Economic Impact of the Compact and Renewal for the Republic of the Marshall Islands

April, 2023

ADB

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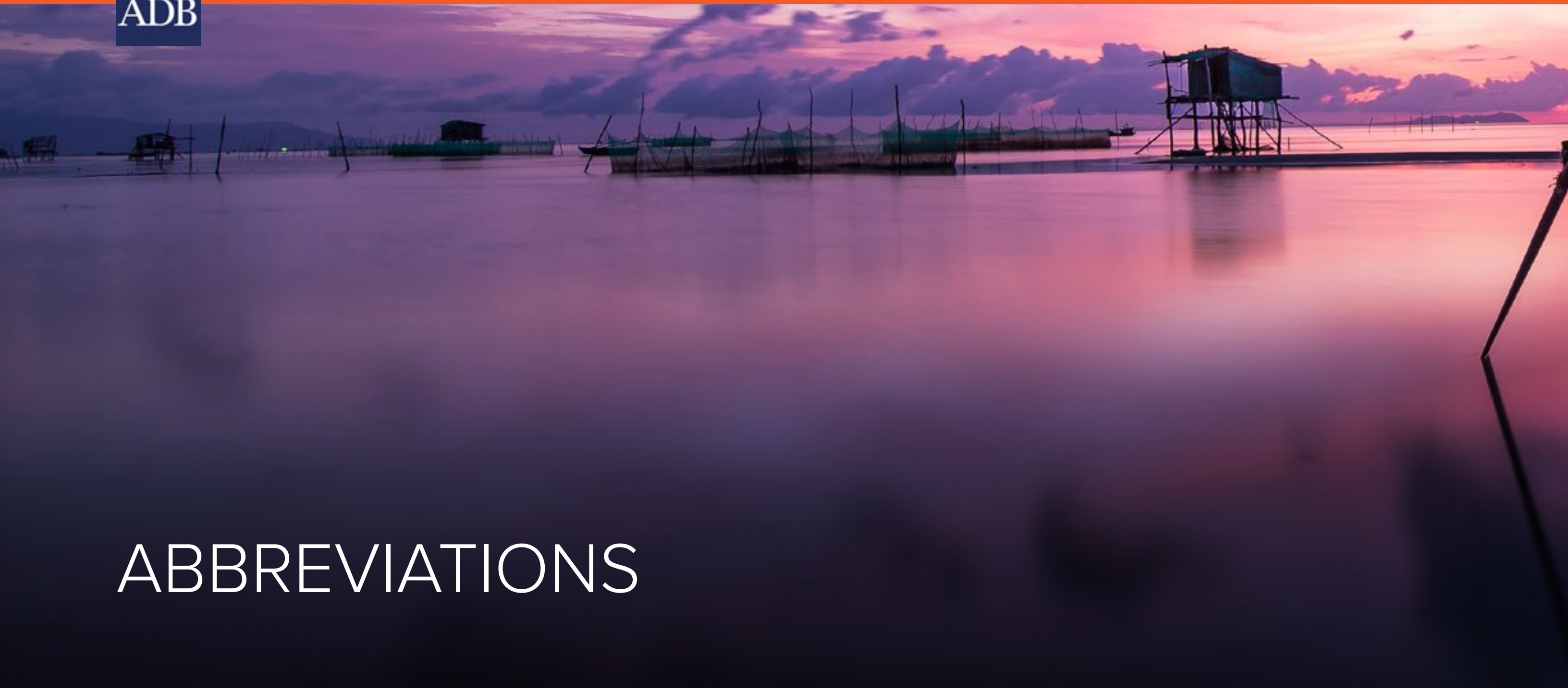


ABBREVIATIONS

ADB	—	Asian Development Bank
AMI	—	Air Marshall Islands
CARES	—	Coronavirus Aid, Relief, and Economic Security Act (US)
CDC	—	Centers for Disease Control and Prevention (US)
CMI	—	College of the Marshall Islands
CPI	—	Consumer Price Index
COFA	—	Compact of Free Association
COVID	—	Coronavirus Disease
CPRO	—	Coronavirus-19 Pandemic Response Option
CTF	—	Compact Trust Fund
DAEF	—	Disaster Assistance Emergency Fund
DOE	—	Department of Education (US)
DOI	—	Department of the Interior (US)
DRP	—	Disaster Resilience Program
DSA	—	Debt Sustainability Analysis
EconMAP	—	Economic Monitoring and Analysis Program (GSUSA)
FAS	—	Freely Associated States
FPA	—	Fiscal Procedures Agreement
FPUC	—	Federal Pandemic Unemployment Compensation (US)
FSM	—	Federated States of Micronesia
FTE	—	Full Time Equivalent
FY	—	Fiscal Year
GAO	—	Government Accountability Office (US)
GDP	—	Gross Domestic Product
GNP	—	Gross National Product
GRT	—	Gross Receipts Tax
GSUSA	—	Graduate School USA
IAG	—	Inter-Agency Group (US)
ICT	—	Information and Communications Technology
IMF	—	International Monetary Fund
JEMFAC	—	Joint Economic Management and Financial Accountability Committee
MUORA	—	Military Use and Operating Rights Agreement
NDC	—	National Disaster Committee
OIA	—	Office of Insular Affairs (DOI-US)
PACTAM	—	Pacific Technical Assistance Mechanism
PFM	—	Public Financial Management
PNA	—	Parties to the Nauru Agreement
PUA	—	Pandemic Unemployment Assistance (US)
RMI	—	Republic of the Marshall Islands
RMICTF	—	RMI Compact Trust Fund
SAFER	—	Sustainability Adjustment for Enhanced Reliability

SEG	—	Supplemental Education Grant (US)
SOE	—	State-Owned Enterprise
TA	—	Technical Assistance
UN	—	United Nations
UNDP	—	United Nations Development Program
US	—	United States
VDS	—	Vessel Day Scheme

NOTES:

RMI government fiscal year (FY) ends on September 30.

Currency unit: United States dollar (US$).

Figures may not add in this report due to rounding.

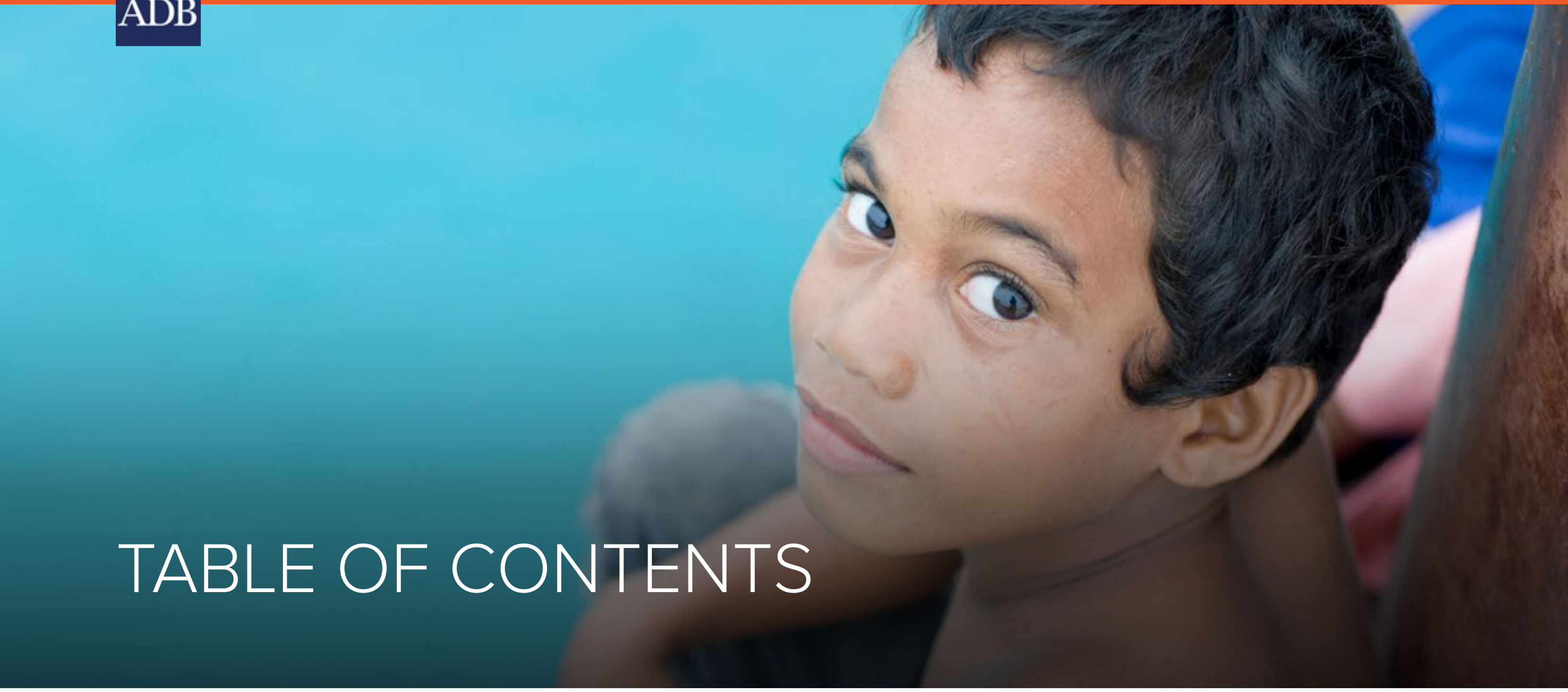


TABLE OF CONTENTS

LIST OF FIGURES AND TABLES

LIST OF FIGURES AND TABLES

ECONOMIC IMPACT OF THE COMPACT AND RENEWAL FOR THE REPUBLIC OF THE MARSHALL ISLANDS

Foreword

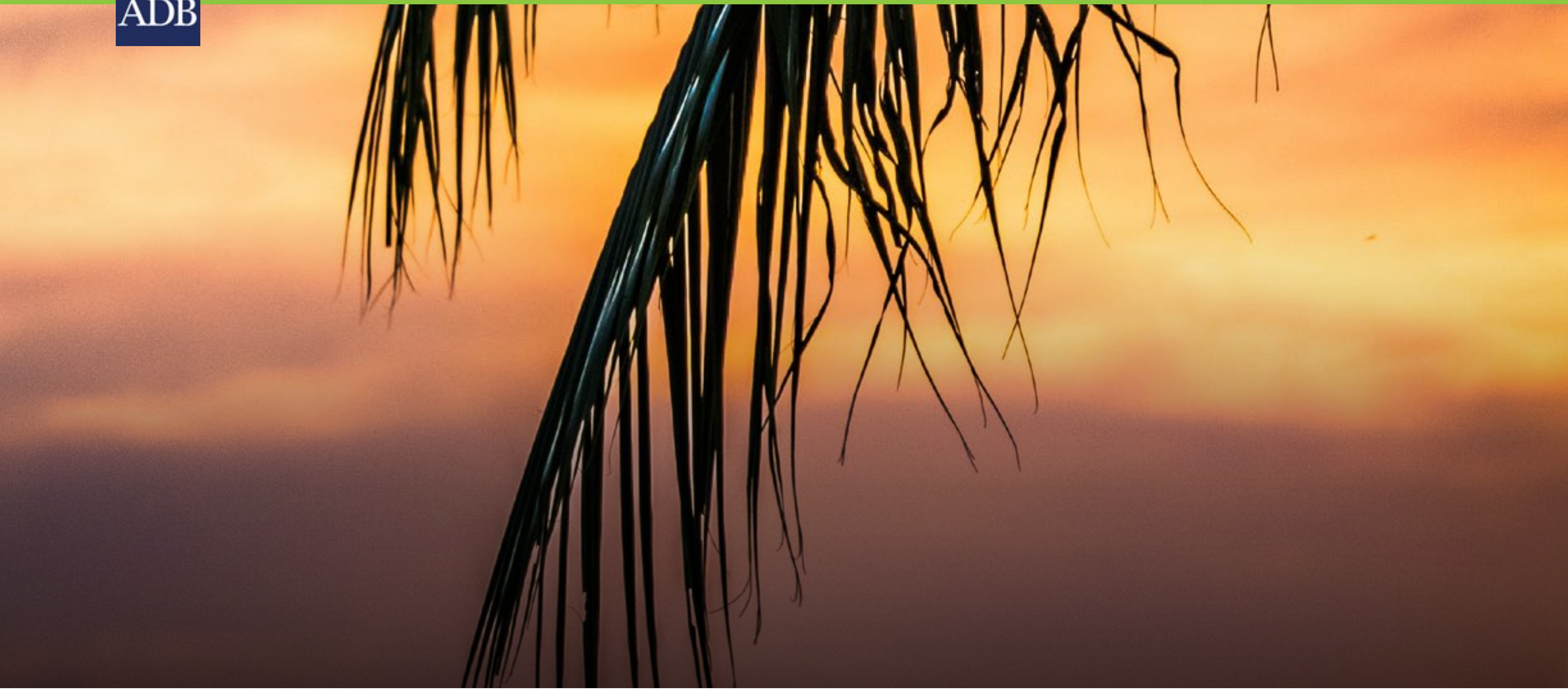
The Asian Development Bank (ADB) commissioned a study to benefit its three North Pacific member countries and their development partners. This study provides information and analysis about the Freely Associated States (FAS) as they approach an important milestone in their respective Compact relationships with the United States (US). At the time of conceiving this study, in late 2018, the range of possible outcomes at the end of each specified Compact funding period for the FAS was quite broad. Consequently, ADB believed that the affected parties and their development partners would benefit from a professional study that estimated the range of 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, before the US government officially announced its intention to negotiate an extension of Compact funding with each FAS, including the Republic of the Marshall Islands (RMI). The US shared an undisclosed offer of assistance with each FAS, including the RMI, in late 2020 as the end of the term of the prior US administration approached. In March 2022, the US named a Special Presidential Envoy for Compact Negotiations and reinitiated formal negotiations with the RMI. ADB decided to continue this study along the initially conceived lines: with downward adjustment and Compact funding renewal scenarios. The downward adjustment case is noted as nearly identical to the outcome that would result even from a delay in a fully funded period of renewal with the RMI. The renewal case, optimistically, provides the welcome challenge of ensuring that additional resources have the greatest sustained benefit to the RMI.

COVID-19 pandemic impacts demand a reassessment of the economic outlook for each FAS. Since the draft findings of the original three-country study were shared with all affected parties in January 2020, the world suffered from the Coronavirus Disease (COVID)-19 pandemic, with varying degrees of impact on each FAS. This RMI country-focused study serves two purposes: (i) it includes more RMI-specific detail; and (ii) it updates all the underlying model assumptions to incorporate the estimated impacts of the COVID-19 pandemic on the RMI. This report is based on economic data available as of October 2022.

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

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



ADB looks forward to a dialogue on this country-focused report in the RMI and welcomes feedback from all parties.

EXECUTIVE SUMMARY

RMI Compact Structural Features, Trends, and Preparedness

Compact structural features. The Compact between the US and the RMI delivered sovereignty and self-governance, included economic development assistance, and provided the right of RMI citizens to move to the US. After two periods of US economic assistance, the RMI and the US are now conducting negotiations for a third round. The RMI Compact entered into force in 1986 with the initial economic assistance provided for fiscal year (FY) 1987 through FY03. 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 and RMI negotiated an amended Compact agreement. The amended Compact provided for economic assistance for FY04-FY23 and included several changes: a Compact Trust Fund (CTF) was established for the RMI, with US annual contributions rising over the 20-year period; and a US-RMI committee was 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 FY05-FY23 that cashed out several existing US federal programs. Under the terms of the RMI amended Compact, annual grants terminate at the end of FY23; thereafter, the RMI receives annual distributions from the trust fund. In addition, the SEG ends at the end of FY23.

Compact period trends. The RMI experienced economic growth and reduced reliance on Compact transfers as they fell over time. RMI achieved moderate but positive real economic growth from FY87 to FY18 that is expected to continue through FY23. This growth occurred while the RMI received declining real transfers through the Compact. The reliance of the RMI on Compact transfers declined from very high levels during the initial Compact period to a projected level of 16 percent of gross domestic product (GDP) in FY23. Over time, under the terms of the Compact, citizens of the RMI have migrated to the US, increasing their cumulative number.

Preparedness. The RMI designated a Chief Negotiator to represent them as they engaged with the US regarding further assistance. The US has a standing mechanism to monitor and implement its policies toward the RMI—an Inter-Agency Group (IAG) led by the White House National Security Council. The IAG has scaled up FAS engagement due to US desire 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. Negotiations are well underway with an expressed desire to reach mutual agreement with the RMI as early as possible.

Multilateral donor support. The RMI has benefited from recent large increases in grant funding commitments from the World Bank, with current program plans indicating $30 million in annual support for infrastructure, sector programs, and projects. The ADB, which has provided long-standing support to the RMI, currently provides grant-only funding. Current program plans indicate ADB's 2023-2024 support for RMI infrastructure, sector programs, and projects is $92 million.

RMI Economic and Fiscal Structure and Performance

Economic structure and performance. The private sector represented an average of 33 percent of GDP during the FY18-FY20 period and falls between the RMI's two sister FAS, the Federated States of Micronesia (FSM), with 22 percent of GDP, and Palau, with 52 percent of GDP. The RMI's government sector represents 30 percent of GDP, compared with 25 percent in Palau and 25 percent in the FSM. As an indirect measure of development of the modern economy, production of the household sector in both informal and non-market or subsistence production in the RMI averaged 13 percent, compared with 24 percent in the FSM and 9 percent in Palau.

The RMI's economic performance from FY04 to FY19 and just prior to the onset of COVID-19 has been modest, with real economic growth averaging 1.4 percent annually. This rate compares favorably with the FSM which averaged 0.3 percent and Palau which averaged 0.5 percent. The RMI's average growth during the period reflects high fluctuation between periods of strong growth in fisheries, construction, and services versus periods of substantial contraction. Fisheries have dominated growth during the amended Compact period.

Fiscal structure and performance. RMI tax effort is low and has fallen from 29 percent of total revenues at the start of the amended Compact in FY04-FY06 to 22 percent in FY17-FY19. The tax regime is based on an outmoded regime inherited from Trust Territory days that lacks buoyancy—or growth in relation to economic activity. The most important source of revenue, grants, has also fallen as a share from 65 percent at the start of the amended Compact to 48 percent. Grants are either fixed in nominal terms or in decline, reflecting the lack of a full inflation adjustment. The major growing source of revenues in the last few years is represented by sovereign rents. These include fishing fees derived from the Parties to the Nauru Agreement (PNA), implementation of the Vessel Day Scheme (VDS), and revenue-sharing from the ship registry.

Payroll is the largest category of government expenditures but has fallen dramatically from 42 percent in FY04-FY06 to an average of 34 percent during FY17-FY19. Meanwhile, subsidies to state-owned enterprises (SOEs), grants to other layers of government, transfers, and "other" expenditures have grown the most rapidly in recent years, from 20 percent at the start of the amended Compact to 31 percent. But expenses for complementary inputs in the use of goods and services has grown only modestly,

Fiscal policy in the RMI has been driven by revenue availability and stage of the economic cycle. During the initial period through FY14, budget discretion was severely limited, and expenses were constrained. Thereafter, with the boom in revenues from sovereign rents, expenses grew in tandem with available revenue within each fiscal year's fiscal envelope.

The Impact of COVID-19 on the RMI Economy and Outlook

Mitigation programs. In early 2020, in response to the COVID-19 pandemic, the government of the RMI prepared a COVID-19 Preparedness and Response Plan with an estimated financing need of $42.3 million. Subsequently extended several times, current information indicates the plan has a total available funding level of $70.6 million. The major benefactor to the Plan has been the US government with $34.8 million of Coronavirus Aid, Relief, and Economic Security Act (CARES) unemployment benefits and health-related funding disbursed through Centers for Disease Control (CDC), OIA and various other Federal Programs. The ADB was the second-largest donor and contributed $23.7 million largely through budgetary support. Additional health-related funding was available from the World Bank, the European Union, and Taipei,China. The RMI allocated $2.8 million of its own funds.

Economic impact. The economy is estimated to have declined by 1.8 percent in FY20, grown by 1.1 percent in FY21, and to have fallen by a further 1.5 percent in FY22, bringing the total impact of COVID-19 to a 2.2 percent decline over the three years. The overall impact of COVID-19 on the economy has been far less than the 5.5 percent decline originally anticipated. However, the impact on the non-fisheries private sector was significant, contracting by 7.8 percent. The public sector played a significant supporting role and grew by 2.5 percent, mitigating the impact of the contraction in the non-fisheries private sector.

A net loss of 127 jobs or a 1.1 percent decline in the total RMI workforce has been estimated for the FY19-FY22 period. However, the distribution of the reduction has been uneven. The commercial fisheries sector lost 281 jobs, primarily at the loining plant. The non-fisheries private sector recorded a loss of 180 jobs, impacting primarily construction, wholesaling and retailing, and the hotel sector. The recent trend of a growing public sector helped to offset this decline by creating 282 jobs.

Fiscal impact. Revenues grew strongly in FY20 with the onset of COVID-19, stabilized in FY21 and are projected to return to normal levels in FY22. While tax revenues performed well despite the contraction in the private sector, the onset of COVID-19 was associated with a massive increase in grants. Reflecting the increase in grants, government expenditures grew strongly in FY20 and FY21 but are expected to fall in FY22 as available funds are drawn down. The RMI ran fiscal surpluses in FY20 and FY21 with the increase in grants and lagged expenditures. This position reversed in FY22 as revenues fell but expenditures were maintained, incurring a deficit.

Modeling the Impact of Non-Renewal of Compact Assistance

Non-renewal scenario. Modeling a scenario with non-renewal of Compact assistance is built on several key assumptions. The RMI moves to the regime outlined in their Compact that has two key features. First, the RMI would transition from sector grants funded by US appropriations to annual distributions from the CTF. Second, SEG funding would cease. In the modeling, the initial level of annual distributions from the CTF is set at a sustainable level (with a high degree of confidence) and subsequent distributions are adjusted for inflation.

The projected level of the CTF in FY23 is estimated to provide a sustainable draw of $21.9 million in FY24, which requires a substantial adjustment. That adjustment would result in a cut in government operations funding equivalent in size to 2.1 percent of GDP, or $6.3 million below the FY23 level. The loss of SEG entails a further reduction in funding, equal in size to 1.9 percent of GDP, bringing the total cut in funding equivalent in size to 4.0 percent of GDP or $11.9 million. Under the non-renewal scenario, the RMI economy is projected to contract by 1.9 percent in FY24. Most of the adjustment will be felt in the public sector, which contracts by 7.3 percent, while the private sector grows by 0.6 percent due to an anticipated full recovery from COVID-19. The resultant loss of 650 jobs is projected to induce almost 3,200 additional migrants to the US.

Independence Illustration. In addition to the adjustment to a sustainable level of CTF distributions and the loss of SEG outlined in the non-renewal scenario, the independence illustration models what the RMI would face if all US federal programs and services ceased, both Compact and non-Compact. This illustration is presented not as a likely outcome, as the relationship between the US and the RMI remains strong, but rather to illustrate the ongoing value of the US relationship to the RMI.

Under the modeled assumptions, the potential *additional* reduction in US funding (nearly all of the listed programs and services) totals $19.2 million annually, which is equivalent in size to 6.4 percent of projected GDP in FY23. Taken in addition to the non-renewal scenario reduction of $11.9 million, the total reduction in transfers would be $31.1 million annually, or equivalent in size to 10.4 percent of projected GDP in FY23. Once that funding is withdrawn from the economy, GDP is estimated to fall by 9.4 percent. The resultant job losses are projected to induce more than 7,700 new migrants to the US, or 18 percent of the RMI population. These results illustrate the dependence of the economy on the Compact and other US grants and the impact of sustainable withdrawals from the RMICTF.

Adjusting to Potential Compact Economic Assistance Renewal

Compact renewal scenario. For the 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). Compared to the non-renewal scenario, the impact on GDP in FY24 is favorable, being projected to increase by 1.6 percent compared with a reduction of 1.9 percent under non-renewal, implying a difference of 3.5 percent. Looking forward, over the period FY25 to FY30, under both the non-renewal and renewal scenarios, economic growth is close to 1.3 percent, a similar economic performance to the 1.4 percent growth during the amended Compact period, FY04-FY19. The impact on employment in FY24 is considerably improved: nearly 240 jobs are created under Compact renewal compared with a loss of close to 650 under non-renewal. The impact on migration is reduced out-migration, with close to 240 people incentivized to remain in FY24.

Better results. While Compact renewal is an improvement on the non-renewal adjustment scenario, the gains are not large and projected performance in the renewal period is modest. 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. With continuing allocations to the CTF during the FY24-FY43 period, the CTF is projected to maintain a very high degree of sustainability through the end of FY64.

This study also models the potential benefit to the RMI of a calibrated CTF distribution for development assistance. This estimated $13 million average annual distribution would support special projects and be sufficient to add 0.5 percent to GDP in FY24, rising to 3.5 percent by FY30. For employment, jobs created rise by over 700 by FY30. In terms of outmigration, the creation of jobs is sufficient to induce a significant reduction of close to 320 people below the trend rate in FY24.

The actual value of this annual distribution stream would be continually calibrated—meaning distributions would be adjusted annually—to ensure CTF sustainability was maintained. The $13 million level of average annual distribution is calculated to be consistent with CTF sustainability, under a prior August 2022 projection of the end of FY23 CFT balance.

To gain maximum benefit, these supplemental distributions could be allocated in a manner that supports RMI priorities and leverages the objectives of RMI's multi-lateral and bi-lateral donor partners, including the US. The objective would 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.

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

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

This chapter describes the structure and timing of the initial and subsequent Compact economic assistance periods for the RMI, 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. For the RMI, like the Federated States of Microneisa (FSM) and the Republic of Palau (Palau), 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, it only came into effect 8 years after the FSM and RMI Compacts.

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

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 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 (UN) 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 September 2022, the RMI had diplomatic relations with 108 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.

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 Compact, Congress authorized and appropriated funds to cover Compact commitments for the full period. Therefore, Compact funds were not subject to annual appropriations processes.

During this initial period, the majority of funding was provided under section 211 as unrestricted budget support. Of this total, 60 percent was allotted to current operations, while 40 percent 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.

Annual transfers totaling $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 maritime 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.

An additional $1.9 million, not adjusted for inflation, was provided annually for Kwajalein Atoll, acknowledging US military facilities at the atoll.

The supplemental years under the initial Compact—FY02 and FY03—were funded at the average level that prevailed during the initial 15 years. However, the RMI contributed most of the incremental increase in funding for those two years--$25 million—to the RMI Compact Trust Fund (RMICTF) created under the amended Compact.

Most of the specified annual transfers 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 Gross National Product (GNP) implicit price deflator, with a capped maximum annual adjustment of 7 percent. (The 7 percent cap never limited the annual adjustments.) An initial adjustment of 22 percent 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 cumulative annual adjustments applied to the affected base grants was 58 percent.

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

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

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:

a. The parties agreed to the creation of a Compact Trust Fund (RMICTF) that would accumulate during the amended Compact period. After that period, the fund would replace terminating sector grants. While explicitly not guaranteeing the level the RMICTF or its distributions would reach, the intent was to provide a smooth transition and a perpetual RMI support fund to end 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 its $25 million nine months late, on 1 June 2004, and made three subsequent deposits that totaled $5 million 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 percent of the projected value of the RMICTF at that time.

b. The US insisted on significant changes to the accountability provisions attached to transfers

Figure 1: 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

- 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

- 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.

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.

c. 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 percent and not more than 50 percent of sector grants to public infrastructure. In practice, the 30 percent minimum allocation has prevailed.

d. The RMI agreed to a “cash-out” provision for 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 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 education programs for FY04), with the authorization partially adjusted for inflation for FY05-FY23. The amount was provided as an authorization for the US Department of Education (DOE) to request annual budget allocations and inflation adjustments in the 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 was projected to be $5.6 million. However, the recent FY23 Congressional appropriation provided $6.552 million for FY23.

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.

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

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

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 $27.7 million in FY23 (after accounting for an annual increase of $2 million dedicated to Kwajalein needs that started in FY14).

   After sector grants are adjusted annually by two-thirds of the change in the US GDP deflator (now capped at 5 percent), 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 addition to grant funds, the amended Compact provided annual payments to the RMI to secure defense sites in the Kwajalein Atoll. These annual 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 contributions (adjusted partially for inflation) are expected to reach $260,000 from each contributor in FY23.

v. **The RMI 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 RMICTF 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 RMICFT is projected at $21.4 million.

Under terms of the amended Compact, all five funding streams are scheduled to terminate at the end of FY23, except the approximately 25 percent of the sector grant stream ($9.1 million) that is dedicated to Kwajalein and carries on under terms specified in the 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 RMICTF 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 Trends

Figure 2 provides four charts covering RMI Compact trends for the full timeline from FY87-FY23.

- The first chart shows the transfers the US made available to the RMI 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 projected to continue through the FY19 to FY23 period. This real growth was achieved while the RMI received declining real transfers through the Compact.
- The third chart shows the combined impact of the declining level of transfers and the growing economy. Specifically, the RMI's reliance on Compact transfers has declined from very high levels during the initial Compact period to a projected level that is equivalent in size to 16 percent of GDP in FY23, which marks the end of the amended Compact period.
- The fourth chart shows the gradual—but mounting—effect of cumulative migration from the RMI to the US.[1]

Preparedness for the End of Compact Funding

RMI

The RMI has named a Chief Negotiator, the current Minister of Foreign Affairs, and a negotiating committee staffed by the Ministry of Foreign Affairs and select government officials. They have established three committees to focus on: (i) economic matters, (ii) Kwajalein and MUORA matters, and (iii) nuclear legacy and changed circumstances matters.

In preparation for the possible fiscal outcomes in the post-FY23 period, the executive branch has initial drafts of a fiscal responsibility framework and a medium-term fiscal strategy that would serve the government in the event of forced fiscal adjustments. However, they would not be sufficient to effectively manage a shock of the magnitude of the non-renewal scenario.

USA

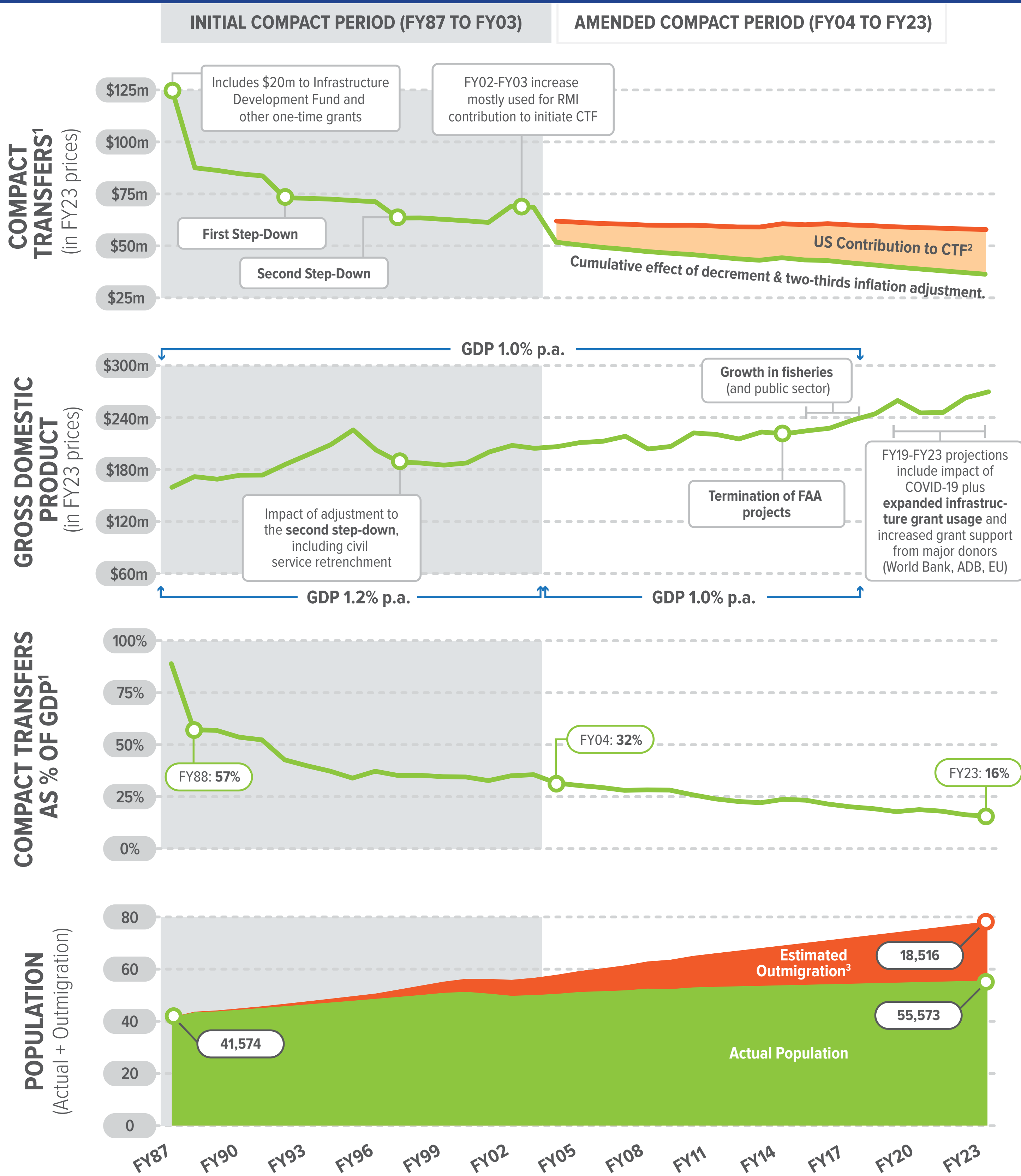
The US has a standing mechanism to monitor and implement its policies toward the three FAS—an Inter-Agency Group (IAG) that is led by the White House (National Security Council) and has both a small group with key agencies and a broader group meant to encompass all agencies with programs or interests in the FAS. The IAG holds meetings on an as-needed basis.

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 desire 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 in name or effect with key regional allies, including Japan, Australia, and New Zealand. This policy concern clearly raises the visibility and importance of the US relationships with the RMI, the FSM, and Palau as well as the combined land and ocean space controlled through the three Compacts of Free Association.

The timing factor which has led to the increased frequency and urgency of IAG meetings is the one built into the respective three Compacts of Free Association.

1 Preliminary RMI Census data suggests that the resident population is less than that shown in this graphic. This also suggests that migration has been greater.

Figure 2: RMI Compact Timeline



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

The inflection point for a change in funding arrangements happens after FY23 for the RMI and FSM and after FY24 for Palau. 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. 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. Negotiations are well under way with an expressed desire to reach mutual agreement with the RMI as early as possible. Once agreement with the RMI is reached, two additional steps remain: (i) approval by the US Congress, and (ii) approval in the RMI of the agreed renewal arrangement.

Major Multilateral Donors

The RMI has 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 RMI after FY23 contributed substantially to the debt stress finding. Current World Bank program plans indicate $30 million in annual support for the RMI infrastructure, sector programs, and projects. It is understood that the World Bank has been considering initiation of a limited program of budgetary support in the RMI.

ADB has provided long-standing support to the RMI. ADB follows the DSA finding and thus currently provides grant-only funding to the RMI. Current program plans indicate ADB's support for RMI infrastructure, sector programs, and other projects is $93.5 million for 2023-2024, including $22.5 million to support regional cooperation and integration, disaster risk reduction and climate adaptation, and gender. COVID-19 related support to the RMI has included $32.6 million in grants.

Since 1996, ADB has supported development partner meetings in the RMI. Periodically, ADB supported each country with technical support through resident advisory teams. A direct correlation exists 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 those commitments is also associated with extended technical support that substantially invests in local hires and advanced training.

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

Major Bilateral Donors

Japan has been a major bilateral donor to the RMI. Infrastructure projects remain the largest share of support, but Japan also provides support for sector projects, equipment purchases, and scholarships. Indirectly, Japan funds United Nations Development Program (UNDP) for support to the FAS in disaster preparation and through Australia to support operating costs under the maritime patrol boat program. The Government of Japan has initiated its own "Free and Open Indo-Pacific Strategy." While its aid levels to the Pacific will increase, modalities will remain similar. There is no direct mechanism for Japan to provide budgetary support in the event of a major fiscal adjustment, and embassy officials in two of the three FAS embassies indicated they have received no requests related to the potential FY23/FY24 Compact adjustments. Officials indicated they are tracking the matter closely with each FAS and through dialogue with their US embassy counterparts.

Taipei,China is an important development partner for the RMI. Programs between the two were recently renewed (after 20 years) to maintain a similar level of annual funding. Support to the RMI is in two forms: (i) general budgetary support and (ii) finance for development projects. Taipei,China has also committed $40 million to the RMI CTF. Taiwanese embassy officials indicated they have received no requests related to the potential FY23 adjustment.

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 Pacific Technical Assistance Mechanism (PACTAM) advisors for capacity-building. All three FAS also benefit from Australia's Maritime Patrol program, which in 2019 Australia renewed 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 Australian officials indicated they have received no requests related to the potential FY23/FY24 adjustment. However, the opening of an Australian Embassy in the Marshall Islands in May 2021 may indicate that the direct aid budget might be enhanced accordingly.

2

RMI ECONOMIC AND FISCAL STRUCTURE AND PERFORMANCE

2 RMI ECONOMIC AND FISCAL STRUCTURE AND PERFORMANCE

In order to analyze the impact of COVID-19 and the Compact scenarios discussed in this report, we first review the structure and performance of the RMI economy. This analysis[1] provides background as to the likely response of the economy to the different scenarios outlined in this report.

Economic Structure

The RMI private sector is small as a share of GDP but has grown significantly. Figure 3 indicates the structure of the RMI economy by institutional sector and the composition of the private sector by industry. The RMI private sector represented an average of 33 percent of GDP during the FY18-FY20 period and falls between the RMI's two sister FAS, the FSM with 22 percent of GDP and Palau with 52 percent of GDP. The RMI's government sector represents 30 percent of GDP, compared with 25 percent in Palau and 25 percent 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 percent of GDP, compared with 24 percent in the FSM and 9 percent in Palau. The RMI has greater integration into the cash economy than the FSM and is more reliant on the public sector as its major engine of growth than Palau.

1 See GSUSA, *RMI FY22 Economic Brief* (posted Nov. 3, 2022) and RMI FY18 Economic Review (posted Nov. 9, 2019) for an in-depth analysis of economic structure and performance. ***https://pubs.pitiviti.org/rmi-fy22-economic-brief; https://pubs.pitiviti.org/rmi-fy18-economic-review***

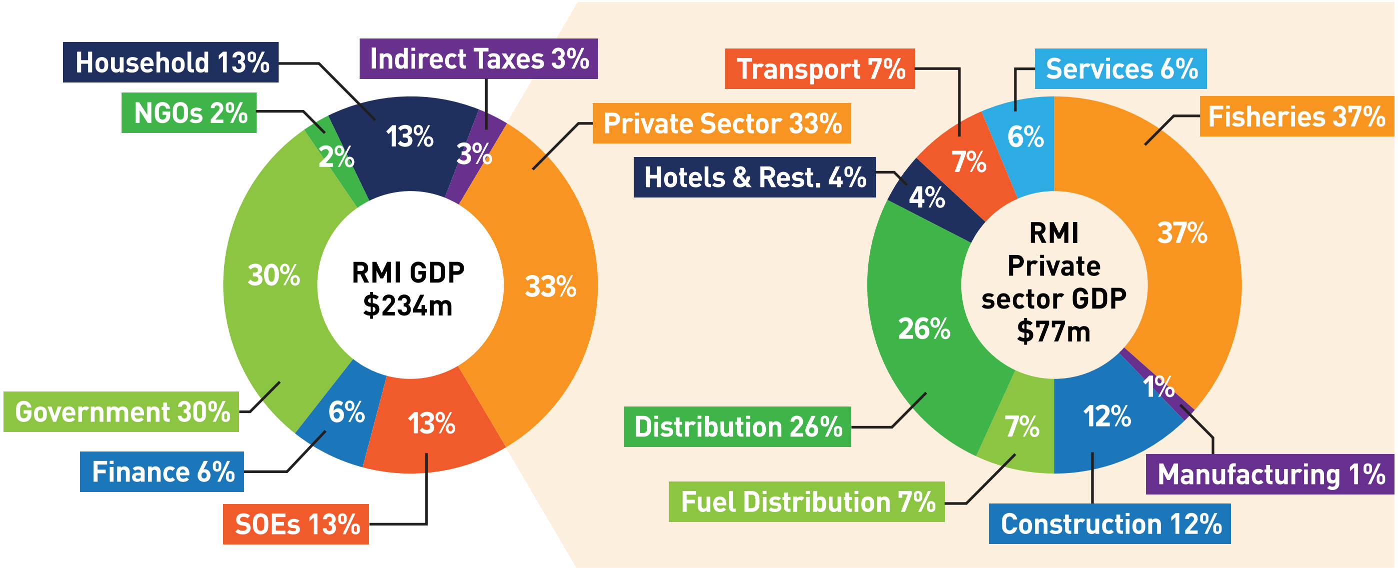
The fisheries export sector is the largest component of the private sector, with other industries providing services to the domestic economy. Figure 3 disaggregates the structure of the private sector by industry. The largest industry is fishing, which is comprised of offshore purse seine fishing, fish loining, and near shore reef fishing. Overall, fishing represents 37 percent of private sector activity. Construction is also a significant driver of economic activity, representing 12 percent of the private sector. The transport, hotels and restaurant sectors are relatively small, together representing 11 percent and providing services to a small number of visitors and tourists–in addition to onshore services to fishing fleets. Retail and wholesaling activity (distribution) is larger, representing 26 percent of private sector activity and is dependent on the overall level of demand in the economy.

Economic Performance

Economic growth in the RMI has been modest during the amended Compact period, averaging 1.4 percent annually, with high volatility. The RMI's economic performance from FY04 to FY19 and just prior to the onset of COVID-19 has been modest, with real economic growth averaging 1.4[2] percent during the period, see Figure 4. This rate compares favorably with the RMI's sister FAS; the FSM averaged 0.3 percent growth, with Palau at 0.5 percent. The RMI's average growth during the period reflects high fluctuation between periods of strong growth in fisheries, construction, and services

2 Log linear growth estimate.

Figure 3: Economic Structure: Economy Wide and Private Sector, FY18-FY20 Average
Private sector is small in the RMI, with fisheries as the largest segment



versus periods of substantial contraction. Fisheries have dominated growth during the amended Compact period, see Figure 5. Public administration, education, and health have all been forces of growth, supported by disbursement of Compact sector grants in education and health and sovereign rents.

During FY15-FY19, economic growth picked up to an average of 4.7 percent before COVID-19 struck. During the first half of the amended Compact, through FY14, economic growth was weak, averaging 0.7 percent per year. However, during FY15-FY19 the economy grew more rapidly, with an average rate of growth of 4.7 percent. This change 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

Figure 4: GDP Growth and Level, FY15 Prices
Economic growth has been volatile and was displaying signs of sustained growth before COVID-19

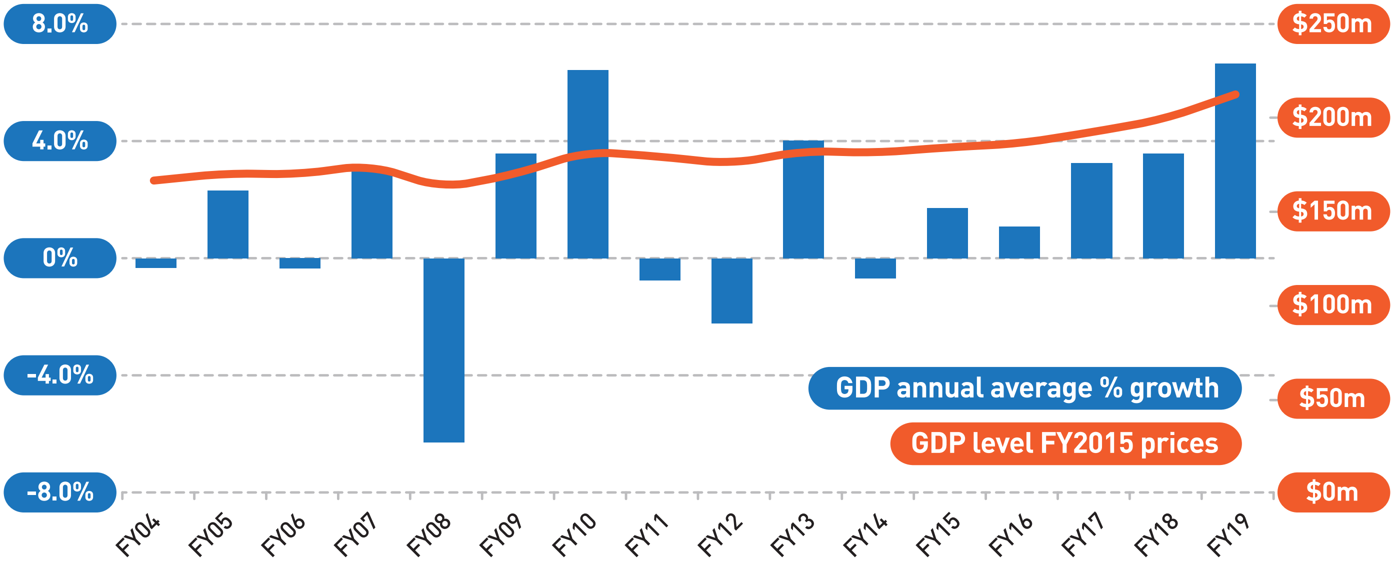
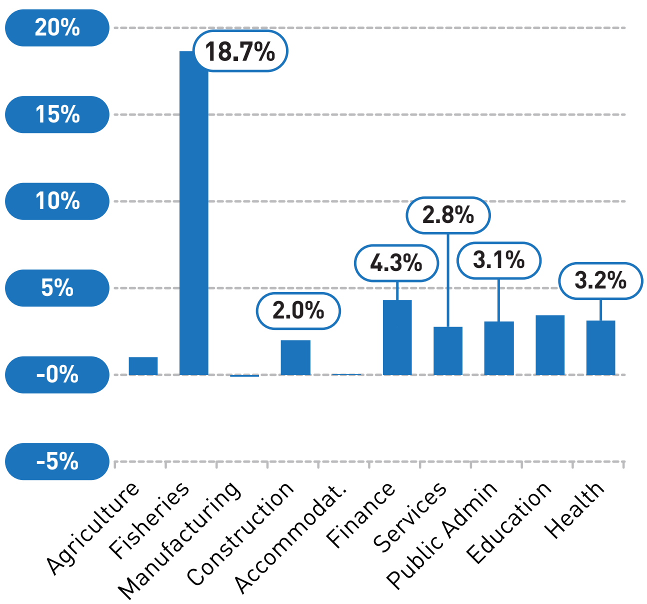


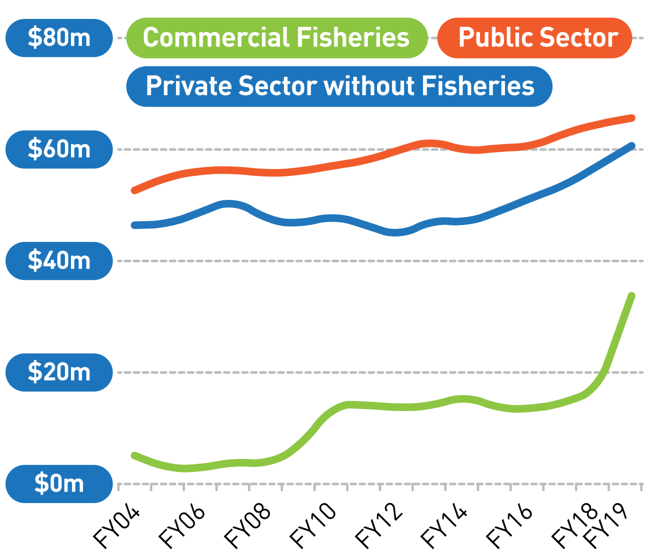
Figure 5: Contribution to GDP Growth by Industry, FY03-FY19, FY15 Prices
RMI economy grows by 33 percent, with fisheries as the main contributor



from the shipping registry), which increased the fiscal envelope and allowed growth in public expenditures.

While the public sector has grown steadily, private sector performance has been dominated by fisheries and the stage of the economic cycle. Figure 6 indicates the growth in the private and government sectors but bifurcates the private sector between commercial fisheries and the private sector excluding fisheries. The growth trend in the commercial fisheries sector reflects that of Pan Pacific fishing and loining operations. These activities went through two periods of rapid growth: (i) the re-opening of the loining plant and commencement of purse seine fishing with 3 vessels in FY09 and (ii) an extension of the fleet to 6 vessels in FY19. The provision of government services grew steadily with little variation, averaging 1.2 percent per year. The private sector also averaged 1.2 percent overall, but in a series of phases reflecting the stage of the economic cycle: (i) a construction-driven spurt at the beginning of the amended Compact, (ii) a subsequent period of stagnation and decline that reflected a weak fiscal position and the global financial crisis, and (iii) a period of more active growth since FY12 when growth averaged 4.2 percent, reflecting strong performance in fisheries and, to a lesser degree, buoyant government revenues.

Figure 6: Public and Private Sector GDP Levels, FY15 Prices
Public sector value added grows consistently, with significant volatility in the private sector



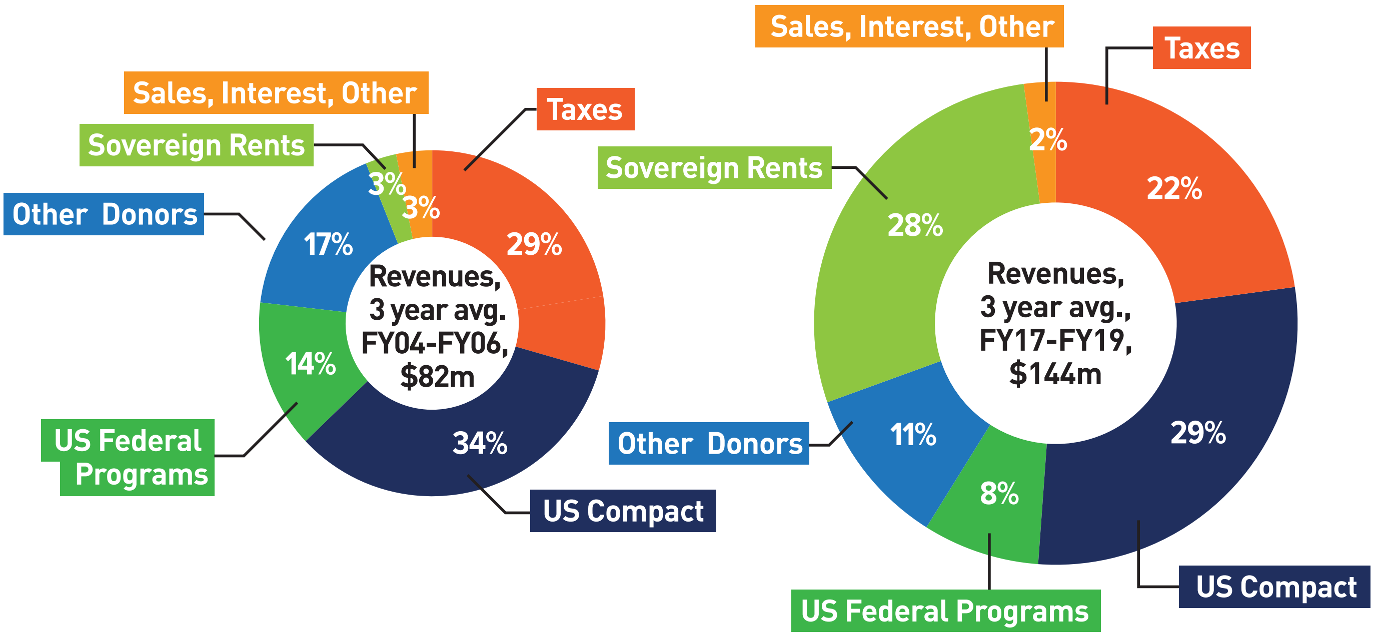
Fiscal Structure

External grants represent the major element of government revenues while tax effort is low, reflecting an outmoded regime. Figure 7 indicates the structure of revenues by type, at the start 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 percent of total revenues to only 22 percent currently. The tax regime is outmoded, inherited from the Trust Territory, and requires reform. It lacks buoyancy—or growth in relation to economic activity. The RMI's most important source of revenue is grants, which have also fallen as a share from 65 percent at the start of the amended Compact to 48 percent. Some Compact grants are fixed in nominal terms, while other grants lack full indexation of Compact grants and decline due to the decrement. The RMI economy remains highly dependent on foreign assistance from its donor partners: U.S. Compact grants and federal programs, and 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 growth. In the last few years, the major, rapidly growing source of revenue has been sovereign rents. These include fishing fees derived from the Parties to the Nauru Agreement (PNA), implementation of the Vessel Day Scheme (VDS), and revenue from the RMI ship registry. Once representing a mere 3 percent of revenues, these rents have grown to represent 28 percent of revenue. Other government fees, sales, and investment earnings are minor, accounting for only 2 percent.

Figure 7: Government Revenue by Source, FY04-FY06 & FY17-FY19

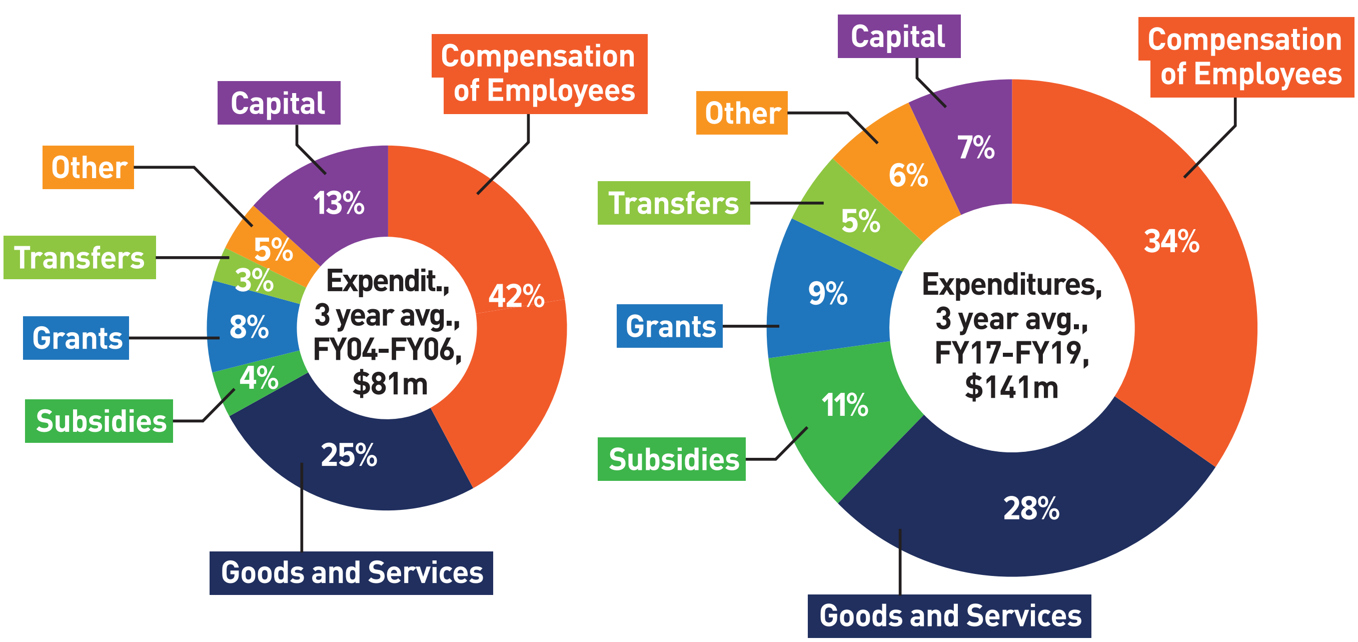
Grants dominate revenues, but with a growing contribution from sovereign rents



Payroll has declined significantly as a proportion of government expenditures, with subsidies and transfers forming the largest area of growth. The structure of RMI government expenditures by economic category is shown in Figure 8. Payroll expense, the largest category, has fallen dramatically, from 42 percent in FY04-FY06 to an average of 34 percent of total expenditures during FY17-FY19. Payroll as a share of GDP has also fallen from 25 percent to 22 percent, indicating that payroll has not been the major source of fiscal expansion that is sometimes believed. Complementary inputs in the use of goods and services have grown as a share of expenditures and significantly in relation to GDP, reflecting the

Figure 8: Government Expenditures by Category, FY04-FY06 & FY17-FY19

Payroll and use of goods and services are largest components of expenses



growing fiscal envelope. Interest payments are almost negligible and reflect declining external debt at concessionary rates and a switch to "grant only" status by donor institutions. Other areas of expenditures include: subsidies to SOEs, grants to other layers of government, transfers, and "other" expenditures, which has grown from 20 percent at the start of the amended Compact to currently represent 31 percent of revenue. This group of expenditures has grown the most rapidly in recent years, reflecting significant expansion of the fiscal envelope and represents significant fiscal risk. Finally, capital expenditures on fixed assets have fallen 13 percent to 7 percent, a disappointing result that indicates the need for greater investment in infrastructure.

The greatest change in government expenditures is the provision of economic services and subsidies to SOEs and to outer atolls. Figure 9 displays the allocation of government expenditures by function.

The main area of increase in service delivery has been economic affairs, which has grown from 9 percent to 17 percent due to 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 correspondingly weak SOE management.

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, indicate a small increase in share, reflecting the importance of improving health outcomes in the RMI under the Compact and by the government.

Fiscal Perfomance

Revenues fell as a share of the economy in the first ten years of the amended Compact but then grew rapidly with the growth in sovereign rents. Figure 10 indicates recent trends in fiscal performance: current revenues and expenses, together with capital grants and fixed assets, as a share of the economy. During the first ten years of the amended Compact, government revenues declined as a percent of GDP, reflecting the inelastic and outmoded tax regime and static nature of Compact grants in nominal terms. The FY14-FY19 period reflected growth in a new form of revenue—fishing royalties arising out of the VDS from the PNA—resulting in a 10 percent increase in the share of overall revenues to GDP.

Payroll has declined as a share of GDP, but expenses on subsidies and transfers have doubled. Current expenses are largely reactive with respect to current revenues. The decline in the revenues-to-GDP ratio during the initial 10 years led to a tight fiscal position, constraining expenses. However, as the revenue base expanded with the increase in fishing fees, expenses also expanded in tandem. Within current expenses, discipline has been maintained over payroll, which declined in relation to GDP, falling from an average of

Figure 9: Government Expenditures by Function, FY04-FY06 & FY17-FY19

Public administration, education and health dominate government expenditures

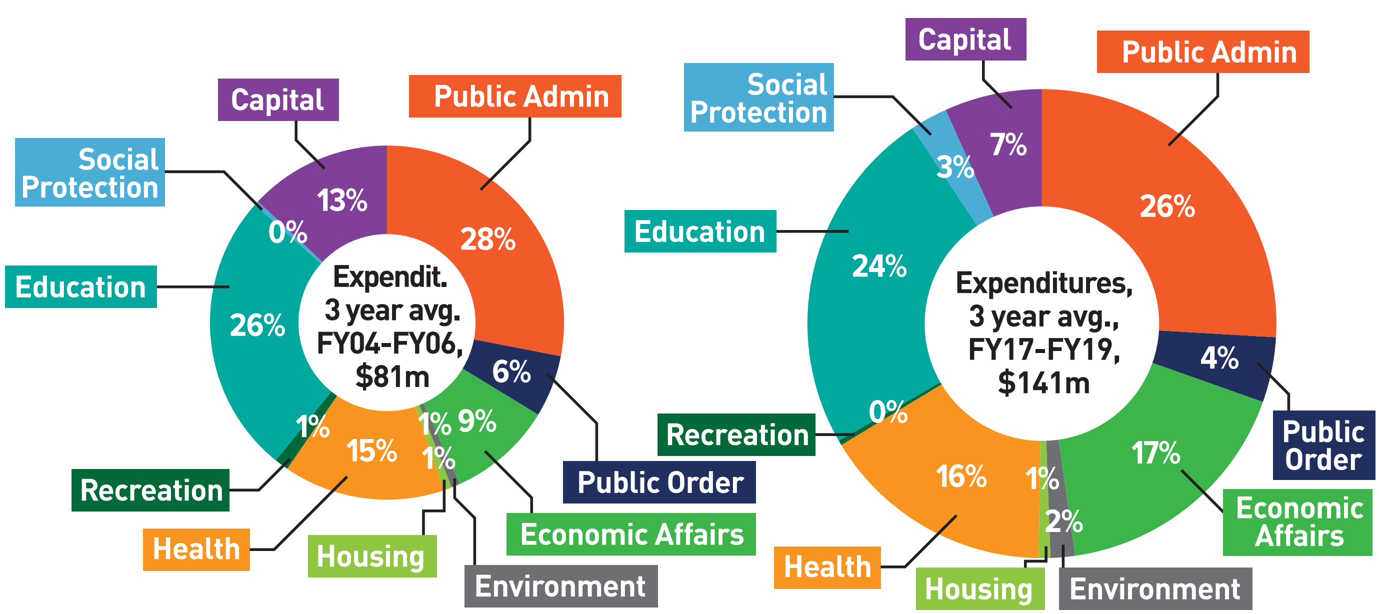
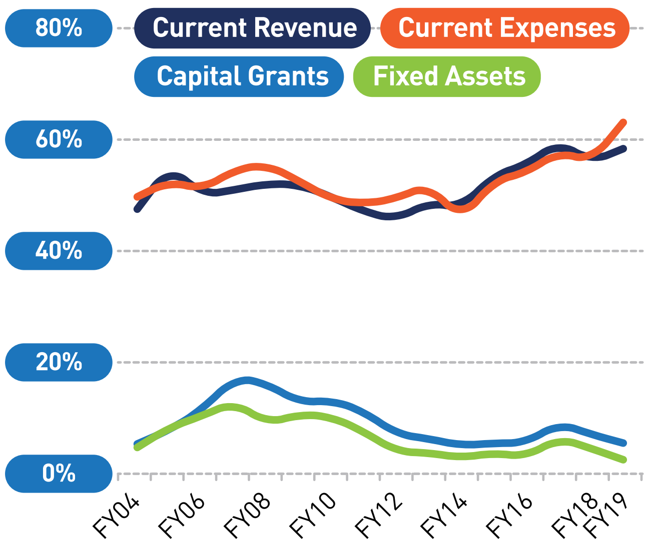
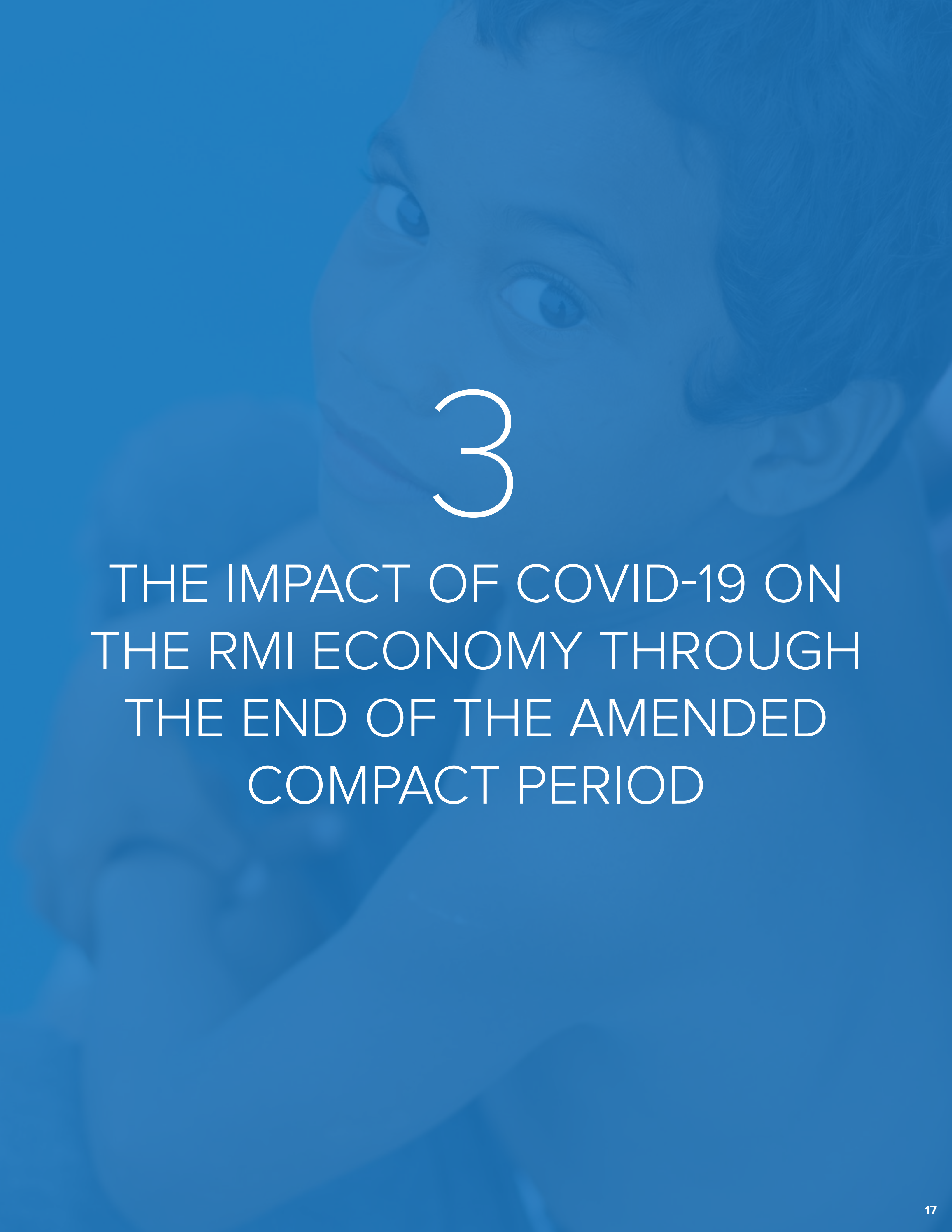


Figure 10: Government Revenue and Expenditures, as a Percent of GDP
RMI executes expansionary budgets during FY15-FY19 with overall fiscal surplus averaging 2.4% of GDP



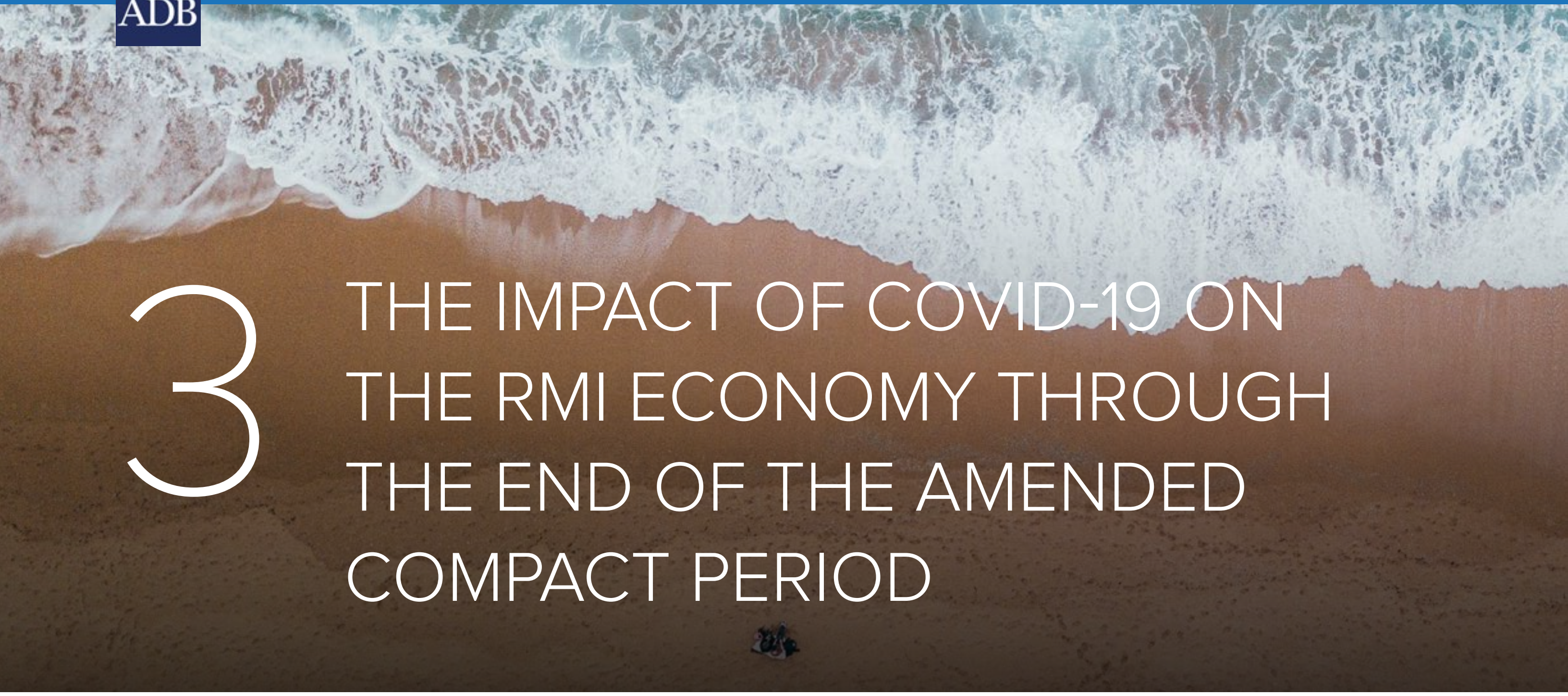
25 percent during the first three years of the amended Compact to 22 percent during FY17-FY19. While the use of goods and services has been largely constant, the main area of expansion has been in subsidies to the large SOE sector and transfers to NGOs and to households, which have nearly doubled from 13 percent to 22 percent 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. While not directly indicated in Figure 10, the fiscal deficit (in essence the difference between current revenues and current 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 of revenue within each fiscal year's fiscal envelope. The failure to create a fiscal reserve during the period when the fiscal envelope was expanding dramatically carries a lesson for RMI policy makers going forward.



3

THE IMPACT OF COVID-19 ON THE RMI ECONOMY THROUGH THE END OF THE AMENDED COMPACT PERIOD



3 THE IMPACT OF COVID-19 ON THE RMI ECONOMY THROUGH THE END OF THE AMENDED COMPACT PERIOD

The economy is expected to be well on the road to recovery by FY23, the final year of amended Compact assistance. In the previous section we discussed recent economic and fiscal performance and important structural considerations. We indicated that the RMI economy is heavily dependent on the public sector, but also substantially dependent on fisheries activity and sovereign rent receipts. The economy relies very little on tourism and visitor arrivals; nevertheless, the economic consequences of the COVID-19 pandemic have been significant. In this section, we report on the FY20 and FY21 economy and the likely result for FY22 based on available information[1]. The projections going forward assume that by FY23, the last year of the amended Compact, the economy will have made up most (two-thirds) of the lost ground and that by FY24 the recovery is complete.

COVID-19 Mitigation Programs and Donor Assistance

Analysis of the pandemic response of both the public sector and donors can be usefully divided into several components:

- The RMI Coronavirus (COVID-19) Preparedness and Response Plan
- Donor health assistance programs
- ADB COVID-19 Pandemic Response Option, and
- US CARES Act and unemployment assistance.

RMI Preparedness and Response Plan sets framework for COVID-19 mitigation. In early 2020 in response to the COVID-19 pandemic, the RMI National Disaster Committee (NDC), chaired by Chief Secretary, was tasked with the primary responsibility for developing the COVID-19 Preparedness and Response Plan. The National Disaster Management Office was tasked to provide technical support to the NDC for implementing the Plan. In June 2020 the government of the RMI released the original version of the Plan with an estimated financing need of $42.3 million. This was subsequently revised several times and current information indicates that total available funding was $70.6 million. This funding was allocated as follows:

- Health mitigation, $30.2 million,
- Household mitigation programs, $14.1 million (CARES support and ADB-funded hot lunch program),
- Education support to the College of the Marshall Islands (CMI), $1.9 million (US),
- Private sector business support, $6 million (Preparedness Plan), and
- General budgetary support, $18.4 million.

RMI has been the beneficiary of a large donor response to support the Preparedness and Response Plan: The major benefactor to support the Plan has been the US government, with $34.8 million. US resources include CARES Act unemployment benefits of $10.8 million and $24.0 million of health-related funding disbursed through

1 The data presented in this report through FY21 is based on provisional economic statistics, while the data for FY22 is based on projections derived from a hybrid of actual data and through the GSUSA economic model for the RMI.

CDC, OIA and various other federal programs. The ADB was the second-largest donor, contributing $23.7 million largely through budgetary support. Additional health-related funding was available from: the World Bank, $2.5 million; the European Union, $2.7 million; and other donors for $2.6 million. Taipei,China contributed $1.5 million in budgetary support and the RMI allocated $2.8 million of its own funds.

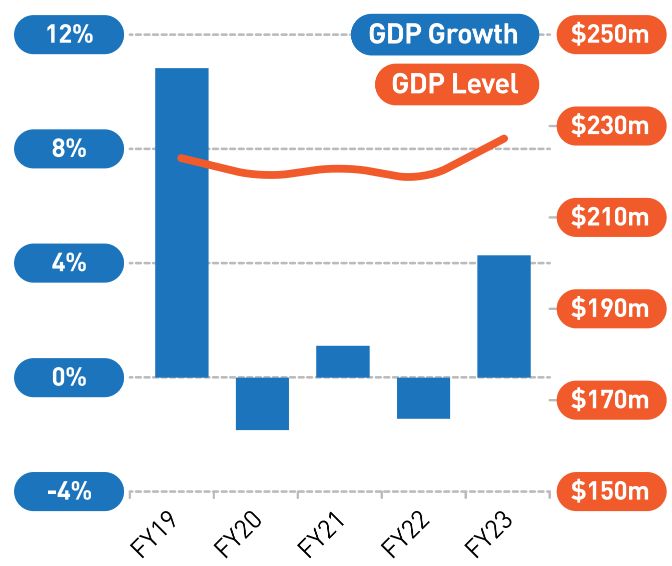
ADB played a major role in funding the mitigation effort. Of the ADB's large $23.7 million mitigation donation, $6 million has been funded through the Disaster Resilience Program (DRP), $16 million through the COVID-19 Pandemic Response Option (CPRO), a further $1 million in grants under the Asia Pacific Disaster Response Fund, and $0.7 million in health-related technical assistance (TA). The DRP and CPRO funds provided budgetary support to cover funding shortfalls in the financing of COVID-19 impact mitigation projects and programs specified under the Preparedness Plan. Of this amount, $3.3 million was earmarked for the government's hot lunch program.

CARES Act unemployment benefits generated significant benefits to affected RMI workers. As in the other FAS, RMI citizens were made eligible for unemployment support from the US government under the US CARES Act. The program has provided two forms of benefit: the Federal Pandemic Unemployment Compensation (FPUC) and Pandemic Unemployment Assistance (PUA). The FPUC was initially awarded at $600 a week to unemployed workers for four months (April-July 2020). A second phase of the FPUC was awarded from January 2021 through early September 2021 at $300 a week. The PUA has been available continuously since July 2020 and expired in September 2021, with $262 a week awarded during the period. Total unemployment funding of $10.8 million has been awarded and $7.5 million has currently been disbursed, with $3.6 million under the PUA and $3.9 million under FPUC as of September 14, 2022.

Economic Impact

The overall economic impact of COVID-19 is a 2.2 percent decline in GDP. The economy is estimated to have declined by 1.8 percent in FY20, grown by 1.1 percent in FY21, and to have fallen by a further 1.5 percent in FY22, bringing the total impact of COVID-19 to a 2.2 percent decline over the three years, see **Figure 11**. That overall economic impact of COVID-19 is less than half of the significant projected decline[2] of 5.5 percent. **Figure 12** provides further information on the impact of COVID-19 by major economic sectors. It shows the growth in commercial fisheries[3], non-fisheries private sector, and public sector during the FY19-FY23 period. There was a surge in commercial fisheries in FY19 when Pan Pacific added 3 new purse seiners to its fleet[4], but a contraction in FY20 as the loining plant closed. In FY21, commercial fisheries recorded a favorable outcome. However, the remaining non-fisheries private sector contracted significantly during COVID-19, leading to a sizeable loss in economic activity of 7.8 percent in the sector. The public sector mitigated that contraction during COVID-19 and grew by 2.5 percent, mitigating the impact of the contraction in the non-fisheries private sector.

Figure 11: GDP Growth and Level, FY15 Prices
GDP falls by 1.6 percent over the FY19-FY22 period, but is expected to recover in FY23



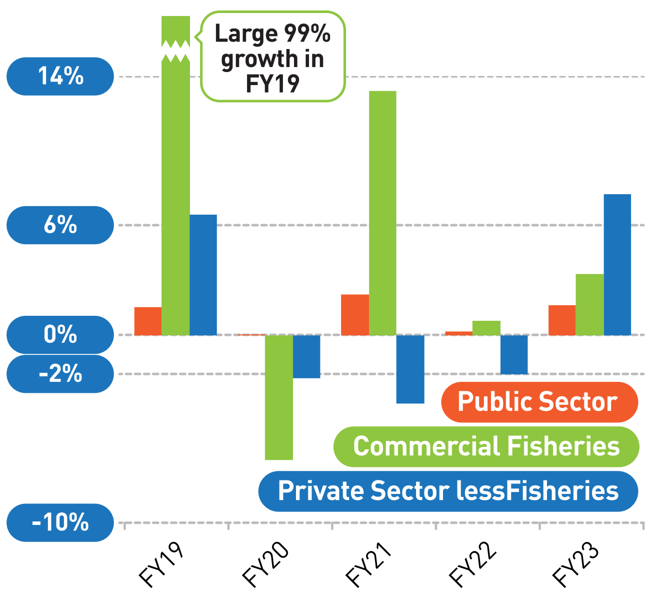
The impact of COVID-19 on distributive trades, construction, and transport turned out less adverse than anticipated. The sector level saw a mix of positive and negative growth. The impact of travel restrictions on fuel distribution led to -1.0 percent impact on the economy, but domestic retailing--largely for local consumption purposes--contributed 0.3 percent, reflecting the donor-driven mitigation effort. The small hotel and restaurant sector, reflecting travel restrictions, is estimated to have been responsible for -0.6 percent of the impact. It was originally anticipated that shore-based activities supporting fishing-fleet provisioning in Majuro port would contract significantly. However, the impact was far less than expected and

2 GSUSA, *RMI FY21 Economic Brief* (posted Oct. 20, 2021). ***https://pubs.pitiviti.org/rmi-fy21-economic-brief***

3 Includes domestic near-shore fishing, Pan Pacific fishing and loining (manufacturing), MIFV (manufacturing), and Koos (transshipment).

4 In FY19 Pan Pacific withdrew 2 leased vessels from operations and replaced them with new vessels.

Figure 12: Private and Public Sector Growth, FY15 Prices
Large 8.4 percent reduction in private sector GDP during FY19-FY22 (less commercial fisheries)



while port activities contributed -0.5 percent to the overall results, increased domestic operations of Air Marshall Islands (AMI) led to an increase of 0.6 percent. Overall, transport made a positive contribution to the economy during COVID-19. The construction sector was expected to suffer a major decline, but the impact was minor and only responsible for -0.3 percent. Further, despite the negative impact of travel restrictions on key skilled personnel, the construction industry avoided any large workforce cutbacks.

In FY23 the economy is expected to rebound, making up most of the ground lost to COVID-19. In FY23 it is assumed that the loining plant will resume operations, although below earlier capacity levels. The non-fisheries private sector is projected to rebound strongly by 7.7 percent with the lifting of travel restrictions. This should end supply shortages of specialized skills in the construction industry and allow the small hotel sector to reopen. The public sector is expected to maintain its long growth trend. The economy is projected to have partially recovered by FY23 such that it is 2.0 percent larger than its FY19 pre-COVID. Further recovery is anticipated in FY24 as the loining plant returns to normal operations, and the transport and small tourism sector fully recover.

Employment Impact

A loss of 127 jobs, or a 1.1 percent decline in the total work force, has been estimated for the FY19-FY22 period[5]. The small loss in total jobs has been similar to the reduction in GDP[6], see Figure 13. However, the distribution of the reduction has been uneven. The commercial fisheries sector lost 281 jobs (FY19-FY22) primarily at the loining plant, where the company cut back on operations to reduce the costs of a loss-making activity, and plant workers increased their income through higher unemployment compensation available under the Coronavirus Aid, Relief, and Economic Security Act (CARES). The non-fisheries private sector recorded a loss of 180 jobs, with the major sectors impacted being construction, with a loss of 26 jobs, wholesaling and retailing 79 jobs, and the hotel sector 69 jobs. Offsetting this decline, the growing public sector helped compensate for the private sector loss with the creation of 282 jobs or 5.1 percent of the public sector work force, see Figure 14.

The labor market is projected to have recovered in FY23, with employment to be above pre-COVID-19 levels, reflecting growth in public sector employment. In FY23, strong growth in employment of 5.2 percent is projected based on resumed operations at the loining plant and a private sector recovery. Overall employment is projected to have risen by 4.0 percent, or 460 jobs, largely reflecting the growth in public sector employment during that time.

Fiscal Impact

The onset of COVID was associated with a massive increase in grants. In FY20, grants increased by 30 percent or $21.7 million, reflecting support from the US for health and basic incomes with additional resources made available from the ADB for disaster mitigation. In FY21, a reduction in health funding was offset by continued resource transfers through the US CARES Act and the $16 million CPRO grant from the ADB for general budget support. Overall, grants continued to grow in FY21 by $7.6 million or 8 percent. In FY22 funding for COVID had largely ended and grants are estimated to fall by 28 percent and return to normal levels in FY23.

Tax revenues declined in FY20 with the onset of COVID, rose in FY21 and are projected to rise in FY22. At the start of COVID, the tax base contracted by 3.9 percent with the loss in economic activity. While wage tax collections and import duties held their ground, the

5 Includes Marshallese employment at the Kwajalein military base.

6 This loss in jobs should be understood as a reduction in full-time-equivalent (FTE) positions rather than a specific loss in employed persons. Firms are likely to institute reduced hours for employees before terminating their jobs.

Figure 13: Employment: Numbers and Growth
Job loss during COVID was 127 or 1.1 percent FTE (FY19-FY22)

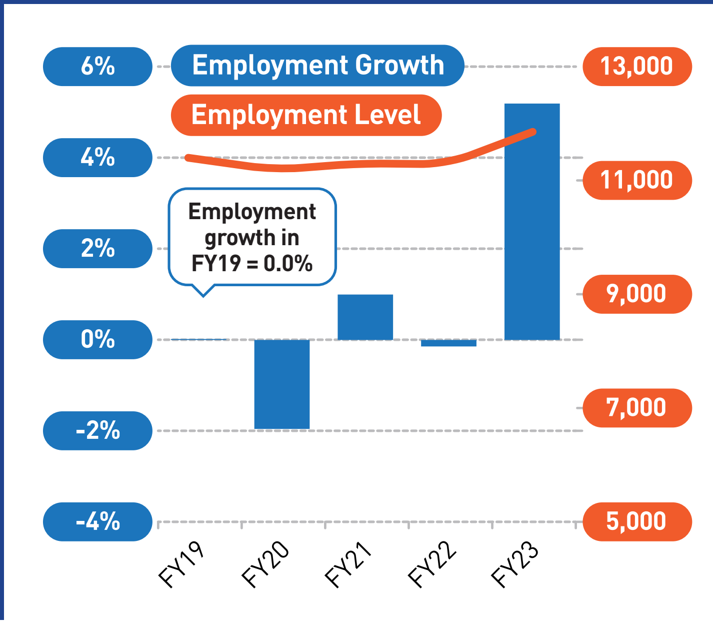
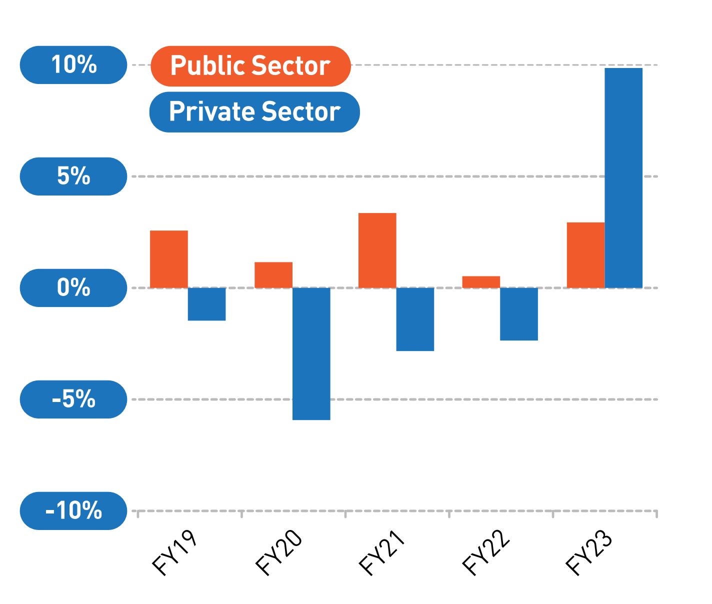


Figure 14: Employment Change in Private and Public Sectors
Job loss in the private sector of 460 or 10.7 percent (FY19-FY22), offset by increase in public sector employment

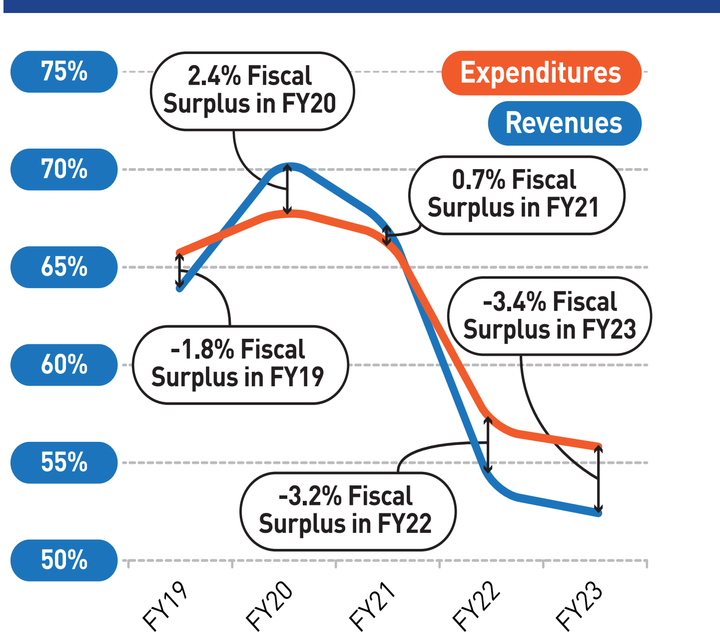


gross receipts tax (GRT) fell by 9.0 percent, reflecting the decline in business activity. In FY21, all categories of taxation rebounded, with total collections growing by 7.1 percent. In FY22 and FY23, similar improvements in revenues of 5.4 percent and 4.0 percent have been estimated, respectively.

During COVID, government expenditures grew strongly in FY20 and FY21 but are expected to fall in FY22. During the COVID period, government payroll costs grew by an average annual rate of 5.3 percent. Most of this increase occurred in FY21 with the large infusions of budgetary support arising from the ADB CPRO. Expenses on goods and services rose during the early stages of COVID with additional health needs but were partially offset by reduced outlays on items that were in short supply due to the travel restrictions. After a period of rapid increases in SOE subsidies, they fell in FY21 due to more favorable world prices of coconut oil but are expected to rise and return to trend thereafter. Grants to other government entities remained largely unaffected by COVID, but transfers to schools, households and private business rose rapidly with additional expenditures on the hot lunch program, unemployment benefits through the US CARES Act, and support to stressed private sector enterprises. Lastly, capital outlays saw a large increase, predominantly due to increased health-related infrastructure.

The RMI ran a fiscal surplus in FY20 and FY21, but a deficit is projected for FY22 and FY23 as a pre-COVID structural deficit reasserts itself. As rising expenditures outstripped revenues in FY19, the RMI saw the emergence of a structural fiscal deficit that was equivalent in size to 1.8 percent of GDP. Balance was restored in FY20 (see Figure 15) as the rapid increase in grants led to an accumulation of unused funds and a 2.4 percent surplus. The fiscal surplus fell to 0.7 percent of GDP in FY21 as capacity limitations were overcome and cash balances were drawn down. In FY22, a 3.2 percent deficit is estimated, followed by a further

Figure 15: Revenue and Expenditures as a Percent of GDP
Fiscal deficit re-emerges after COVID grant funds have been used



deficit of 3.4 percent in FY23. By FY22 and FY23, the large increases in COVID-related grants and additional expenditures will have worked their way through the system, and the underlying, pre-COVID structural fiscal deficit is expected to reassert itself. Over the combined period FY20-FY23, the projections indicate a large and unsustainable drawdown on cash reserves.

4

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

ADB

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

This chapter outlines the potential impact on the RMI of non-renewal of Compact economic assistance after FY23. The chapter also explores the impact on the RMI of full independence from any US assistance. Two scenarios are presented:

The first, "***Non-Renewal Scenario***" assumes the RMI moves to a regime outlined in the Compact that has two key features. First, the RMI transitions from sector grants funded by US appropriations to annual distributions from the RMICTF. Second, SEG funding ends. In our modeling, the initial level of annual CTF distributions is set at a sustainable level (with a high degree of confidence) and subsequent distributions are adjusted for inflation.

The second scenario, the "***Independence Illustration***" is presented to indicate the economic impact that would occur if the RMI became fully independent of all US assistance, federal programs, and services, both Compact and non-Compact. With the strong US and RMI relationship this illustration is not a likely outcome, but it is included to show the ongoing value of the US relationship to the RMI. In our modeling, this scenario also sets the initial level of annual CTF distributions at a sustainable level (with a high degree of confidence) and subsequent distributions adjusted for inflation.

Scenario analyses utilize economic models developed by the GSUSA for the RMI and Compact trust fund analyses developed for FAS trust funds. The economic models developed by the Graduate School USA are based on economic sector accounts and use programming techniques like those used by the International Monetary Fund.[1] The trust fund analyses use the Monte Carlo method of statistical analysis and a projected median value of the RMICTF at the end of FY23 to solve for a value that corresponds to the "SAFER" distribution. The nature and rationale of the SAFER distribution method is described in the Appendix and importantly it ensures the RMICTF is able to provide a long-term sustainable yield with a high degree of probability.

The RMI trust fund projection was prepared in August 2022, when the RMI CFT was projected to attain a value of $715 million by the end of FY23 and the corresponding SAFER distribution for FY24 would be $21.9 million. Since the projections were prepared, RMI portfolio values have declined, and markets remain volatile. By the end of December 2022, the value of the RMI CTF had fallen to $639 million with a projected value of $676 million by end of FY23 with a SAFER distribution of $20.7 million. The value of the RMI CTF projected for the end of FY23 is thus less than the value projected at the time this report was prepared but has a minor impact on the presented results.

1 See GSUSA, *RMI FY18 Economic Review* (posted Nov. 9, 2019) for a discussion of the model. ***https://pubs.pitiviti.org/rmi-fy18-economic-review***

Non-Renewal Scenario

The total adjustment required under the RMI Non-Renewal Scenario is $11.9 million, which is equivalent in size to 4.0 percent of GDP and a significant fiscal shock.

- The non-renewal of Compact grants requires a budget reduction that is equivalent in size to 2.1 percent of GDP. Under the terms of the RMI's amended Compact, the level of expiring non-Kwajalein targeted Compact sector grants is projected at $28.2 million in FY23. Without new funding, the RMI CTF can cover that amount. However, at the SAFER sustainable distribution level of $21.9 million, there is a $6.3 million shortfall above the SAFER distribution. This reduction in transfers to support government operations and capital investments is specified in **Figure 16** and equates in size to 2.1 percent of projected FY23 GDP.
- The loss of the Supplemental Education Grant requires a budget reduction that is equivalent in size to 1.9 percent of GDP. An additional decline in transfers will occur through the loss of the SEG. The RMICTF has no provision to serve as a source to replace this loss of annual SEG transfers. Figure 16 illustrates the potential reduction in support to the RMI's education programs—$5.6 million annually starting in FY23, or a loss equivalent in size to 1.9 percent of projected FY23 GDP.

Correction of the reemerging fiscal deficit that first occurred in FY19 and the impact of the non-renewal scenario requires significant fiscal adjustment in FY24. In FY24, the economy will have to grapple with not only the impact of reduced US Compact funds incurred under the non-renewal scenario and the loss of SEG, but also the structural deficit originally generated in FY19. In order to restore fiscal balance in FY24 and beyond, this study presents a set of adjustments: reductions in payroll and in the use of goods and services. In reality, other areas of government expense such as subsidies and transfers to non-profits and households could be cut. All areas of government expense reduction would come with a high associated cost. Modeled reductions:

a. Reversal 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.

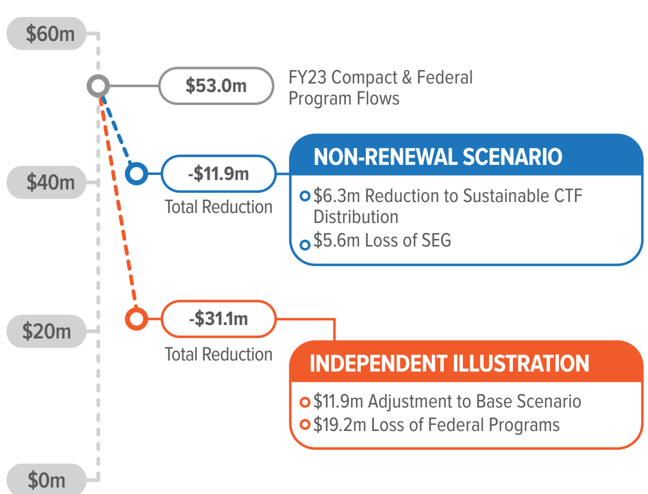
b. Implementation of a 25 percent reduction in the administrative services work force in FY24 followed by a 2.5 percent annual reduction thereafter through FY30 (education and health are protected).

c. A wage freeze applied to public administration through the projected period FY24-FY30

After a contraction in GDP of 1.9 percent in FY24, the economy returns to its long-run rate of growth through FY30. The impact on the RMI economy of these adjustments is shown in **Figure 17**. After the COVID-19 years and partial recovery from COVID in FY23, the economy is projected to decline by 1.9 percent in FY24 before resuming its steady state growth of close to 1.0 percent. FY24 will feature two opposing forces: completion of the COVID-19 recovery and contractionary impact of the reduction in the public sector from the fiscal adjustment. The impact of these forces on GDP is spread between the private and public sectors. For the public sector, the reduction in public administration has a large impact and the public sector contracts by 7.3 percent. For the private sector the cuts in government use of goods and services and the wage freeze dampen demand. However, the completion of the recovery from COVID-19 outweighs the negative impact of the fiscal adjustment program and the private sector grows by 0.6 percent.

A small increase in household incomes is projected for FY24 despite a large loss of 652 jobs. **Figure 18** indicates that the impact on household real incomes is due to a variety of forces. As in the case of GDP, the impact of the fiscal adjustment is offset by the recovery from COVID-19. However, the projections also assume a reduction in consumer prices of 1.0 percent, reflecting a correction after the current surge in global inflation. It should be noted that RMI household incomes are subject to external factors that fall outside the domestic economy such as: receipts from workers at

Figure 16: RMI Downward Adjustment Scenarios
Components and Magnitudes



Note: Sustainable distrbutions from the CTF ($21.9 million in FY23 prices) is assumed to be available.

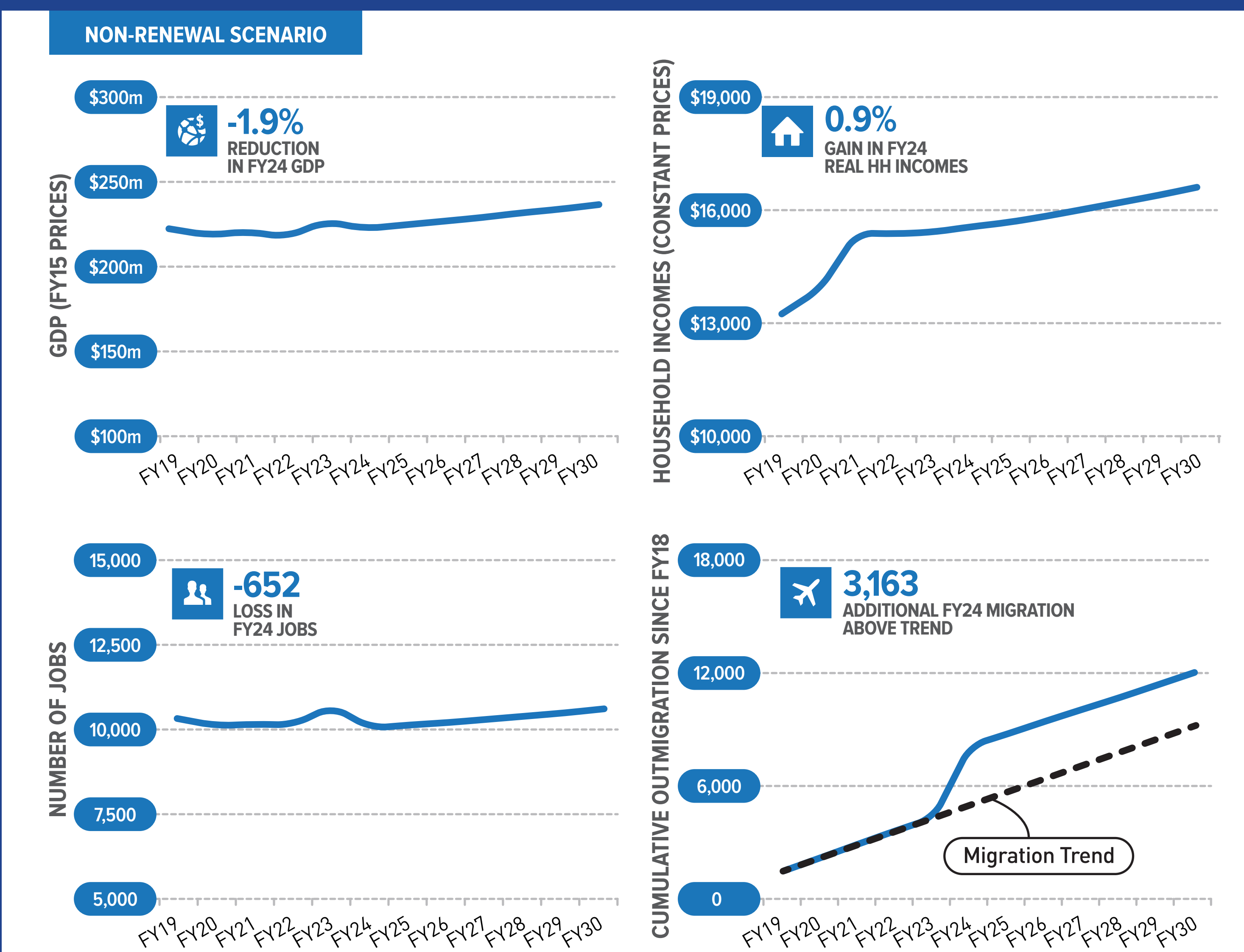
the Kwajalein military base, landowner receipts from Kwajalein under the Compact, social security benefits, and transfers from overseas. The overall result is that household real incomes grow by 0.9 percent in FY24. The impact on employment shown in **Figure 19** is a pronounced loss of jobs. Private sector employment is projected to grow by 31 jobs or 0.7 percent, close to private sector GDP growth. The impact on the public sector is, however, strong and negative with a total loss of 689 jobs or 11.5 percent of the public sector workforce. For the economy overall, including all employment categories, there is a projected loss of 652 jobs or 6.1 percent of the labor force.

Increased out-migration of 3,163 people can be anticipated under the non-renewal scenario. **Figure 20** indicates the accumulated impact on migration[2]. Approximately 1.6 percent of the population in the RMI is projected to migrate to the US each year[3]. The observed rate is mostly insensitive to the state of the local economy, although migration has been observed historically to rise during periods of severe fiscal adjustment. Thus, each of those employees affected by job loss due to non-renewal and the fiscal adjustment is projected to migrate with his or her dependents. The dependency ratio in the RMI is estimated at 5.4

2 See GSUSA, *RMI FY22 Economic Brief* (posted Nov. 3, 2022) for an analysis of the recent demographic trends. ***https://pubs.pitiviti.org/rmi-fy22-economic-brief***

3 This estimate of migration is based on the US Department of Transportation "TRANSTATS" database, 1990-2011. This estimate is used in this study until the RMI 2022 census has been validated. Preliminary census information suggests that the migration rate may well have increased significantly based on the recent population census.

Figures 17-20: RMI Non-Renewal Scenario: GDP, Household Income, Employment, and Migration



people per job. However, the model dampens migration projections when the job loss is within 1.0 percent of total jobs. Under the non-renewal scenario, the projected job loss is projected to induce an additional 3,163 migrants above the normal trend migration rate.

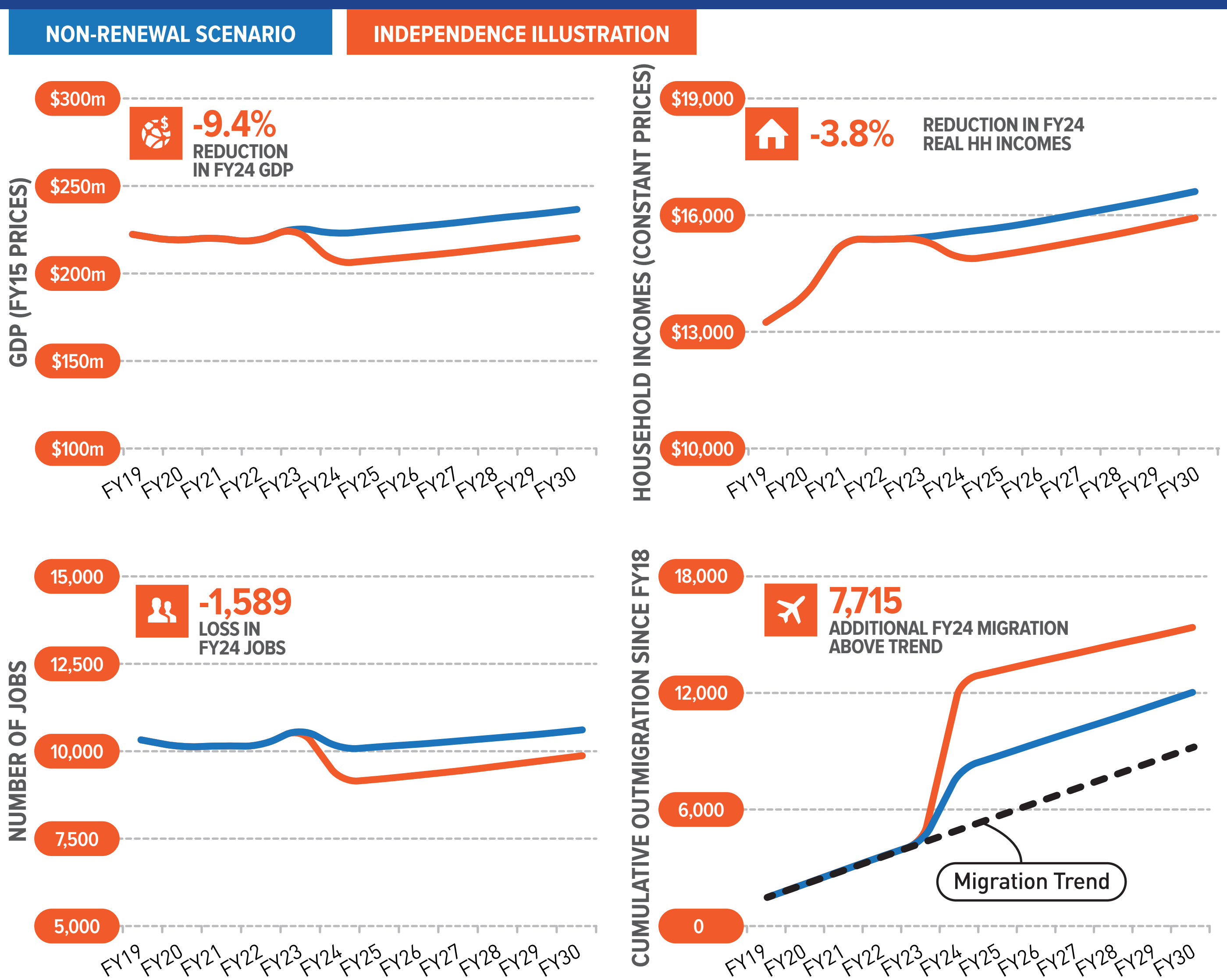
Independence Illustration

The independence illustration--without any US support--is a total annual reduction in transfers of $31.1 million and is equivalent in size to 10.4 percent of FY23 GDP. Under the independence illustration, we analyze an additional reduction in US funding of listed federal programs and services. This equates to $19.2 million annually and is equivalent in size to 6.4 percent of projected FY23 GDP. Taken together with the non-renewal scenario reduction of $11.9 million that is equivalent in size to 4.0 percent of GDP, the total reduction is $31.1 million annually and is equivalent in size to 10.4 percent of projected FY23 GDP.

In addition, this independence illustration does not account for the loss of several important US Federal programs and services. For example, the RMI benefits from the provision of US postal services and that loss would imply higher costs for RMI consumers. However, the cost of subsidizing postal rates in the RMI is not known and modeling the impact on public services, businesses and households is beyond the capability of the GSUSA macroeconomic modeling framework as currently developed.

A large adjustment in public administration is required to restore fiscal balance. To restore fiscal balance under the independence illustration, the adjustments

Figures 21-24: RMI Independence Illustration: GDP, Household Income, Employment, and Migration



required under the non-renewal scenario remain with the following elements added to redress the loss of federal programs:

a. The government is required to further increase the size of the FY24 cut in public administrative services from 25 percent to 33 percent.

b. Both education and health are required to reduce operations and staffing by 10 percent, a highly undesirable result.

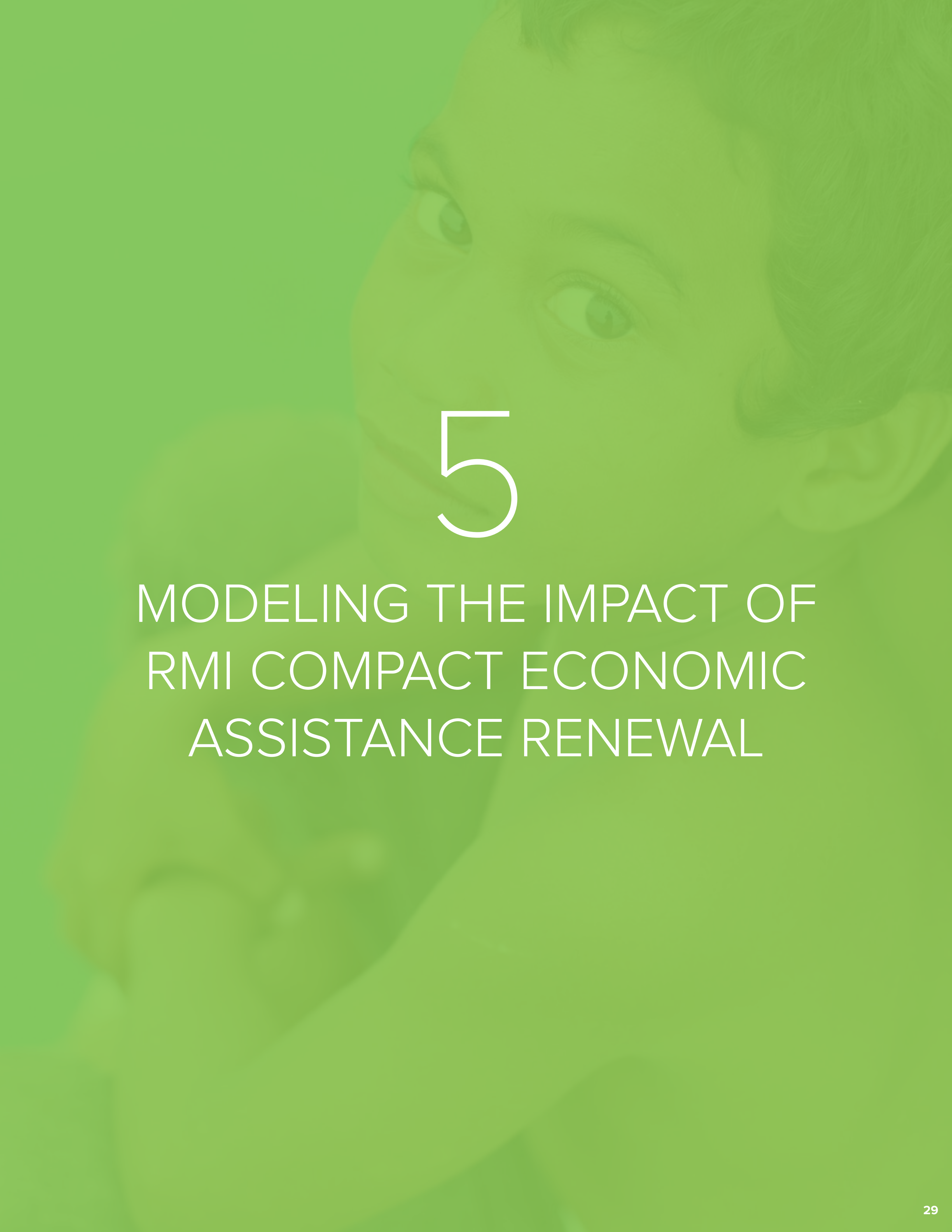
c. A further 23 percent cut in the use of goods and services.

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

The independence illustration results in a large reduction in GDP, jobs and incomes. Figures 21, 22, 23, and 24 indicate the outcome of both the non-renewal scenario and the independence illustration. The negative impact rises from a loss in GDP of 1.9 percent to 9.4 percent. While private sector GDP is projected to fall by 3.2 percent, public sector GDP is estimated to fall by a massive 23.6 percent. The job loss rises from 652 employees in the non-renewal scenario to 1,589 or 15 percent of total employment under the independence illustration. The implied jobs loss rises to 5 percent in the private sector and 23 percent in the public sector. The resulting impact on household incomes is also large, falling from a positive 0.9 percent to a negative 3.8 percent change in incomes.

The fiscal adjustments under the non-renewal scenario were large, with a 25 percent cut in public administration and a reduction in the use of goods and services. In the independence illustration these adjustments become extreme: large reductions in payroll not only in public administration but also in health and education are required to restore fiscal balance.

Impact on migration is extraordinary but may be spread over several years. The potential impact on migration is substantial. The independence illustration could result in 7,715 additional migrants to the US, or 18 percent of the RMI population in FY23, if each eliminated employee migrates with dependents. In practice, actual migration is likely to be spread over more than one year and not all primary job earners or dependents may migrate.



5

MODELING THE IMPACT OF RMI COMPACT ECONOMIC ASSISTANCE RENEWAL

5 MODELING THE IMPACT OF RMI 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 a plausible RMI response to reduced Compact economic assistance without any modified development partner support and relied 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. Two scenarios are presented:

The "***Compact Renewal Scenario***" provides a more secure RMI future and would avoid a shock. However, it would not by itself place the RMI on a sustained higher growth trajectory. Continued Compact resources would improve economic and fiscal outcomes and avoid the fiscal cliff 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. While such a result would avoid fiscal shocks, the renewal would not by itself place the RMI on a sustained higher economic growth trajectory.

A "***Better Results Scenario***" requires restructuring the Compact trust fund drawdowns to enable greater financial support and reform of RMI institutions and policies. The "Better Results Scenario" is based on a restructuring of the Compact economic assistance package to enable greater financial support than prevailed at the end of FY23/FY24 and institutional and policy reforms. Attaining better results would require both an RMI commitment and development partner support with projects and programs to support and reward institutional and policy reforms.

Modeling does not consider the impact of climate events. Under the Compact renewal we do not address specific, additional expectations that the RMI may have with respect to climate change, nor do we 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 the cost of achieving climate resilience. While resources are being made available to the RMI 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.

Compact Renewal Scenario

Compact economic assistance renewal assumes a further 20-year period of annual support, including the SEG. Continued US support assumes that the US renews and extends amended Compact assistance to the RMI at a level equivalent to the existing sum of the annual sector and SEG grants and RMICTF contributions, with continuation of the same partial inflation adjustment rule (two-thirds of annual change in the US GDP deflator, capped at 5 percent). However, it is assumed that the composition of the package would vary slightly from the amended Compact period. The projected levels of the sector grants and the SEG (essentially converted into a Compact sector grant) would be fully indexed. Contributions to the RMICTF would continue, but as a residual out of the total annual funding after allowance for the fully inflation-adjusted sector grants and SEG, see Figure 25.

However, a fiscal correction is still needed in FY24 due to the lingering imbalance inherited from the FY19 budget. Although the full range of adjustments, such as the Reduction-In-Force under non-renewal are not required, the adjustment needed to restore fiscal balance is limited to the measures outlined below:

a. Reversal 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.

b. A wage freeze applied to public administration through the projection period FY24-FY30.

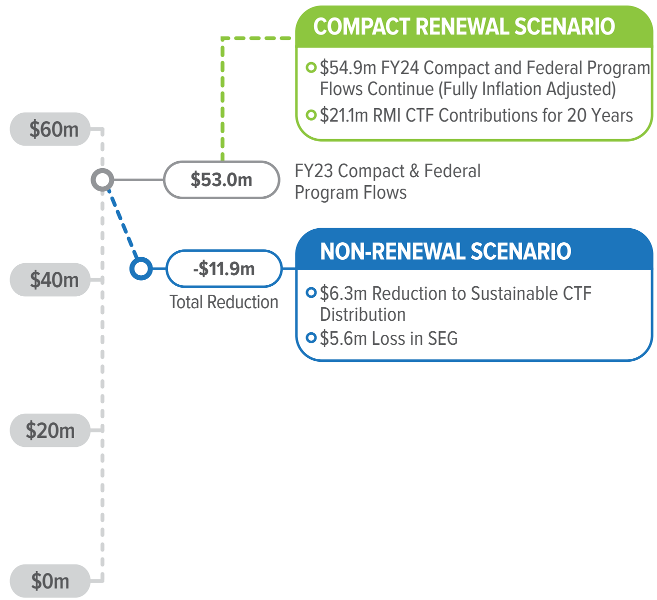
Full inflation indexation of annual grants and SEG would release the RMI economy from the fiscal drag experienced in prior Compact periods. During the amended Compact period, the fiscal drag imposed on the economy due to the decrement and lack of full indexation is estimated to average approximately 0.36 percent annually. The impact of a continuation of the Compact at similar levels to those of the amended Compact, but with grants fully indexed and no decrement, should provide a modest boost to annual economic growth of about 0.33 percent.

Compact renewal generates a positive economic outcome. Figure 26 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 favorable, but due to the pre-existing structural deficit, the economy still needs to adjust. GDP under the renewal scenario is projected to increase by 1.6 percent compared with a reduction of 1.9 percent under the non-renewal scenario. Over the period FY25 to FY30 under both the non-renewal and renewal scenarios, economic growth is close to 1.3 percent compared with 1.4 percent during the amended Compact period, FY04-FY19, indicating a similar economic performance.

- The impact on household real incomes is also favorable and grows by 3.7 percent in FY24, see Figure 27, compared with 0.9 percent growth under the non-renewal scenario.

Figure 25: RMI Renewal Scenario
Components and Magnitudes



- The impact on employment in FY24 is considerably improved: 237 jobs are created under Compact renewal compared with a loss of 652 under non-renewal, see Figure 28. Job creation over the period FY24-FY30 is projected to be favorable at 1.7 percent per year, with 1,333 new jobs created.

- The impact of job creation in FY24 and thereafter on migration is positive and instead of a high level of induced out-migration, 237 people are incentivized to remain in FY24, see Figure 29.[1]

While Compact renewal is an improvement on the non-renewal adjustment scenario, the projected performance in the renewal period is modest. 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 future fiscal shocks.

Under the renewal scenario the RMICTF is expected to achieve a high degree of sustainability and perpetual status. With renewal of Compact economic assistance 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)

1 While the migration function assumes each job loss results in the whole household migrating, an increase in jobs is assumed to only reduce migration by a matching amount to the increase in jobs. There is no assumed induced migration for changes in employment of less than one percent.

volatility of annual distributions. A score of 95 percent is analogous to a 95 percent statistical confidence level. A Trust Fund attaining this level of performance is defined as perpetual. While increased funding alone improves the RMI CTF performance, it is further enhanced by adopting SAFER rules. See Table 1.

- In the absence of a renewal, the RMICTF would score 87 percent using existing Compact of Free Association (COFA) rules and 27 percent of simulated cases would have at least one zero distribution year over the period FY24-FY63 (see Appendix).
- In the absence of a renewal, BUT using SAFER rules, the RMICTF would score 92 percent and have no cases of zero distributions over the period FY24-FY63.
- Under the Compact economic assistance renewal and using SAFER rules, the RMICTF achieves a score of 98 percent and has no cases of zero distributions over the period FY24-FY63.

The 20-year extension of the Compact coupled with additional contributions achieves a score greater than the target of 95 and would be highly satisfactory from a financial security perspective for the RMI. Greater detail on the Trust Fund simulations, measures and methodology deployed by the Graduate School USA can be found online[2].

The total cost to the US of the renewal strategy over 20 years is estimated to be $1,089 million. Under the assumptions outlined in this paper, the total cost to the

2 See GSUSA, *RMI FY18 Economic Review* (posted Nov. 9, 2019). ***https://pubs.pitiviti.org/rmi-fy18-economic-review***

Figures 26-29: RMI Renewal Scenario: GDP, Household Income, Employment, and Migration

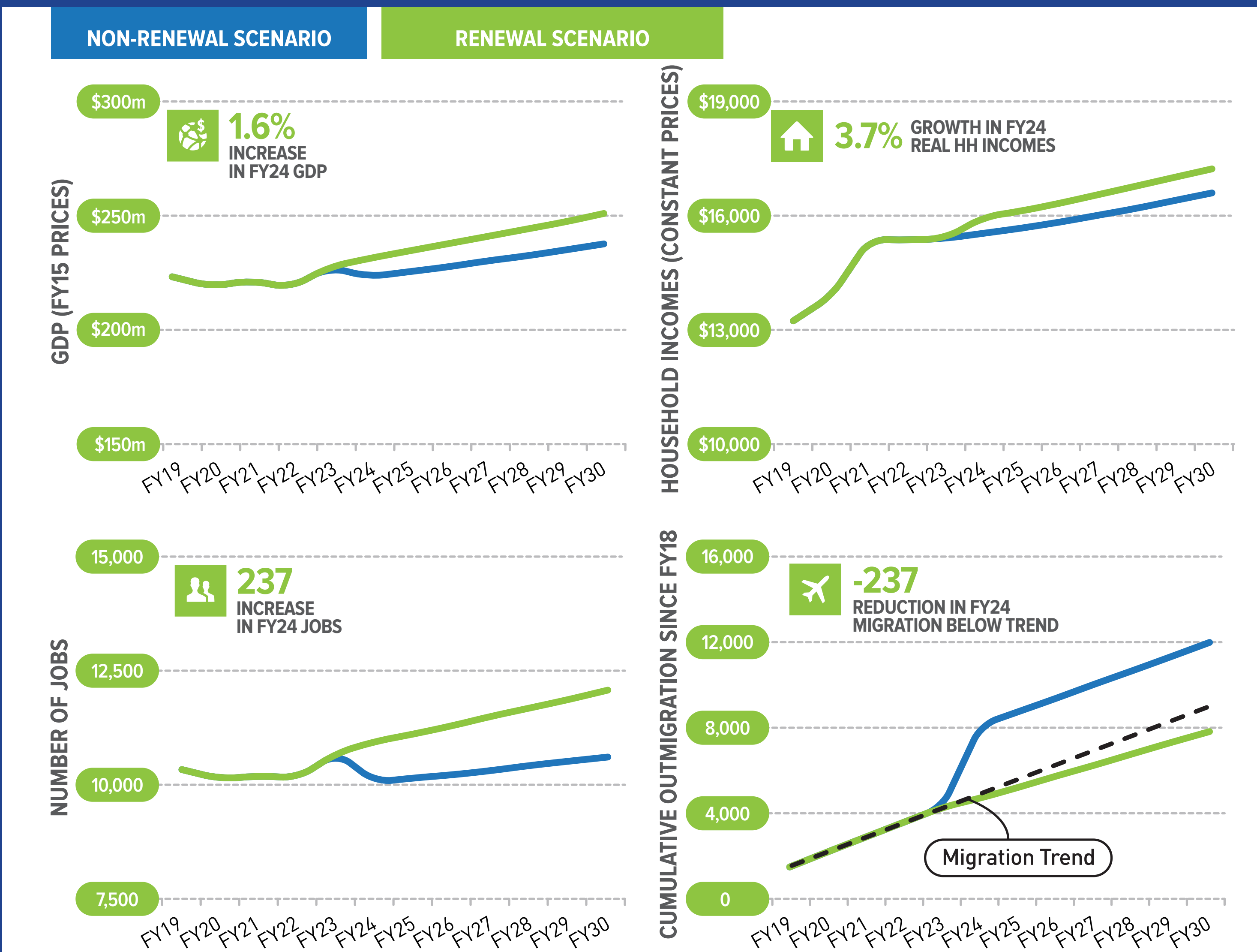


Table 1: RMI Compact Trust Fund Performance Under the Existing Arrangement and Compact Renewal

Performance Measures	Compact renewal	Non renewal COFA rules	Non renewal SAFER rules
Evaluation period	**FY44-FY63**	**FY24-FY63**	**FY24-FY63**
Percent cases where real CTF in FY63 is above FY2023 sim value	92,9%	75,6%	89,3%
Percent cases where CTF value is above the PT in FY2063	99,6%	80,4%	93,9%
Average distribution through FY2044-FY2063 percent target	98,8%	95,8%	86,0%
Probability of attaining target distribution in FY2063	94,3%	88,3%	82,9%
Percent of cases with zero distribution in FY2024-FY2063	0,0%	27,2%	0,0%
Val of distribution % prior year counted for reduction years only	0,2%	3,0%	0,4%
Number of years with reductions in distributions % total years			
CTF Performance Index	97,8%	86,7%	92,1%

US in FY24 dollars of the articulated Compact extension scenario would be $1,089 million. Annual US transfers to the RMI would be $58 million in FY24 dollars, including annual contributions to the RMICTF.[3] Actual annual outlays will be higher over time as they are partially indexed for inflation and the total cost, including inflation, is projected to be $1,340 million.

Better Results Scenario

The strong performance of the RMICTF indicates the potential for withdrawing funds, provided such distributions do not degrade the value of the corpus below sustainability. Past RMI actions have benefited and strengthened the RMICTF. These actions include decisions to: (i) devote a large proportion of amended Compact resources to the CTF, (ii) immediately allocate the annual decrement in amended Compact economic assistance to the CTF, (iii) 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 to the RMICTF. The RMICTF was already projected to be in a strong position in FY23.

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, in FY64. This high degree of sustainability suggests the potential for an annual withdrawal of funds, provided this does not degrade the value of the RMICTF corpus below the 95 percent notional sustainability target.
We model a $13-million calibrated CTF distribution for development assistance. This study models the potential benefit of a calibrated development assistance distribution. For example, the RMI could benefit from an estimated $13 million average annual distribution to support special projects involving 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 percent target was maintained. If the RMICTF faced early and/or persistent disappointing returns, the "calibrated distribution" would necessarily be reduced—with the remaining funds invested in the RMICTF—thereby fortifying the corpus for 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 expressed RMI priorities that are also consistent with the expressed aims of the RMI's multi-lateral and bi-lateral donor partners, including 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 expenses and capital projects for model projections. The better results scenario assumes the following use and allocation of the $13-million average distribution stream fully adjusted for inflation:

3 These transfers are in addition to ongoing US payments to the RMI related to Kwajalein that are not ending after FY23.

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

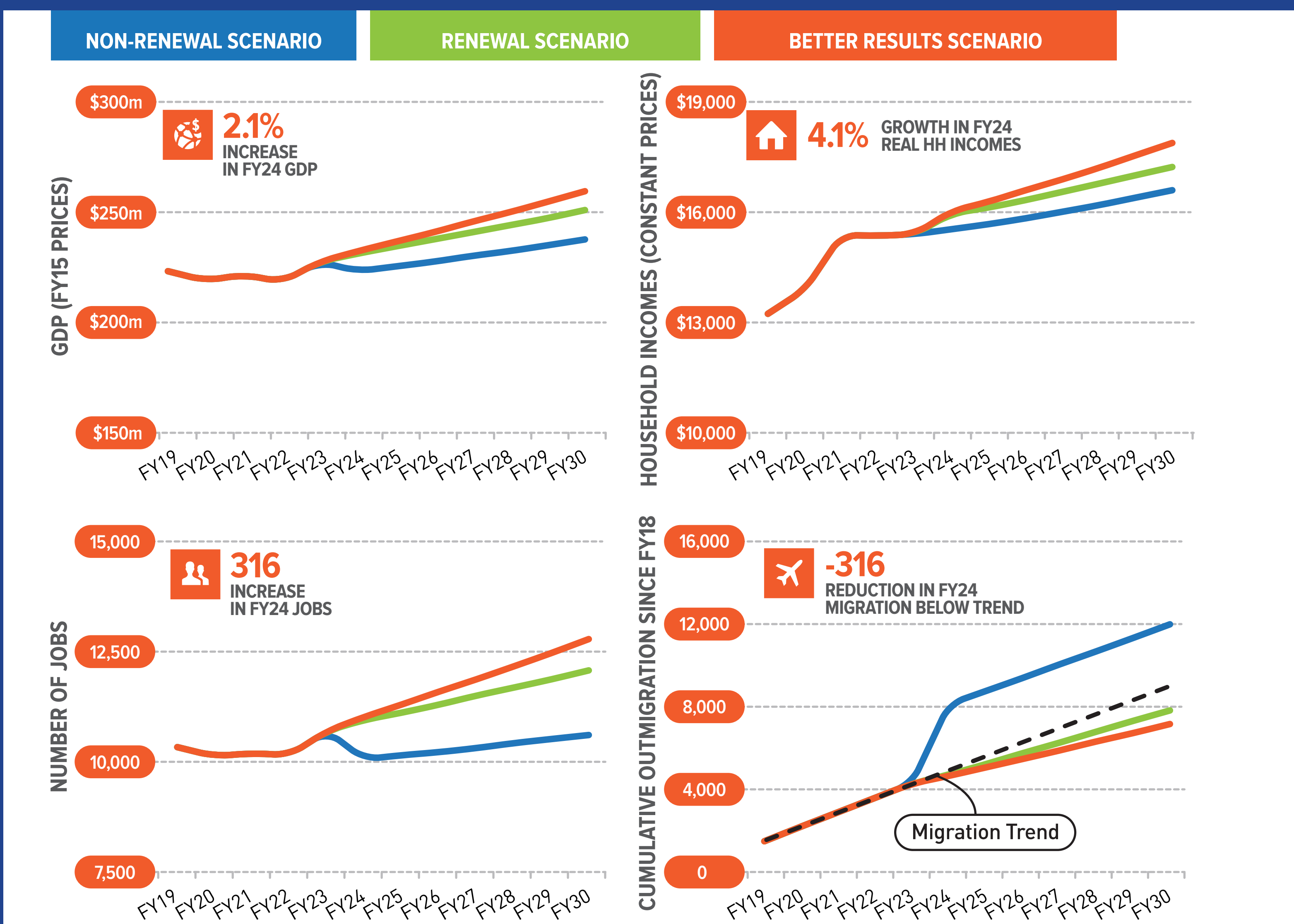
ii. Non-recurring expenses are divided 50:50 between payroll and use of goods and services.

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 positive impact on GDP, job creation and reduction in out-migration. The modeled results are shown in Figures 30, 31, 32, and 33, where there are benefits beyond the compact assistance renewal scenario.

- While the better results scenario assumes the same need for fiscal adjustment in FY24, but without the need for the wage freeze as under the renewal scenario, the addition of a $13 million distribution to the renewal scenario is sufficient to add 2.1 percent to GDP in FY24, and by FY30 this has risen to 14 percent over FY23.
- The impact on household real incomes is also favorable and grows by 4.1 percent in FY24.
- For employment, an additional 316 jobs are created in FY24 and this rises to 2,082 by FY30.
- In terms of out-migration, the creation of jobs is sufficient to induce a significant reduction of 316 people below the trend rate in FY24.

Figures 30-33: RMI Better Results Scenario: GDP, Household Income, Employment, and Migration



Reforms and Donor Support

A favorable Compact extension coupled with policy reforms would likely lead to a higher economic growth outcome. The growth projections in this chapter, although an improvement over the downward adjustment scenarios of chapter 4, 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 extension. Implementation would, therefore, entail reform programs to improve not only the efficiency and effectiveness of service delivery in the public sector, but also reform to support private sector development. In the case of favorable Compact negotiations, reforms coupled with a secure and known future, would place the RMI on a higher growth trajectory. In the case of less favorable Compact extension terms, donor assistance and domestic reform will become essential to sustain even disappointing economic performance.

It is not within the scope of this study to outline a specific program of reform for the RMI. Rather, an indicative list of key areas of reform is provided.

Key Areas of RMI Public Sector Reform

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

- Fiscal responsibility
- External debt
- Tax reform
- Public Financial Management
- Fiscal reserves
- State-Owned Enterprise reform.

Key Areas of Reform for RMI Private Sector Development

The former World Bank "Doing Business Survey" indicates a weak environment for private sector development in the RMI. While it has been discontinued, the most recent World Bank 2020 "Doing Business Survey"[4] provides an overall assessment of the environment for private sector development in the RMI. Out of the 190 countries included in the study, the RMI ranks 153; in comparison, the FSM and Palau rank 158 and 145, respectively, indicating a weak environment for private sector growth. A study conducted by the Pacific Private Sector Development Initiative provided an excellent analysis of the environment for private sector development in the RMI[5], confirming the picture presented in the World Bank overview. The following are some of the impediments to private sector growth in need of reform:

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

Development Partner Support and Coordination

Development partners have a vital role to play in building capacity and supporting reforms. The former section is intended to provide an indication of the breadth of reform issues that require attention and resolution for the RMI to function well and to achieve sustained improvements. The development partner community has supported reforms in the past, but the opportunity provided by Compact 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 bring about better results. The development partner community has a vital role to play in building capacity and supporting reforms.

Multilateral programs of budgetary support could support and reward implementation of long-delayed reforms. During the last few years—with the emergence of the World Bank as a major player in the subregion, coupled with additional resources from ADB—the development partner community has been well placed to finance public infrastructure alongside sustained, complementary technical assistance. While budgetary support has not been a part of the recent development partner programs, it could be used to support and reward the implementation of long-delayed reforms. It is understood that a preliminary program is being considered for the RMI. In summary, in the case of

4 World Bank. 2020. *Doing Business 2020*. Washington, DC: World Bank. ***https://openknowledge.worldbank.org/bitstream/handle/10986/32436/9781464814402.pdf***

5 Pacific Private Sector Development Initiative, *Republic of the Marshall Islands, Private Sector Assessment, Unpublished:* July 15, 2016

less favorable Compact negotiations, coordinated donor action will be essential for mitigating shocks and smoothing adjustments. In the case of a favorable outcome of Compact funding renewal, development partner actions can assist the RMI to improve its economic growth rate and help ensure growth is increasingly driven by the private sector.

6

CONCLUDING OBSERVATIONS

6 CONCLUDING OBSERVATIONS

This study provides relevant and timely analysis of several Compact scenarios. Following discussions with the principal parties, it is 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. 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 that RMI might face even during a period of delayed and uncertain renewal. In such circumstances, transitional financial support from the US could clearly mitigate some or all of the painful outcomes projected.

It is hoped that the analysis of the Compact economic assistance scenarios in this report may prove useful to the affected parties. The modeling shows that the opportunities for improved economic performance, household income, job creation, and perhaps even a modest reversal of migration trends for the RMI are enhanced in proportion to the level and length of ongoing Compact and related US federal economic assistance. The combination of a robust Compact funding extension will likely be coupled in time with increased development partner financial and technical assistance. This will allow the RMI to prioritize and consolidate its efforts with respect to fiscal and economic reforms consistent with its own desired path to sustained economic growth.

APPENDIX:
WHAT'S WRONG WITH THE COFA TRUST FUND RULES?

Appendix: What's Wrong with the COFA Trust Fund Rules?

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

Various studies of the FSM and RMI CTFs conducted by the Government Accountability Office (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.

Trust Fund Problems Identified

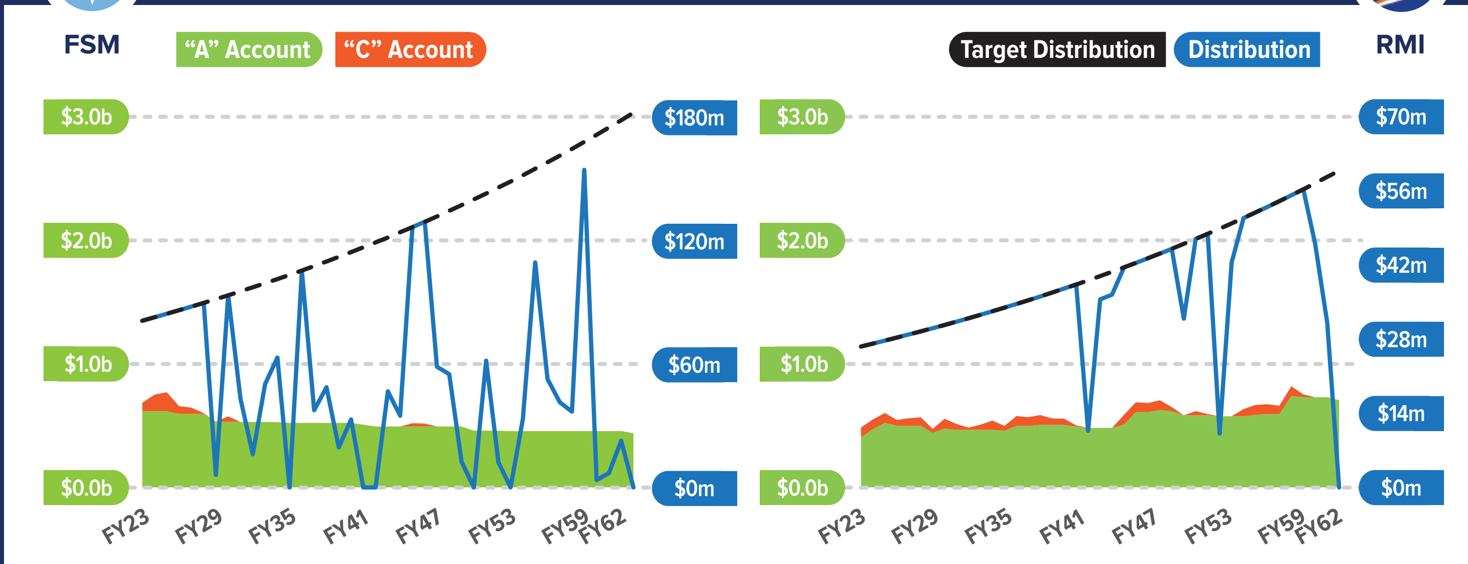
The most important change required in the operation of the CTFs is to establish a direct relationship between the allowable distribution (in FY24) and the size of each CTF at the end of FY23. Under the current COFA rules there is no such linkage. The smaller the CFT value in relation to the allowable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

The Trust Fund Committees for both CTFs are exploring alternative distribution rules to move away from the expectation that the distributions in FY24 would match the real value of the FY23 sector grants. The methods considered include using a fixed percentage rate of distribution (4 percent or 4.5 percent) 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, "FSM and RMI CTFs under COFA Rules (Sim 9)," shows the devastating results that might occur if the prevailing COFA rules are followed based on the case of the FSM on the left and the RMI on the right where the projected value of the CTF at the end of FY23 is undeniably too small to sustain the real value of FY23 sector grants going forward. "Sim 9" is just one of 10,000 cases studied using a statistical method (Monte Carlo analysis) based on actual market returns of six asset classes allocated in a typical institutional investing approach.

In the case shown, the FSM would suffer 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. However, Monte Carlo projections find that the FSM would suffer one or more years of zero distributions in 89 percent of total cases.

FSM and RMI CTFs under COFA Rules (Sim 9)



Can "SAFER" Rules Achieve Better Results?

To resolve the identified problems with the COFA Trust Fund Rules for the FSM and RMI, several practical administrative amendments should be considered; however, the most important methodological change required is to ensure a linkage between the annual distribution from each CTF and the value of each CTF.

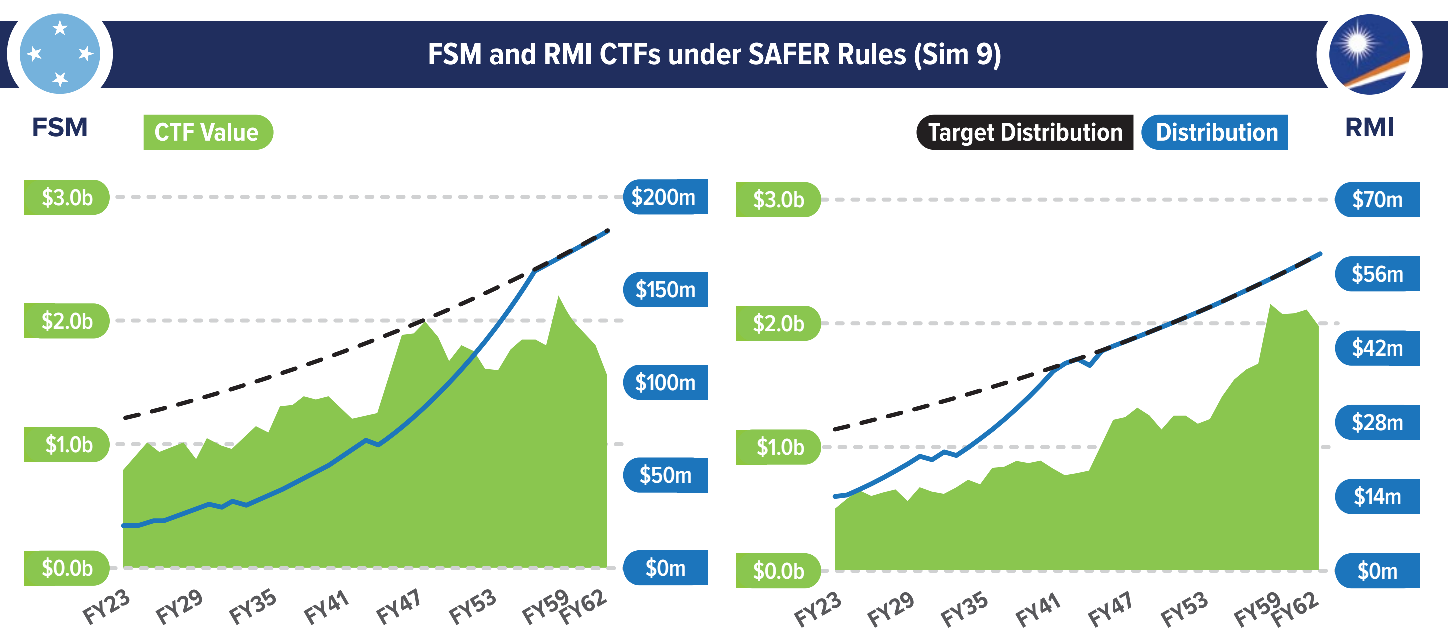
The GSUSA has worked collaboratively with the ADB and the GAO studies. The GSUSA analysis has put a greater focus on comparing a wide range of potential distribution rules. The ongoing goal is to find an optimal distribution rule. Knowing there is now widespread understanding that the COFA Trust Fund Agreements for the FSM and RMI need to be amended (even if only for administrative viability) the ongoing work will be published and available for consideration by the principal parties. Optimization of the rule allows for an objectively scored better result for any given level of each CTF.

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

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

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

The figure below, "FSM and RMI CTFs under SAFER Rules (Sim 9)," 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 non-renewal and independence illustration 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 extending the Compact funding period to strengthen the value of each CTF in proportion to the desired value of annual distributions is, unsurprisingly, the most advantageous way forward for each FAS. Combining such an extension with improved rules yields compounded benefits.

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