistance renewal scenario, the Palau CTF using SAFER rules achieves a score of 97% and has no cases of zero distributions over the period FY24-FY63. Absent a Compact economic assistance renewal, the Palau CTF would score 74% using COFA rules and 6% of cases result in at least one zero distribution year over the period FY24-63. The COFA rules for Palau are such that the 6% of cases with a zero distribution is equal to the number of cases where the CTF is completely exhausted during the period.

### *Better results scenario*

**No better results scenario is modeled for Palau although a proposal to create a stream of calibrated development assistance distributions would be worth exploring**. In the case of the FSM, a significant structural surplus at the national government level enabled additional transfers to the states, achieving a significantly better result. In the case of the RMI the extraordinarily well-resourced CTF led to the modeling of a calibrated development assistance distribution to fund supplemental well-designed and monitored projects, and the projection of a better result. Palau has neither a large structural surplus nor an extraordinarily well-resourced CTF. However, our calculations indicate with the resources programmed into the renewal scenario, the COFA Trust Fund will achieve a SAFER score of 97% by FY64. This would enable a calibrated development assistance distribution of an average of $2.5 million annually subject to the same framework as described for the RMI. However, the overall size of the distribution would be less than 1% of GDP and we have chosen not to model this scenario as the results are not macroeconomically significant. However, the calibrated approach developed for the RMI would be equally applicable and worthy of consideration for Palau.

## Estimating the Cost to the US of Compact Economic Assistance Renewal

The Compact economic assistance renewal 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 distributions, SEG, audit, and CTF contributions for the FSM and RMI. The sector distributions 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 distributions, infrastructure maintenance, infrastructure funding, audit, and CTF contributions. Table 1 below shows the estimated costs to the US for the modeled Compact economic assistance renewal scenarios. Also included is the projected score of the CTF at the end of the 20-year renewal, looking forward to the following 20 years after FY43 for the FSM and RMI and after FY44 for Palau.

Table 1 Funding Costs and Confidence Level Results

| Billions of US $'s | FSM | RMI | Palau |
|---|---|---|---|
| Total transfers/contributions in FY23/24 prices | $2.54 | $1.08 | $0.73 |
| Total transfers/contributions in current prices | $3.13 | $1.33 | $0.90 |
| Projected CTF score at end of FY43/44 | 95% | 98% | 97% |

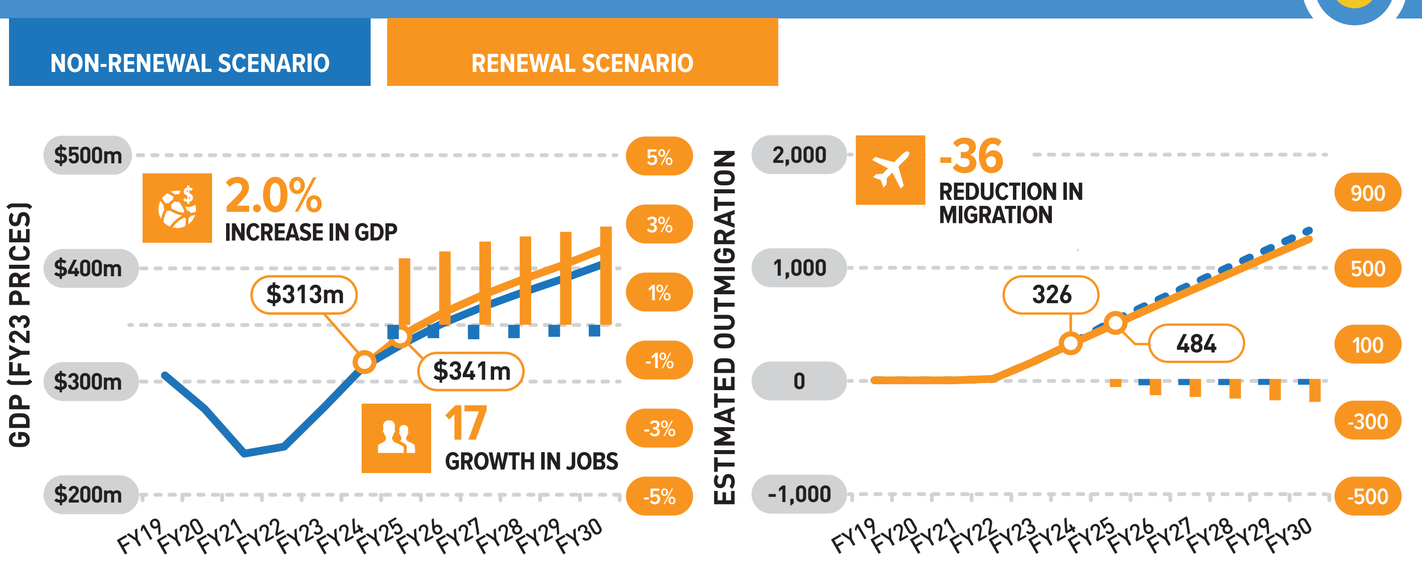
## Reforms and Donor Support

### *Potential Reform Agenda for Improved Performance with Compact Economic Assistance Renewal*

The discussion in the previous sections indicated potential economic benefits of the modeled Compact economic assistance renewal. The results differ among the three FAS, with potential economic performance improving the greatest in the FSM. Palau shows significant potential benefits and the RMI 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 uncertain. It is clear, though, that the US is committed to a negotiation process that is likely to lead to a renewal. The eventual outcome of negotiations will likely be above the non-renewal scenario; it is less clear if the best-case robust Compact economic assistance renewal scenarios can be matched or even exceeded through the soon-to-be re-activated negotiation process with each FAS.

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 economic assistance renewal. Implementation would, therefore, entail reform programs to improve not only the efficiency and effectiveness of public sector service delivery, 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 economic assistance renewal terms, donor assistance and domestic reform will become essential to sustain even disappointing economic performance.

Figure 44: Palau Compact Renewal Scenario: GDP, Jobs and Emigration



### Key Areas of Public Sector Reform

It is not within the scope of this study to outline a specific program of reform for each FAS

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

**World Bank 2020 "Doing Business Survey" indicates all 3 FAS rank in the lowest quartile, suggesting room for improvement**. The World Bank 2019 "Doing Business Survey"[1] provided an overall assessment of the environment for private sector development in the three FAS. The FSM, RMI and Palau rank 158, 153 and 145, respectively, out of the total 190 countries included in the study, indicating a 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

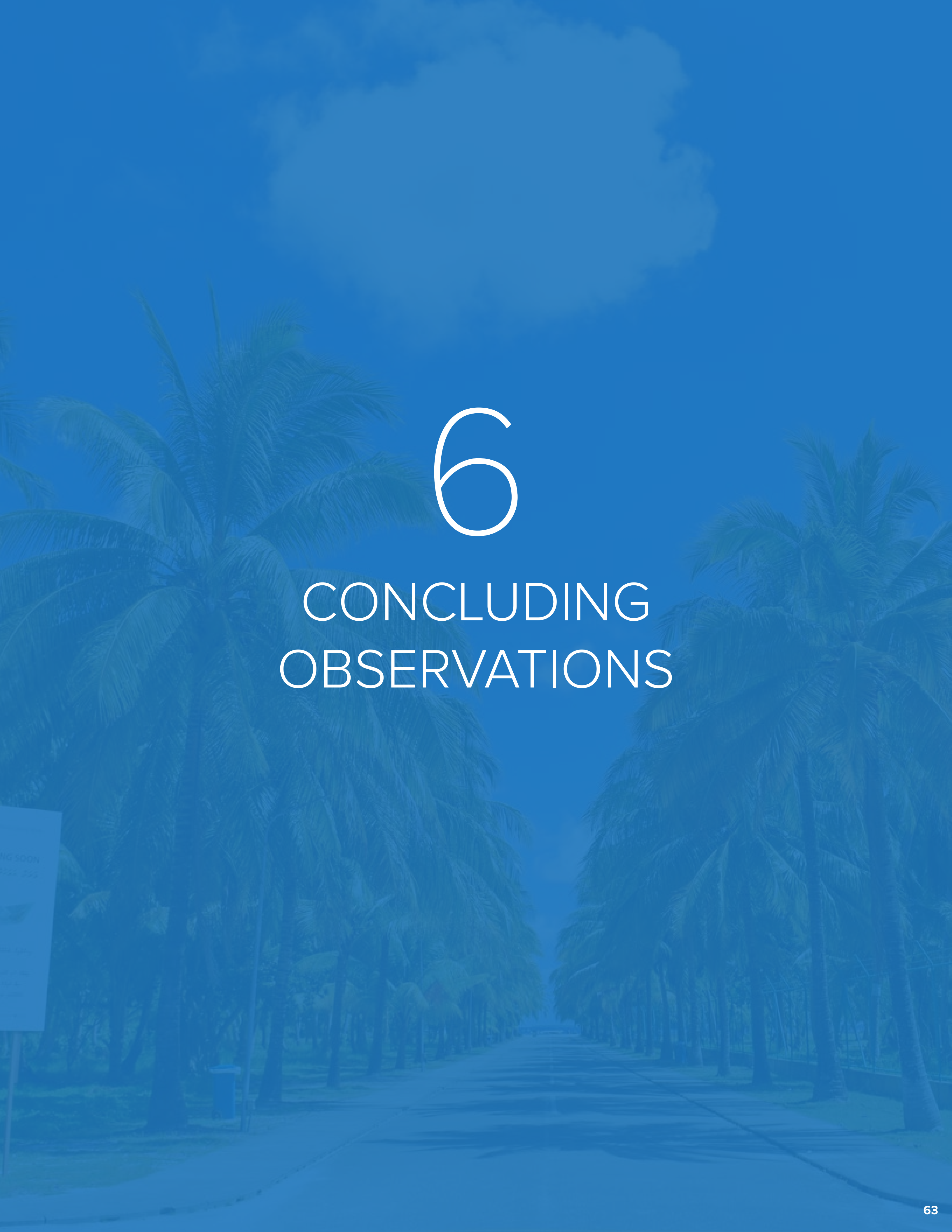
The previous section indicates the breadth of reform issues that require attention and resolution in order for the economies to function well and to achieve sustained improvements. The development partner community has supported reforms in the past, but the opportunity provided by a Compact economic assistance renewal 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 create 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 an increase in 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 prominent part of 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 economic assistance renewal, development partner actions can assist each FAS to improve its economic growth rates and help ensure growth is increasingly driven by the private sector.

[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.



# 6

# CONCLUDING OBSERVATIONS

# 6 CONCLUDING OBSERVATIONS

This study has attempted to provide timely analysis of a few scenarios for each FAS. Already, in discussions with the principal parties, it has become clear that the range of likely scenarios differs in some important ways from the specific scenarios modeled in this study. Still, this study's scenarios are intended to elucidate the economic and fiscal outcomes from plausible scenarios. It seems clear that all likely negotiated outcomes will be an improvement on the "Compact economic assistance non-renewal" scenario presented for each FAS; however, given the potential for delay in achieving mutual agreement and subsequent US Congressional approval for all three FAS, the results of that relatively dismal scenario are indicative of the potential economic and fiscal shock each FAS might face even during a period of delayed renewal. In such circumstances, transitional financial support from the US could clearly mitigate some or all of the painful outcomes projected for each FAS.

It may be possible that the assumptions used and the US funding level implicit in 20-year versions of the "Compact economic assistance renewal" scenario for each FAS will prove to be too costly in the context of three separate bi-lateral negotiations . The authors are not privy to the deliberations that led to Compact extension offers to each FAS in December 2020. Neither are the authors privy to specific funding counter-requests, if any, of the FAS in the wake of those December 2020 US offers. In general, the RMI and Palau have expressed to US officials and in public events their rejection of the level of funding implicit (or explicit) in the offer each received. All three FAS have clearly stated that continuation of US Postal Service as part of a renewal package is of vital importance, implying that initial offers may have been silent on postal services.

The cost of each Compact economic assistance renewal scenario is detailed in Table 5.1. The scenarios are based, in the first instance on a 20-year renewal of economic assistance to the FSM and RMI at a level equivalent to annual appropriation levels for each at the end of FY23 and continuing the past practice of partial inflation adjustment through the period from FY24-FY43. Because the initial two periods of economic assistance under the Palau Compact were structurally different, the assumptions made for Compact economic assistance renewal for Palau entailed adjustments to attempt to make the structure of funding from FY25-FY44 proportionately equivalent and therefore structurally similar to the provisions for the FSM and RMI over FY24-FY44.

It is hoped that the analysis of Compact economic assistance scenarios in this report may prove useful to the affected parties as they prepare to return to negotiations after a lengthy delay through at least March of 2021. The August 5, 2019, announcement by then US Secretary of State Michael Pompeo, "… that the United States has begun negotiations on extending our respective Compacts of Free Association with each country.[1] "act was warmly welcomed by all three FAS leaders present. 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

[1] Remarks to the press by Secretary of State, Michael R. Pompeo in Palikir, Pohnpei, FSM, following meeting with FSM President David W. Panuelo, RMI President Hilda C. Heine and Palau Vice President Raynold B. Oilouch; August 5, 2019; archived at www.state.gov.

proportion to the level and length of ongoing Compact and related federal economic assistance.

This study has 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 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, substantial resources have been saved. In the optimistic scenario of a robust Compact economic assistance renewal, even the most pessimistic economists might set aside their prototypical "dismal" outlook and agree with the strong 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 "Compact economic assistance non-renewal" 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 of the new period. 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 economic assistance renewal, the benefits of a SAFER distribution rule will remain, while the immediate pain of a substantial adjustment would likely be eliminated entirely.

The authors are hopeful that in an "all good things go together" scenario, the combination of a robust Compact economic assistance renewal will be coupled in time with an increase in major development partner financial and technical assistance. Such a confluence may motivate and empower each FAS to implement institutional, fiscal, and economic policy reforms consistent with its own desired path to sustained economic growth.

# APPENDIX: WHAT'S WRONG WITH THE COMPACT TRUST FUND RULES FOR FSM & RMI?

# What's Wrong with the Compact Trust Fund Rules for FSM & RMI?

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 (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 distributions. 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).

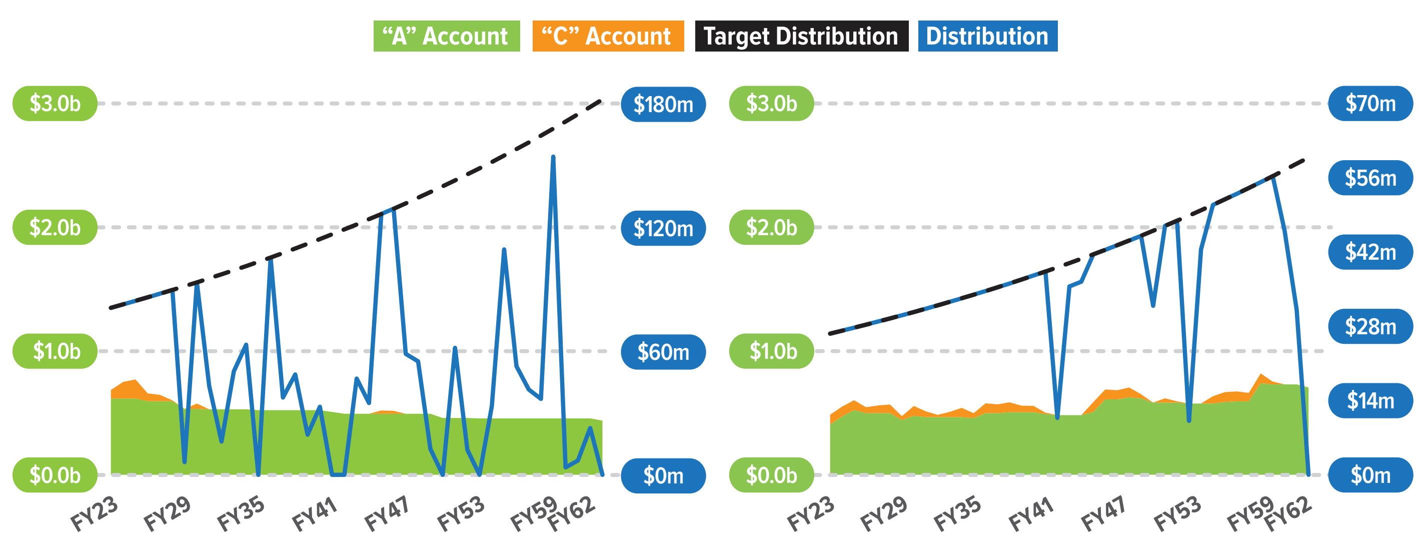
The figure below shows the devastating results that might occur if the prevailing COFA rules are followed based on the case of the FSM on the left and the RMI on the right where the projected value of the CTF at the end of FY23 is undeniably too small to sustain the real value of FY23 sector distributions 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. In fact, Monte Carlo projections find that the FSM would suffer one or more years of zero distributions in 89% of total cases.

### *Can "SAFER" or Other 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; 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.

**FSM and RMI CTFs under COFA Rules (Sim 9)**



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. While many rules-based distribution policies can improve upon the existing rules, optimization of any rules-based distribution policy can best be achieved through the introduction of an objective scoring mechanism. Such a scoring mechanism can then be used to compare alternative policies for any given level of each CTF.

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. GSUSA has 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%. In statistical terms, this is equivalent to a 95% confidence level while allowing for equal weighting of the three principles.

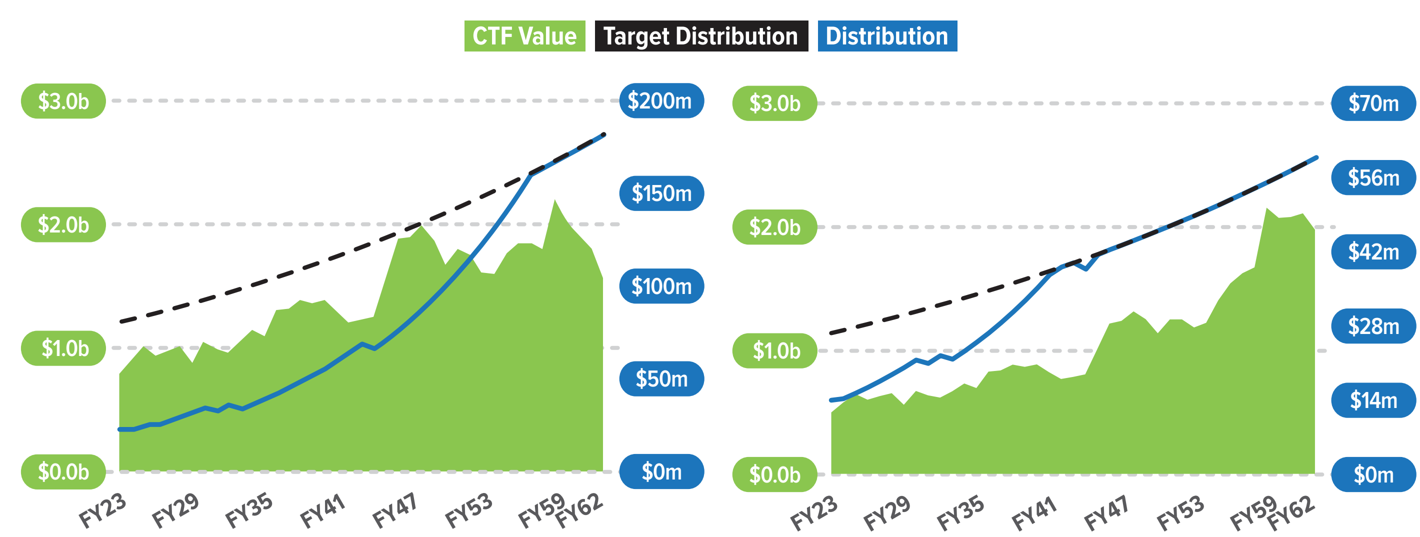
The accompanying rules are important. While more detailed than a simple "fixed-rate" rule, they address the unavoidable reality in the investment world of upside and downside risks. Very briefly, once the SAFER adjustment is made, annual distributions stay the same in real terms every year unless an 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, annual increases can be as much as 5% until the fund value falls below a defined guardrail. On the downside, annual decreases of 5% are called for until the fund value returns above a defined lower guardrail. The method is designed to keep volatility low.

The figure below shows the improved results that occur if the SAFER method is utilized. "Sim 9" is used again. 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 period—hence the fiscal adjustment we describe in the base and severe adjustment cases in Chapter 4. The results for the RMI are even more favorable using SAFER rather than COFA rules.

One important observation is that renewing the Compact economic assistance 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 a renewal with improved rules yields compounded benefits.

**FSM and RMI CTFs under SAFER Rules (Sim 9)**



ASIAN DEVELOPMENT BANK