Republic of the Marshall Islands

2024

RMI ECONOMIC REVIEW

Republic of the Marshall Islands

May 2025

Graduate School USA

EconMAP

Abbreviations

CURRENCY EQUIVALENTS

Currency unit: United States dollar (US$)

ABBREVIATIONS

ADB	—	Asian Development Bank
AIP	—	Annual Implementation Plan
AMI	—	Air Marshall Islands
AML	—	Anti-Money Laundering
APG	—	Asia Pacific Group
BGRT		Business Gross Receipts Tax
BIF	—	Budget and Investment Framework
BOMI	—	Bank of the Marshall Islands
BPT	—	Business Profits Tax
C-03	—	The 2003 amended Compact
C-23	—	The 2023 amended Compact
CARES	—	Coronavirus aid, Relief, and Economic Security Act
CBDC	—	Central Bank Digital Currencies
CBR	—	Correspondent Bank Relationship
CDC	—	Centers for Disease Control and Prevention
CFT	—	Combatting the Financing of Terrorism
CMI	—	College of the Marshall Islands
CNMI	—	Commonwealth of the Northern Marianas
COFA	—	Compact of Free Association
COVID	—	Coronavirus Disease
CPI	—	Consumer Price Index
CPRO	—	Coronavirus Pandemic Relief Option
CSO	—	Community Service Obligations
CTF	—	Compact Trust Fund
DAEF	—	Disaster Assistance Emergency Fund
DAO	—	Decentralized Autonomous Organizations
DBS	—	Doing Business Survey (World Bank)
DEZRA	—	Digital Economic Zone Rongelap Atoll
DSA	—	Debt Sustainability Analysis
EPPSO	—	Economic Policy Planning and Statistics Office
END	—	Extraordinary Needs Distributions
FAS	—	Freely Associated States
FDI	—	Foreign Direct Investment
FDIC	—	Federal Deposit Insurance Corporation
FIU	—	Financial Intelligence Unit
FMIS	—	Financial Management Information System
FPA	—	Fiscal Procedures Agreement
FRDMA	—	Fiscal Responsibility and Debt Management Act
FSM	—	Federated States of Micronesia
GASB	—	Governmental Accounting Standards Board
GDP	—	Gross Domestic Product
GFC	—	Global Financial Crisis
GFS	—	Government Finance Statistics
GSUSA	—	Graduate School USA
IDP	—	Infrastructure Development Plan

IMF	—	International Monetary Fund
JEMFAC	—	Joint Economic Management and Fiscal Accountability Committee
KBE	—	Kili, Bikini, and Ejit
KYC	—	Know Your Customer
LRA	—	Land Registration Authority
MEC	—	Marshalls Energy Company
MICT	—	Marshall Islands Consumption Tax
MIDAO	—	Marshall Islands DAO
MIDB	—	Marshall Islands Development Bank
MIFV	—	Marshall Islands Fishing Venture
MIMRA	—	Marshall Islands Marine Resources Authority
MISC	—	Marshall Islands Shipping Corporation
MISSA	—	Marshall Islands Social Security Administration
MOF	—	Ministry of Finance
MSC	—	Marine Stewardship Council
MTBIF	—	Medium-Term Budget and Investment Framework
MTEF	—	Medium-Term Expenditure Framework
NSP	—	National Strategic Plan
NTA	—	National Telecommunication Authority
OBC	—	Office of Banking Commission
OIA	—	Office of Insular Affairs
PCRAFI	—	Pacific Catastrophe Risk Assessment and Financing Initiative
PEFA	—	Public Expenditure and Financial Accountability
PFM	—	Public Financial Management
PFMRR	—	Public Financial Management Reform Roadmap
PFTAC	—	Pacific Financial Technical Assistance Center
PITP	—	Pacific Island Tuna Provisions
PNA	—	Parties to the Nauru Agreement
PPA	—	Performance and Policy Actions
PPF	—	Pan Pacific Foods
RFP	—	Request for Proposals
RMI	—	Republic of the Marshall Islands
SCI	—	Statement of Corporate Intent
SEG	—	Supplemental Education Grant
SME	—	Small Medium Size Enterprises
SOE	—	State-Owned Enterprise
SOEMU	—	State-Owned Enterprise Management Unit
SOV	—	Sovereign (Crypto Currency)
SPC	—	The Pacific Community
TCMI Islands	—	Trust Company of the Marshall
TCPA	—	Tobolar Copra Processing Authority
TNC	—	The Nature Conservancy
TRAM	—	Tax and Revenue Reform and Modernization Commission
TRMC	—	Tax Reform Modernization Committee
UBI	—	Universal Basic Income
USA	—	United States of America
VAT	—	Value Added Tax
VDS	—	Vessel Day Scheme

NOTE:
1. The RMI government fiscal year (FY) ends on September 30.

2. Figures in the report are subject to rounding

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Disclaimer

The views, thoughts, and opinions expressed in this economic review are those of the authors and represent an independent assessment of the economic performance of the Republic of the Marshall Islands. This document does not necessarily represent the views of the government of the Marshall Islands, the Graduate School USA, the US Department of the Interior, or any other organization, committee, sponsor, group, or individual.

Foreword

This Economic Review, produced for the Republic of the Marshall Islands, aims to support the RMI in implementing the renewed economic assistance under the 2023 Amended Compact, enacted in legislation by the U.S. Congress and passed into law by the US President in March 2024. This review has also been designed to assist the RMI in overall policy and economic management. It has been developed under contract with the US Department of the Interior's Office of Insular Affairs (OIA) and administered through the Graduate School USA's Pacific Islands Training Initiative. The review is intended to assess the RMI's economic performance and policy environment and to present a comprehensive set of economic statistics.

This Review was prepared in late 2024 with preliminary economic data covering FY24, and the fiscal accounts based on the FY24 Financial Management Information System. Preliminary economic data for FY24 were prepared using a combination of actual outcomes and forecasts.

On behalf of Graduate School USA and EconMAP (Economic Monitoring and Analysis Program), the review was authored by Mark Sturton; Michael Barsabal and Glenn McKinlay compiled the statistical data set. Additional input was received from Emil Friberg, Kevin O'Keefe, and Jason Aubuchon. Special thanks are extended to: Hon. David Paul, Minister of Finance; Fred DeBrum, Director of the Economic Policy, Planning and Statistics Office; Junior Peter also of EPPSO; and the many civil servants and business operators from the RMI

who supported the preparation of this review and its statistical tables.

A digital copy of this review is available online at *http://www.econmap.org*.

Key Features in the Review

The 2021 census recorded a population of 42,418, marking a 20 percent decline from 2011. Based on projections from the 2011 census data and assumptions about migration, fertility, and mortality rates published in previous economic reviews, the Graduate School USA had estimated the 2020 RMI population at 54,962. The sharp decline was not anticipated by the Graduate School, nor was it anticipated by the Secretariat for the Pacific Community (SPC), the United Nations organizations, or other agencies monitoring the region. Economic and employment indicators had not indicated such a sharp decrease, and while high levels of outmigration were recognized, the extent of the decline was unexpected. Clearly, such a large reduction in RMI population will have important implications for many areas of policy.

The direct impact of COVID on economic activity was limited, but GDP declined significantly in the post-pandemic period. Initial projections estimated a 5.5 percent decline in GDP due to COVID, but actual contraction from FY19 to FY22 was 2.7 percent, consistent with typical year-to-year fluctuations. When excluding the fishing sector, the overall decline during the COVID period was a modest 0.6 percent. However, in FY23, the economy contracted by 4.0 percent due to the collapse of the Kili, Bikini, and Ejit (KBE) local government, high inflation, and the end of COVID-related stimulus. Preliminary estimates for FY24 indicate a further 0.8 percent decline. Although the Compact was renewed in 2024, no C-23 operational grants were awarded, tightening fiscal conditions and weakening demand, which contributed to continued economic contraction.

Employment unexpectedly grew by 2.6 percent during COVID but declined in the post-pandemic period. While the private sector lost 363 jobs, or 8.4 percent of its workforce, this was offset by a gain of 660 jobs, or 12 percent, in the public sector. Most private sector losses occurred in the commercial fisheries industry, including 324 jobs eliminated, with 222 layoffs at the Pan Pacific Foods loining plant. In FY23-FY24, employment fell by 4.9 percent, with a total loss of 580 jobs. Although private sector employment rebounded, adding jobs in both fisheries and non-fisheries sectors, the public sector shed 1,099 jobs, an 18 percent decline. This reduction was driven by the collapse of the KBE government and a decrease in national government positions as services normalized following the end of COVID-related stimulus funding.

After a period of modest inflation during COVID, prices increased by 14.9 percent between FY22 and FY24. Inflation remained relatively low during the COVID years, with prices rising by 4.4 percent from FY19 to FY22. The global inflation surge caused by the Ukraine war, stimulus policies, and supply shortages did not immediately impact the RMI. However, in FY23, prices rose sharply by 7.4 percent, driven by higher food costs and increased local government tobacco taxes. In FY24, inflation is estimated at an additional 7.0 percent, though changes in the CPI estimation methodology currently prevent a detailed analysis of contributing factors.

The government raised the minimum wage to $4.00 an hour in FY24 and approved gradual increases through FY28 that will eventually attain $5.25 an hour and align with the basic needs poverty line. In March 2024, the Graduate School USA drafted a Technical Note[1] utilizing data from the 2021 Household Income and Expenditure Survey to estimate a basic needs poverty line at $5.25 an hour. In September 2024, the government enacted legislation to raise the minimum wage to $4.00 an hour, with additional staged increases of $0.50 in FY26 and FY27 and $0.25 in FY28. The Graduate School USA's analysis also projected that reaching $5.25 an hour would add 7.7 percent to inflation over the four-year period.

Fiscal policy in the RMI has been primarily driven by revenue availability, with expenditures closely tracking increases in revenue. During the first decade of C-03 through FY14, revenues averaged 50 percent of GDP, while expenditures averaged 51 percent. From FY14 onward, revenues grew significantly due to increases in sovereign rents, fishing fees, and ship and corporate registry fees, reaching an average of 61 percent of GDP by FY22-FY24 as COVID-related funding declined. Expenditures followed this upward trend, averaging 59 percent of GDP during the same period. This pattern reflects a fiscal policy in which spending adjusts quickly to revenue growth, with no countercyclical adjustments based on economic conditions.

The Fiscal Responsibility and Debt Management law requires review and modification to better align with the RMI's needs. Drafted in late 2019 and modeled on the Cook Islands, the Fiscal Responsibility and Debt Management Act (FRDMA) became law in May 2021, with accompanying regulations issued soon after. Adoption of these regulations was a condition for both the World Bank's Development Policy Operation (budgetary support) and the Asian Development Bank's (ADB) Performance and Policy Actions (PPA), which were necessary for continued grant funding. However, due to the urgency of securing grant support during COVID, the law received limited debate before its passage. As a result, the FRDMA does not effectively constrain expenditure growth within the medium-term revenue framework or in relation to the size of the economy. Revising the law is necessary to ensure it establishes a framework for responsible fiscal

1 See "Minimum Wage in the Republic of the Marshall Islands (RMI)," March 2024, https://pubs.pitiviti.org/rmi-min-wage

management rather than reinforcing existing spending patterns.

The RMI is at risk of losing its "grant only" status with the ADB and World Bank due to the favorable terms of the 2023 Amended Compact and a reassessment of the IMF's Debt Sustainability Analysis (DSA). External debt has declined significantly to sustainable levels under the "grant only" designation, which has helped prevent the debt surges seen during the original Compact period and the early years of C-03. However, with the continued US grant support secured in the C-23 negotiations, the RMI may lose this status in the next DSA update. Irrespective of its status, the RMI remains highly vulnerable to climate change and sea level rise, and past instances of unsustainable debt accumulation suggest the need to maintain the current designation. If the RMI loses its "grant only" status, implementing a well-defined Fiscal Responsibility and Debt Management Act (FRDMA) tailored to the country's needs will be essential to ensuring responsible debt management and sustainable borrowing practices.

With a reform-oriented administration and favorable fiscal conditions, the RMI has revived its previous tax reform program. Following the inauguration of a new administration in early 2024, the positive outcome of the Compact negotiations, strong sovereign rent revenues, and the absence of fiscal pressure, the RMI seized an opportunity to renew interest in tax reform. The government adopted a proposal developed by the Graduate School USA[2], which built on earlier initiatives. The proposed reforms include implementing a Value-Added Tax (VAT) and a business profits tax while repealing the outdated and distortionary gross receipts tax. To oversee the process, the RMI cabinet established a Tax Reform Modernization Committee (TRMC), which has engaged with internal stakeholders, the IMF, and the Palau Ministry of Finance, which recently implemented similar reforms in the Republic of Palau. While initial business community reactions were apprehensive, there now appears to be widespread, if not universal, support for the initiative.

The RMI has pursued several digital fintech initiatives, but these efforts pose significant risks to the integrity of its financial system. In February 2018, the government passed legislation to issue a cryptocurrency, the SOV, intended for use alongside the US dollar. Like other cryptocurrencies, the SOV carries risks related to price volatility, anti-money laundering (AML) and counter-terrorism financing (CTF) compliance, and the potential loss of correspondent banking relationships and access to international financial institutions. Implementation of the SOV was paused, and while legislation to repeal it was drafted, it was never passed. Separately, a proposal to issue a stablecoin has been introduced, but only a limited pilot program is under consideration to assess and mitigate risks. Additionally, the RMI enacted legislation allowing the establishment of Decentralized Autonomous Organizations (DAOs), an unregulated structure that presents further financial system risks. In its recent Article IV mission, the IMF recommended repealing the SOV legislation, exercising caution with the stablecoin initiative due to the RMI's capacity constraints, and suspending the DAO project until appropriate regulatory oversight can be established.

The RMI is exploring the creation of a Monetary Authority (MA) to enhance financial oversight and management. As the RMI uses the US dollar as its legal tender, it would not have the ability to conduct monetary, interest rate, or exchange rate policies. However, the MA would still serve several important functions, even in a limited capacity. These include (i) overseeing banking regulation and supervision, currently managed by the Office of the Banking Commission, (ii) managing

2 See "Tax Reform Options for the RMI and Estimation of Fiscal and Economic Impact" May 2024, https://pubs.pitiviti.org/rmi-tax-reform, and "Adopting a Two-Phased Approach to Tax Reform in the RMI" August 2024, https://pubs.pitiviti.org/rmi-tax-reform-2

the local payments system, (iii) handling the RMI's international reserves and operating an account at the Federal Reserve, (iv) providing banking services to the government, and (v) offering financial and economic policy advice. The IMF has been providing technical assistance in developing the MA, and legislation has been drafted to formalize its establishment. To inform the public, the Office of the Banking Commission has prepared a white paper outlining the MA's role. The legislation has been introduced in the Nitijela and is currently under active consideration.

The RMI's 2011 PEFA assessment and 2015 PFM Roadmap require updates to evaluate progress, reassess priorities, and reaffirm the government's commitment to public financial management (PFM) reform. In 2011, the government commissioned an external PEFA assessment, followed by the development of a PFM Roadmap in 2015. To implement the Roadmap's initiatives, a Reform Coordinating Unit was established within the Ministry of Finance with support from the ADB to strengthen PFM and financial reforms. However, progress has been slow, and given the significant time since the initial assessments, an updated review is needed to realign priorities and reinforce the RMI's dedication to improving financial management.

The RMI National Strategic Plan (NSP) lacks the necessary detail to support comprehensive planning and medium-term budgeting and requires revision. Originally developed in 2019 to align the government's long-term development goals, the NSP outlines broad objectives but does not define sector policies, projects, or activities needed to achieve them. It also lacks measurable outcomes that could serve as a basis for performance monitoring. Additionally, the plan does not specify sector activities or outputs that government ministries are responsible for delivering, making it ineffective as a framework for the annual budget process. To address these gaps, the RMI's planning system must be revised to incorporate not only strategic goals and objectives but also outcome performance measures, detailed activities, and quantifiable outputs to guide budgeting and policy implementation effectively. As explored below, these are important requirements of the 2023 Amended Compact.

The SOE sector has struggled with financial underperformance and continues to pose significant fiscal costs and risks to the RMI. Over the past several years, state-owned enterprises have operated at an average annual loss of up to 6.9 percent of GDP, requiring subsidies averaging 5.4 percent between FY21 and FY23. In an effort to improve performance, the government introduced the SOE Act in 2015 to enhance commercial viability, strengthen governance, and increase accountability. In 2018, with ADB support, the government established the SOE Management Unit (SOEMU) to assist in implementing the Act. SOEs developed business plans and submitted Statements of Corporate Intent to the Nitijela, leading to initial progress. However, momentum declined due to the impact of COVID, staff turnover, and resource constraints. Recent sector reviews highlight persistent weaknesses in management and financial capacity, preventing SOEs from operating efficiently. While a Community Service Obligation (CSO) has been implemented for one SOE and is under development for another, broader adoption of CSOs as an alternative to subsidies has been unsuccessful. Addressing these challenges will require long-term solutions, but increasing resources and strengthening capacity are essential for achieving a more commercially viable and financially sustainable SOE sector.

The 2023 Amended Compact provides increased funding but comes with extensive reporting requirements. Signed into law on March 9, 2024, the C-23 agreement marks a significant milestone for the RMI, ushering in a new era of expanded financial resources. Annual sector grants will rise from $35 million (including the Supplemental Education Grant) to $50 million, with an additional $8 million allocated annually for supplemental health and various one-time grants. Federal grants and services will continue, alongside the Joint Economic Management and Financial Accountability Committee (JEMFAC), whose role has expanded. While JEMFAC previously focused on ex-ante grant approvals, its oversight has now shifted toward ex-post monitoring. The agreement also introduces extensive annual reporting requirements, including (i) a budget and investment framework, (ii) an infrastructure development plan, (iii) an implementation plan, (iv) financial reports covering both annual and quarterly periods, and (v) performance reports.

A key change in the 2023 Amended Compact is the restructuring of the Trust Fund to allow for current use rather than long-term investment. The existing trust fund, originally intended as a perpetual source to replace annual sector grants, will be repurposed as "Account 1" to support additional sector grants or individual income assistance, with annual withdrawals capped at 4 percent. A new "Account 2" will be created, funded by $700 million in grants over the first four years, with withdrawals of up to 5 percent allowed to address extraordinary needs in the outer islands. Additionally, carryover funds from previous years will be placed in "Account 3" and allocated for sector use. The "D" account, now designated as "Account 4," will continue to be funded by the RMI, Taiwan, and potentially other donors, serving as a reserve for unanticipated shortfalls.

The RMI is utilizing funds from the Compact Trust Fund (CTF) to support a Universal Basic Income (UBI) program. The CTF agreement allows withdrawals to supplement the original sector grants or to fund the UBI initiative. Following the signing of the Compact, the government began planning the program's implementation and establishing administrative procedures to comply with the CTF subsidiary agreement. While the initial goal was to begin payments by the end of 2024, delays in defining eligibility criteria, payment frequency, and administrative processes have pushed back the timeline. The Marshall Islands Social Security Administration (MISSA) will oversee the program and has been registering eligible citizens, but it must also develop new IT systems to facilitate bank payments and track disbursements. The impact of the UBI on work incentives, access to basic needs, and the cost of living remains uncertain, requiring careful monitoring to assess its effectiveness and ensure it represents the best use of available resources.

Using extraordinary needs distributions from the Compact Trust Fund (CTF) could provide a more efficient alternative to the copra subsidy for outer island income support. The current subsidy supports outer island copra producers despite the industry's lack of comparative advantage in the RMI and its decline across the Pacific. In fact, the RMI copra industry generates negative value added, meaning GDP would increase if production ceased. Under C-23, the government has the opportunity to replace the copra subsidy with targeted income support funded through extraordinary needs distributions from the CTF. This review proposes that distributions align with the basic needs income threshold established in recent minimum wage legislation, ensuring that individuals and households in the outer islands—a key government policy focus—receive sufficient income to cover basic needs. Additionally, shifting away from the copra subsidy could significantly reduce the annual cost of SOE subsidies.

1. Recent Economic Performance

Performance

Economic growth in the RMI was modest during the pre-COVID amended Compact, averaging 1.5 percent annually[3] but with high volatility. The RMI's low average growth during FY04-FY19 reflects periods of substantial fluctuation, with times of strong growth and substantial contraction, see Figure 1. The main drivers of growth during C-03 were dominated by fisheries, with construction, finance, and public sector services playing significant, though lesser, roles, see Figure 2. In the public sector, administration, education, and health have all been forces of growth supported by the disbursement of the C-03 sector grants in education and health, and more recently, by booming sovereign rents (fishing royalties and fees from the shipping registry).

During FY14-FY19, economic growth picked up to an average of 4.4 percent before COVID struck. Most of this result was due to growth in commercial fisheries and the private sector. During the first half of C-03, through FY14, economic growth was weak, averaging 0.8 percent per annum, and without fisheries, it was largely stagnant, growing by a mere 0.2 percent. During the later pre-COVID years, FY14-FY19, the economy grew more rapidly with an annual average growth rate of 4.4 percent. During this period, the fisheries sector and non-fisheries private sector contributed 2.2 and 1.5 percent, respectively, while the public sector made only a modest contribution of 0.6 percent.

3 Log linear growth estimate

Figure 1: Real GDP level and annual growth, FY15 prices, percent

Economic growth has been volatile but was displaying signs of sustained growth before COVID.

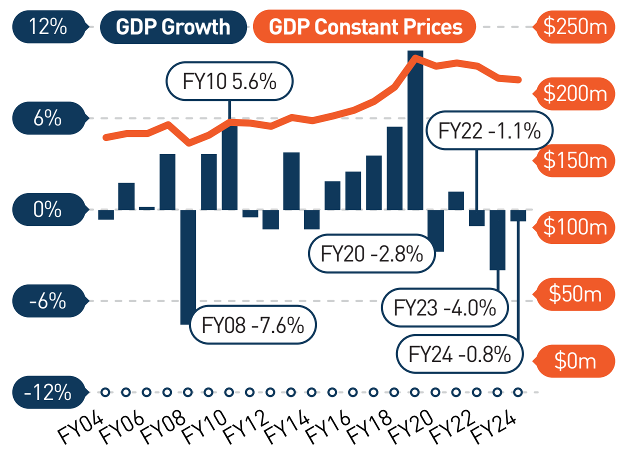
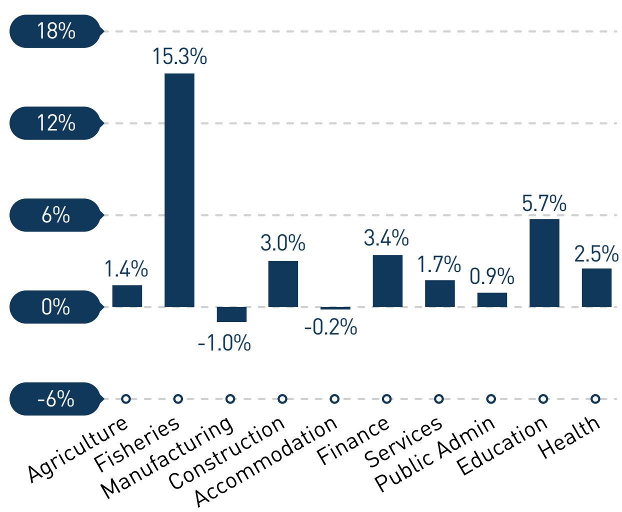


Figure 2: Contribution to economic growth by industry, FY04-FY23

Fisheries has been the main contributor to economic growth



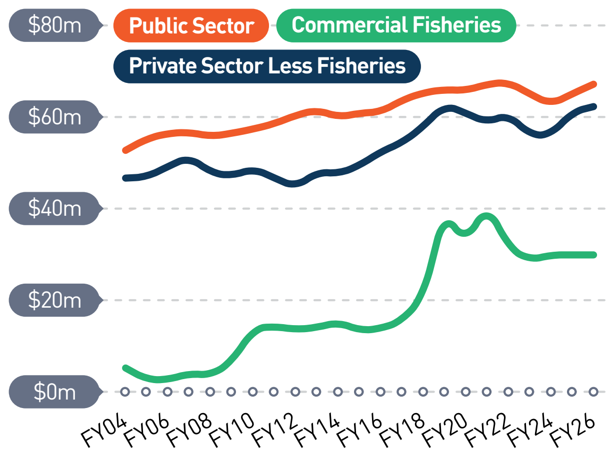
The economic impact of COVID is now estimated to have been modest. The economy is estimated to have declined by 2.8 percent in FY20 at the start of COVID, grown by 1.2 percent in FY21, and fell by 1.1 percent in FY22, *The economy is projected to have fallen by 2.7 percent during COVID, FY19-FY22, and was essentially negligible if the volatile impact of the fisheries sector is excluded.*

bringing the total impact of the pandemic to a 2.7 percent decline over the three years[4]. If the volatile impact of commercial fisheries (-2.6 percent) is excluded from this total[5], the overall impact of COVID during the FY19-FY22 period was essentially negligible. Initial estimates of the impact of COVID had projected an overall decline[6] of 5.5 percent of GDP, but as events transpired, they were similar to the normal annual fluctuations in the economy.

During the pandemic, the public sector maintained and supported the economy while both the commercial fisheries and the non-fisheries private sector contracted. The significant growth in commercial fisheries[7] during FY04-FY24 is evident from the surge in FY10 when Pan Pacific commenced operations and again in FY19 with the addition of 2 new purse seiners to its fleet[8], see Figure 3. During the FY19-FY22 COVID period, commercial fishing contracted by 15.7 percent and was responsible for the majority, 2.6 percent, of the overall (2.7 percent) contraction in the economy. The remaining private sector contracted 2.8 percent and was responsible for 0.7 percent of the overall result. The public sector played a significant role throughout the period, growing consistently. During COVID, it grew by 2.4 percent and contributed 0.7 percent to the overall outcome, mitigating some of the impact of the decline in commercial fisheries and the remaining private sector.

Figure 3: RMI constant price GDP: commercial fisheries, private (less fisheries) and public sectors, FY15 prices

Public sector value added grew consistently with bursts of growth in commercial fisheries



At the industry level, COVID had a mixed impact with some positive effects in unanticipated sectors. The closure of the loining plant[9] due to health concerns (now reopened) had a negative impact on GDP and accounted for -0.6 percent of the overall contraction. Reflecting the reduction of fisheries-related activities and restrictions on shipping entering RMI's borders, port activities also contracted and made a negative contribution of 0.9 percent. However, increased domestic operations of AMI and MISC led to a 1.2 percent increase in GDP, reflecting

4 The data presented in this report through FY23 is based on provisional economic statistics, while the data for FY24 is based on a hybrid of actual and estimates derived from the GSUSA economic model. Actual data is measured for the private, finance and government sectors (52 percent of the total), while for fisheries, SOEs, government agencies, and non-marketed production estimates are derived from the model.

5 Double deflation of Pan Pacific foods value added led to a significant reduction in GDP.

6 Graduate School USA, September 2021, Economic Brief, Honolulu.

7 Includes domestic nearshore fishing, Pan Pacific fishing and loining (manufacturing), MIFV (manufacturing), and Koos (transshipment).

8 In FY19 Pan Pacific withdrew 3 leased vessels that had not been included in GDP and replaced them with 2 new vessels that were included in GDP.

9 The fish loining plant is treated as part of the manufacturing sector in GDP.

additional support to the outer islands during the pandemic. It had also been feared that the construction sector would suffer a major decline. However, the recorded impact was minor, and the sector made a small positive contribution of 0.3 percent. Despite the negative impact of travel restrictions on key skilled personnel, the construction industry avoided large cutbacks. Finally, while there were other offsetting impacts, the education sector is estimated to have supported the economy by contributing a positive 1.0 percent to GDP growth.

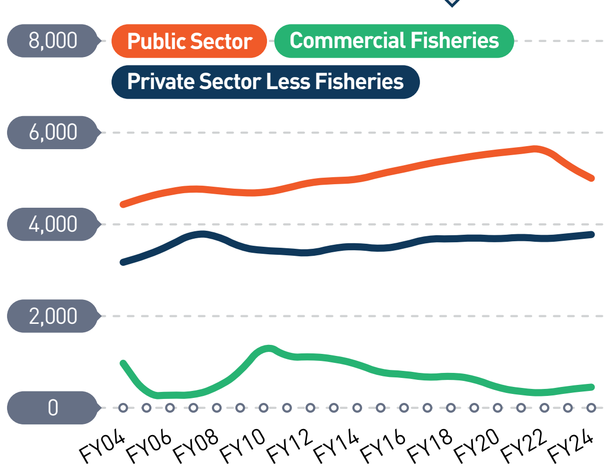
The post-COVID results for FY23-FY24 saw a continued contraction in the economy of 4.7 percent despite the emergence from the pandemic. While inflation remained modest in FY22 and did not follow the surge experienced in the global economy, it picked up in FY23 and FY24, recording rates of 7.4 percent and 7.0 percent, respectively, depressing consumer demand. The cessation of payments from KBE (Kili, Bikini, Ejit) local government had further large macroeconomic implications. Transfers to households fell dramatically by $4.4 million or 41 percent with the termination of transfers from the resettlement fund, and employment by the local government fell from 784 to 211 jobs (albeit at low wages). This had a negative impact on the banking sector as loans secured against payroll went into default. Further, government expenditure fell by 4.4 percent after the highs of the COVID era, and despite the renewal of the Compact, the RMI had not received any new allocations by the end of the fiscal period. Reflecting these forces, consumer expenditures are projected to have fallen in FY23 and FY24 by 4.8 and 4.2 percent, respectively. On the upside, construction activity was the one bright spot in the economy during this period. It improved slightly with COVID restrictions lifted and supply constraints alleviated, adding a positive 0.9 percent to the overall economic outcome.

Significant job loss after COVID with collapse of the KBE local government and reductions at the national government.

Employment

Before COVID, public sector jobs grew steadily, but in the non-fisheries private sector, employment growth has been anemic. Figure 4 indicates the growth in employment in the commercial fisheries, non-fisheries private, and public sectors since the start of C-03. The pattern in the public sector during FY04-FY19 mirrors that sector's contribution to GDP with little volatility. During the early years FY04-FY13, growth was modest at 0.9 percent per annum reflecting the tight fiscal conditions. With the increase in sovereign rents FY14 through FY19, the RMI's fiscal envelope grew significantly, which enabled the expansion of the civil service by an average of 2.1 percent. In the commercial fisheries sectors, the pattern largely reflects the operation of the fish loining plant. In FY04, the former owners of the plant

Figure 4: RMI employment in commercial fisheries, private (less fisheries) and public sector
After FY10 public sector employment grew steadily as private sector (less fisheries) employment stagnated



ceased operations and employment in the sector declined. In FY09, the plant reopened under new management, Pan Pacific, and employment peaked in FY10. However, beset by labor shortages, employment levels fell through FY19. In the remaining non-fisheries private sector, employment growth reflected the health of the economy. During the fiscally repressed era, FY04-FY14, employment growth was anemic, growing by an annual average of just 0.2 percent per annum. As economic conditions improved FY14-FY19 pre-COVID, private sector job creation increased, recording an annual average of 1.4 percent.

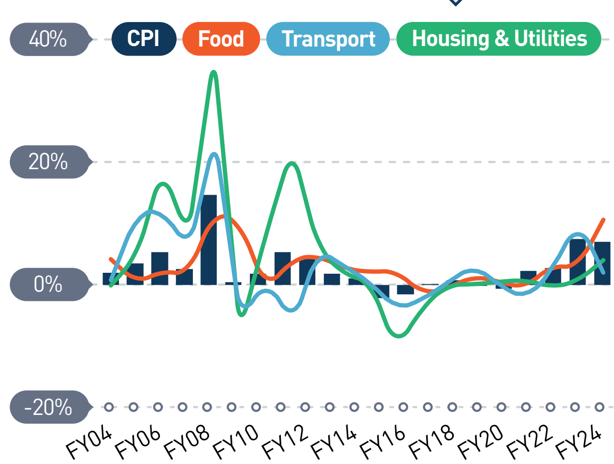
During the COVID period, FY19-FY22, a gain of 299 jobs or growth of 2.6 percent of the workforce was experienced despite the impact of the pandemic. While a loss of 363 jobs was experienced in the private sector, this was more than compensated for by a gain of 660 jobs (12 percent) in the public sector. In the commercial fisheries sector, there was a loss of 324 jobs, with 222 employees being laid off at the Pan Pacific loining plant, 49 at the MIFV shore base for longliners, with the remainder in other domestic fishing operations, including purse seining. In the early stages of the pandemic, fishing operations were restricted due to travel and port regulations. Under the US CARES Act, plant workers at the loining plant were able to increase their income through higher unemployment compensation, while at the same time, Pan Pacific was able to cut back on loining operations and reduce costs. In the non-fisheries private sector, a loss of 62 jobs was recorded. Clearly, the overall impact of the pandemic was far less than originally feared as the government significantly increased job opportunities, which more than compensated for the reduction of jobs in the private sector.

During the post-pandemic period, FY22-FY24, the loss of jobs was negative and opposite to that created during the COVID era. In the commercial fisheries sector, with the loining plant reopened, 141 jobs were recreated although this was less than the loss recorded during COVID of 324. The downward trend at the loining plant continued, reflecting the marginal nature of the operation. For the non-fisheries private sector, 113 jobs were recreated, surpassing the loss of jobs during the pandemic. In the public sector, the changes were exactly the opposite as 1,099 jobs were lost compared with the 660 created during COVID. This reflected two factors: the loss of 573 jobs at KBE and a loss of 502 jobs at the national government. The reduction of national government employees reflected the reduction of contractor workers hired during the later stage of COVID of 427, and a reduction of 75 civil servants due to migration, labor shortages and other factors. During the post-COVID period, FY22-FY24, there was a loss of 580 workers or 4.9 percent of the workforce.

Inflation

Inflation was moderate after the global financial crisis and did not rise in FY22 as global inflation rose rapidly. After the initial part of C-03 and the rapid price increases of the global financial crisis, inflation moderated and the overall price level at the end of FY19 was slightly below that of FY12, see Figure 5. Inflation continued to be modest at the start of the pandemic, falling by 0.7 percent

Figure 5: Change in CPI by selected major commodity groups, annual percent change
Inflation surges in FY23 and FY24 reflecting global rises in prices



in FY20 and rising by a moderate 2.2 percent in FY21. In FY22 inflation rose by 2.8 percent but failed to surge to levels experienced in the global economy or other regional nations such as Palau, which recorded 13.2 percent. In the RMI, the major driver of inflation in FY22 was increases in the international oil price, which reflected the impact of the Ukraine war, causing the transport section of the CPI to rise by 8.9 percent. However, this large increase was offset by moderate increases in food and other prices.

In FY23 inflation rose by a significant 7.4 percent and global price increases had finally arrived in the RMI. In FY23, inflation shot up, reflecting a large increase in food prices of close to 10.5 percent, contributing 4.1 percent to the overall result. In addition to the increases in food prices, the increase in taxes on tobacco by MalGov led to a 21.4 percent increase in the cost of "other goods and services" and contributed 2.1 percent to the overall increase in the CPI. With the fortuitous decline in oil prices, transport costs moderated, but the housing and utility section, which includes electricity prices, rose by 4.0 percent, adding 0.9 percent to the cost of living.

Increases in fuel costs without the provision of increased tariffs placed MEC in financial distress. By September 2022, the MEC had recorded a doubling of fuel costs, but without any increase in tariffs, the utility was running a large deficit and cash reserves were close to exhaustion. An increase in utility tariffs at the end of 2022 was requested by the MEC Board, and Cabinet approved increases for businesses and government while rates for residential customers remained unchanged. With the fall in oil prices at the start of FY23, the increase in tariffs reverted to prior levels. A new utility tariff, prepared with support from the ADB, has been approved by the cabinet and is due to come into effect shortly.

Inflation during COVID was modest but rose rapidly between FY23-FY24 by 14.9 percent.

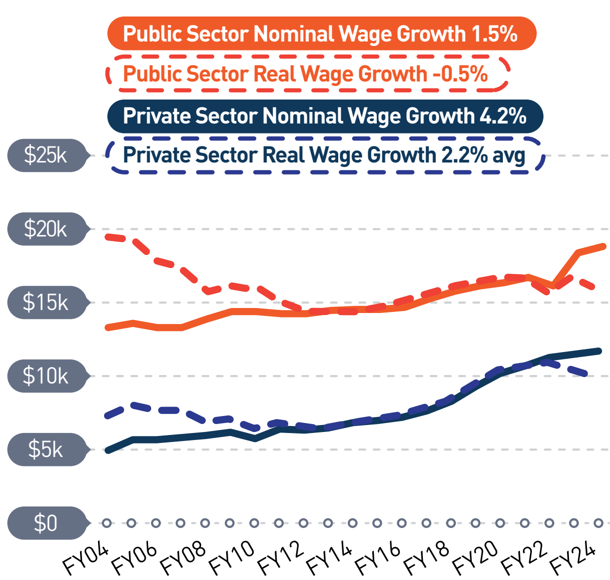
In FY24, prices continued to rise rapidly by 7.0 percent. However, analysis of the contributions to the increase is complicated by the change in both the method and items priced in the CPI. Reflecting the 2021 Household Income and Expenditure Survey and with support from the IMF, EPPSO revised and improved the CPI methodology and more than doubled the number of items in the CPI basket. While this will improve the accuracy of price changes, in the short term and during FY24, analysis of price changes is not possible and has not been attempted.

Wages

Over the long-term FY04-FY24, real wages have grown in the private sector and fallen in the public sector. Taking a long-term view of nominal and real wages, Figure 6 describes developments since FY04. Average nominal wages in the private sector have grown by 4.2

Figure 6: Nominal and real wage rates (FY15 prices) by major institutional sector

Real wages have risen since FY14; but declined in FY23 and FY24 with high rates of inflation



percent while those in the public sector grew by an annual average of 1.5 percent. In real terms, real wages grew by 2.2 percent and negative 0.5 percent, respectively. However, these figures represent averages and there have been three distinct periods in wage developments in the RMI.

While real wages fell significantly during the first part of the amended Compact, they rose significantly during FY13-FY21. During the early years of C-03, between FY04 and FY12, which covered the period of the Global Financial Crisis, nominal wages in both sectors were repressed and failed to keep up with inflation, reflecting the tight financial conditions facing the RMI. Real wages in the two sectors fell by 2.3 and 3.6 percent in the private and public sectors, respectively. The RMI experienced high rates of inflation during the GFC eroding the small increases in nominal wages. During the subsequent period between FY13 and FY21, financial conditions improved significantly with large increases in sovereign rents. Over this period, inflation was negative, recording -0.4 percent. Real wages grew by 6.8 and 2.2 percent in the private and public sectors, respectively.

More recently, in FY21-FY24, inflation once again surged, eroding the value of nominal wages. During the FY21-FY24 period, private sector wages grew by an annual average of 2.9 percent but after inflation fell by 2.8 percent. In the public sector, nominal wages grew by 4.9 percent, but real wages fell by 0.8 percent. However, part of the changes for the public sector reflects the demise of the KBE local government, and for the national government, individually nominal wages grew by 1.2 percent and fell by 4.5 percent in real terms.

The wage differential between private and public sectors has fallen continuously since FY04. The wage differential between the private and public sectors has been large throughout C-03 although the different skill mix between the two sectors would explain much of the difference. However, the differential has fallen gradually over the period from close to 2.7

The RMI introduces minimum wage legislation to bring wages up to a basic needs level.

in FY04 to 1.6 in FY24, which is a welcome development. More recently, labor market conditions have tightened in the private sector reflecting significant out-migration and have led to skill shortages and rising wages.

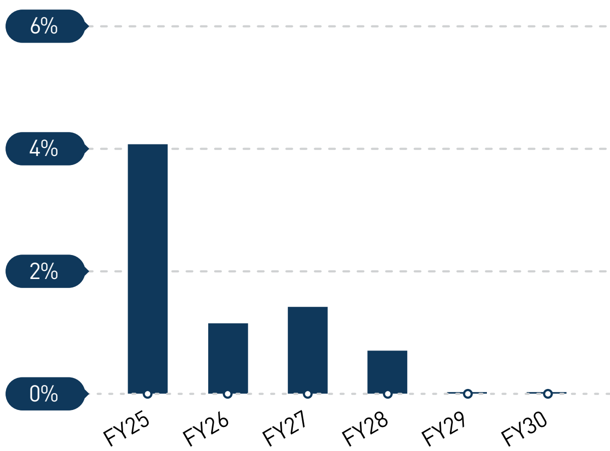
At the end of FY24, the government passed legislation to increase the minimum wage. In 2017, the Nitijela passed legislation to raise the minimum wage to $2.50 and increase the rate by 50¢ an hour to $4.00 every subsequent year. However, while the minimum wage was increased in 2018 to $3.00 an hour, no further increases were approved. In 2024, the Graduate School prepared a technical note on "Estimating an Appropriate Minimum Wage in the Republic of the Marshall Islands (RMI) Based on the Basic Needs Poverty Line."[10] As a result of the analysis, the Government decided to increase the minimum wage to $4.00 an hour effective from the start of FY25 and to increase by 50¢ in FY26 and FY27 and by a further 25¢ starting in FY28, bringing the total to $5.25, the rate recommended in the GS technical note that would provide a level of income sufficient to cover basic needs.

Implementation of the minimum wage legislation is expected to have a significant impact on the cost of living. In addition to estimating a basic needs income, the GS paper also estimated the potential impact on wage costs and inflation. The paper indicates that full implementation of the minimum wage to $5.25 an hour from present levels would increase private sector wage costs by 46 percent and for local government by 52

10 Graduate School USA; *Estimating an Appropriate Minimum Wage in the Republic of the Marshall Islands (RMI) Based on the Basic Needs Poverty Line*; Honolulu, Hawaii, see https://pitiviti.org/marshall-islands, March 2024

Figure 7: Inflationary impact of raising the minimum wage

Implementation of minimum wage is expected to have a substantial impact on the cost of living



percent. Other sectors in the economy would be less impacted, and wage costs would rise by 3.5 percent in the banking sector and 5.7 percent in the RMI government. Overall, these increases were estimated to have a potential increase on the CPI of 7.7 percent. Figure 7 indicates the estimated impact on inflation derived from the GS economy model of the RMI economy. Reflecting the phased approach to implementation of the reforms, the figure shows inflation would rise by 4.1 percent in FY25 but more slowly in the following years, with a total accumulated inflation of 7.4 percent over the period of implementation. Both the GS technical note and economic model use a similar methodology of cost-plus pricing, and it is not surprising the results are in close alignment.

2. Fisheries Developments and Policy

Loining plant resumes operations at the start of 2023. In FY20, the largest negative impact of COVID-19 was the closure of the loining plant. The plant was originally anticipated to reopen in FY21. However, access to the US CARES Act provided incentives for keeping the plant closed and for individuals remaining unemployed. Workers who lost their jobs received higher compensation than those working at the plant. From the loining plant's perspective, a similar incentive existed to remain closed and reduce the loss normally incurred from operations[11]. By delaying the rehiring of employees, the business reduced losses until the provisions of the CARES Act expired at the end of FY21. Staffing levels at PPF were 303 employees in FY19 pre-COVID, which had dropped to 82 in FY22, representing the minimum needed to keep the plant functional. In FY24, after reopening, staffing had risen to 177 but still significantly below the pre-COVID level, reflecting the marginal nature of operations.

FSM Arrangement provides discounts to domestically flagged vessels at substantially reduced rates. A particular issue of concern for the PNA region is the operation of the FSM Arrangement (FSMa). The FSMa was established to encourage the development of domestic fishing fleets and to permit access to fishing resources of other Parties' fleets. Fishing operators are accorded domestic

11 Pan Pacific's fishing operations qualify for VDS discounts under the FSM arrangement in exchange for running the loining plant and creating jobs. The loining plant normally runs at a loss and is cross subsidized from purse seine operations.

The FSM arrangement leads to distortions in the management of the Vessel Day Scheme and potential loss of revenues.

fishing fleet status under the FSMa and pay a reduced daily rate, which is considerably less than the current bilateral market rate of $11,500 per day. The issue of concern is whether the reduced fishing fee and concurrent loss in revenue will be offset by increases in benefits to the PNA economies. In the RMI case, domestically flagged operators include Koo's Fishing Company, which operates 4 purse seiners, and two other boats under a joint equity venture with the government. Pan Pacific operates 5 boats. As noted, the loining plant operates at a significant loss in order to take advantage of the reduced domestic fee rate.

FSMa is an economically inefficient regime that misallocates sovereign rents. A recent study[12] of the fisheries sector conducted by the GSUSA suggests that the additional economic benefit to RMI from each domestic vessel compared with bilateral vessels is about $500 per day. Discounts to domestic vessels that exceed $500 per day would thus represent a loss to the economy. Under the FSMa, fish caught by RMI-flagged vessels pay a transfer fee of $4,000 a day when fish are caught in other FSMa jurisdictions. Discounts to locally flagged vessels caught outside RMI waters must therefore at least match the $4,000 to enable fishing operators to cover the cost of the transfer fee. However, the FSMa entails a loss of sovereign rents when fish are caught in RMI waters, and the benefit of the discount accrues to the locally flagged operators. Based on the economic benefit of domestic fishing fleets of $500 per day, plus the transfer fee of $4,000, it's estimated that the annual loss to the RMI economy could be as much as $8.3 million depending on where the fish are caught. In the case of the RMI, fish are frequently caught outside domestic waters, and the loss to the economy will be less. The FSMa is inherently inefficient and incurs a loss in sovereign rents to participating nations. It needs replacement with a more efficient approach in which fishing fleets are rewarded in amounts more closely related to the value added and contributions made to the local economy.

Creation of a new joint venture between MIMRA and the TNC and entry into the tuna global supply chain provides a valid means to create value. The RMI has instigated two important initiatives to diversify the local fisheries industry and create more domestic value added[13]. The first involves the creation of a joint venture, known as Pacific Island Tuna Provisions (PITP), between MIMRA and The Nature Conservancy (TNC). At the start of 2022, PITP supplied its first batch of Marine Stewardship Council (MSC) certified free-school caught skipjack and yellowfin to Walmart. A key part of the process relates to the operations of the VDS, which supports a monitoring and control program to promote sustainability in the fishery. Elements of this system — independent verification and a rigorous chain of custody — have enabled MSC certification of free school caught skipjack and yellowfin fisheries in the PNA region for the last 10 years. The creation of PITP and the associated provisions of the PNA through the MSC process enabled the RMI to enter into an initial one-year agreement to supply Walmart and break into the tuna value chain. After successfully delivering 8 shipments in 2022, the initial one-year agreement was extended by a further two-year agreement in June of 2023. By October 2023, PITP had sourced tuna that produced over 20 million cans of Walmart house brand "Great Value". This new enterprise, if it can further build on its success and avoid countermeasures from established global suppliers, represents a potentially

12 Graduate School USA, *Unpublished analysis of the fishing industry in the North Pacific*, 2019, Honolulu.

13 MIMRA, MIMRA Annual Reports, 2022 and 2023, Majuro.

important means of enhancing the value of the fisheries sector to the RMI.

Measures are underway for the RMI to create a Competent Authority recognized by the EU for the export of fish products. The second area pursued by MIMRA to enhance local fisheries value added is the establishment of a Competent Authority for the export of tuna to the EU. The nascent RMI Competent Authority is the agency that oversees quality assurance and compliance of local fish processing facilities with EU rules for fish handling and prevention of illegal, unreported, and unregulated fishing. A missing link for recognition of the Competent Authority has been its lack of an adequate laboratory to sample and test fish products. To remedy this requirement, MIMRA has expanded its premises to create a new facility that will fulfill a key requirement for EU recognition. A second key element required for recognition is that local fish processors will need to significantly upgrade their infrastructure, facilities, and processing systems. The work to achieve recognition of the Competent Authority by the EU is a long-term process but steady progress is being made.

MIMRA has generated a significant pool of underutilized reserves. In September 2016, the Nitijela passed a law, "*the Marshall Islands Marine Resources Authority Surplus Funds Amendment Act*", designed to enable "surplus" funds, defined as resources in addition to those approved by the Board as part of the annual budget, to be transferable to the government. The provision arose due to the large accumulation of unused revenues in the MIMRA account, which had reached over $30 million by the end of FY16. In FY17, approximately $14 million of the surplus reserves were drawn on and used to fund additional expenditures. However, the remaining reserves are substantial and by the end of FY23, current assets recorded a value of close to $33 million. The reserves are held either in cash or TCDs.

MIMRA undertakes new initiatives to increase retention of valued added.

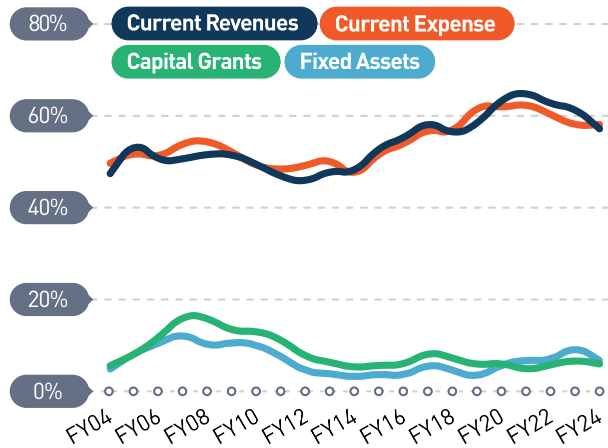
Revisions to the Fiscal Responsibility and Debt Management Act would provide a sound basis to guide the use of any available reserves. The use of any additional funds (such as what occurred in FY16 to inflate general fund expenditures) does not reflect responsible fiscal management. The current legislative framework for the identification and use of surplus funds is not well formulated. It reflects Article VIII of the Constitution, which enables surplus funds to be treated as "unanticipated revenues." Unanticipated revenues can be apportioned by the cabinet of the day without the need for appropriation by the Nitijela. Revision of the Fiscal Responsibility and Debt Management Act, discussed in the next section, would provide an appropriate institutional structure to guide responsible use and investment of the reserves, including possible transfer to accumulation in the proposed cyclical and/or climate reserve funds or the proposed new Central Monetary Authority. The adoption of well-defined principles in the FRDMA to guide the use of any surplus funds could then establish a sound basis for resource management without the risks of fiscal indiscipline inherent in current practices and law.

3. Fiscal Performance and Policy

Long-Term Fiscal Trends[14]

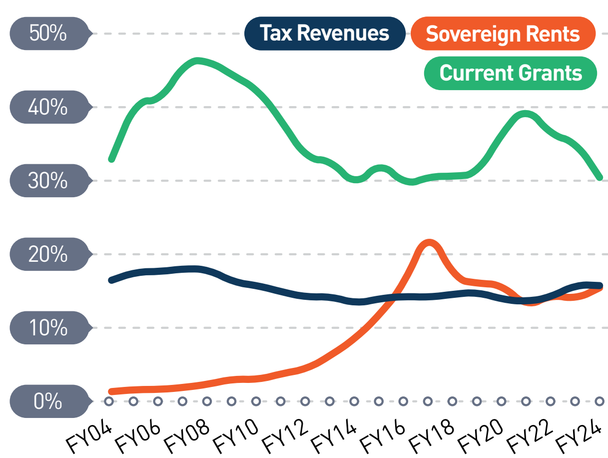
After falling as a share of GDP in the first half of C-03, revenues rose rapidly in the second half with the growth in sovereign rents. Figure 8 indicates recent trends in fiscal performance, highlighting current revenues and expenses, along with capital grants and fixed assets, as a share of the economy. During the first ten years of C-03 through FY14, revenues declined as a percent of GDP due to an inelastic and outdated tax regime and the static nature of Compact and other current grants in nominal terms (see Figure 9). The FY14-FY19 period saw growth in new forms of revenue, particularly sovereign rents, comprising both fishing royalties from the VDS under PNA and increased earnings from TCMI, resulting in an 11 percent increase in the ratio of revenues to GDP. During the COVID period, FY20-FY21, upward momentum in revenues was sustained by large grants for health protection and budgetary support to mitigate the pandemic's impact. However, after FY21, COVID grant support began to taper off, and with the end of C-03 in FY24 and the lack of replacement grants from the new Compact arrangements, revenues to GDP fell further.

Figure 8: RMI consolidated revenues and expenditures, percent GDP
RMI executes expansionary budgets during FY15-FY22 with overall fiscal surplus averaging 2.0% of GDP



Payroll has declined as a share of GDP, but expenses on subsidies and transfers have doubled. The decline in revenues-to-GDP ratio before FY14 led to a tight fiscal period with constrained expenditures. However, as the revenue base expanded with sovereign rents, expenses also grew. The rapid increase in grants during the COVID period financed matching health- and mitigation-related expenses, but these declined as pandemic needs waned at the start of C-23. Within current expenses, payroll declined as a share of GDP from 25.3 percent in FY05-FY14 to 21.6 percent and then stabilized close to 22 percent through FY22. Post-COVID, payroll costs fell

Figure 9: RMI revenues by source, percent GDP
Tax revenues are an inelastic source of revenues while sovereign rents have boomed.



14 Fiscal trends are based on audits through FY21, the old 4Gov IDC/Dilog FMIS in FY21 and FY22 and the new Bisan FMIS for FY23 and FY24.

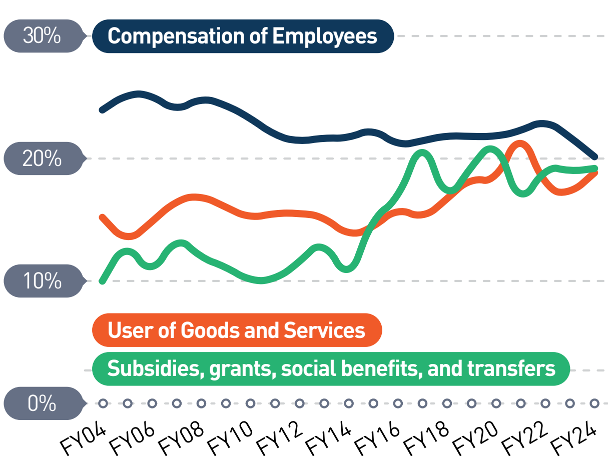
Payroll expenses have declined as a share of GDP while expenses on subsidies and transfers have doubled.

to 20.1 percent of GDP in FY24 (see **Figure 10**). The use of goods and services remained stable until FY17, peaking during COVID due to medical supplies but fell back as the economy emerged from the pandemic, although still above pre-COVID levels. The main area of expansion was in subsidies to the large SOE sector, grants to other government levels, and transfers to NGOs and households, rising rapidly from 11 percent to 19 percent of GDP. Capital expenditures were primarily covered by grants, rising and falling accordingly.

Fiscal policy in the RMI has been driven by revenue availability. During the initial period of C-03 through FY13, budget expenses were forcibly constrained, resulting in an average fiscal surplus of 1.0 percent of GDP[15].

15 In essence the fiscal balance in the RMI is reflected in the difference between current revenues and expenses since investment in fixed assets is financed through capital grants.

Figure 10: Expense by economic category, percent GDP
Subsidies and transfers have grown rapidly since FY14



As sovereign rents boomed through FY18, expenses were less constrained, resulting in an average surplus of 3.4 percent of GDP. However, the expansion in expenses was unsustainable, leading to a fiscal deficit of 1.8 percent of GDP in FY19. During COVID, the strong growth in grants covered additional expenses, avoiding deficits. In FY24, with the start of C-23 and without expanded grants, fiscal conditions tightened, resulting in a projected deficit of 1.7 percent of GDP. Throughout C-03, fiscal policy operated on the basis of utilizing all available resources with little consideration for the stage of the economic cycle or future financing needs, making revenue availability the fiscal anchor.

Fiscal performance over the Medium-Term, FY20-FY24

Revenue Effort

Contrary to expectations, revenues grew strongly during COVID but declined in the first year of the 2023 amended Compact as grant disbursements were delayed. Despite initial expectations of a sharp revenue fall at the pandemic's onset, government revenues increased by $33 million or 22 percent between FY19-FY21, reflecting record-level grants. Revenue remained strong in FY23 but slid by 5.4 percent in the first year of C-23 due to delayed Compact grants (see **Figure 9**).

After declining in FY20, tax revenues grew strongly through FY24, the first year of C-23. In FY20, the tax base contracted by 3.9 percent with reduced economic activity. Despite this, wage tax collections and import duties remained stable, while gross receipts tax fell by 9.0 percent. By FY21, there was a rebound in all tax categories, with BGRT improving significantly, and total collections were 1.6 percent above pre-COVID levels. Tax revenues continued to rise each year through FY24, 23 percent above pre-COVID levels.

The onset of COVID led to a large increase in grants, but these tapered off post-pandemic. Grants increased by 24 percent ($17.0 million) in FY20, supported by US health and unemployment benefits funds and additional ADB resources under the Disaster Resilience Program. In FY21, reduced health funding was compensated with further US CARES Act resources and a large ADB CPRO grant ($16 million for general budget support). By FY23, COVID-related grants were largely exhausted, except for a further $6 million from ADB's Disaster Resilience Program for COVID community spread support. Overall grants in FY23 remained $14 million above pre-COVID levels, largely due to increased World Bank project spending.

The late start of the new Compact, C-23, meant no sector grants were received during the year and were replaced by CTF drawdowns. Delays in the new Compact grants in the first year of C-23 resulted in the RMI replacing FY23 Compact grants of $17.4 million with a $16.8 million drawdown from the Compact Trust Fund (CTF) and temporary funding of $7.1 million from the US under a continuing resolution due to delayed passage of the US budget.

Sovereign rents were a stable source of revenue during COVID and in the aftermath. MIMRA transfers to government hit a record[16] high of $31.3 million in FY20, but subsequently averaged $25.5 million over the next three years, offsetting high levels of grants received during COVID. In FY24, receipts rose to $30 million, reflecting a government shortfall in Compact funding due to the late start of C-23. TCMI receipts, a mix of sovereign rents from shipping and registration fees, averaged $8.0 million during FY19-FY22 and rose to an average of $11.6 million through FY24, reflecting increased transfer agreements with TCMI.

16 In FY17 a large and unusual transfer of $14 million drawn from MIMRA's reserves was credited to the national government, in addition to the normal annual transfer of revenues of $26 million.

Expense Control

During early COVID (FY20-FY21), government expenses grew strongly but fell in FY22, reverting to pre-COVID levels by FY23. Payroll costs accelerated at the start of COVID due to budgetary support from ADB CPRO, leading to additional contract workers. By FY22, payroll costs had grown by $7.9 million, or 15.5 percent compared with FY19. As the pandemic waned, payroll costs fell to 20.1 percent of GDP in FY24, 1.7 percent lower than in FY19 (see **Figure 10**). Use of goods and services was stable with minor variations except for a large spike in FY21 due to COVID-related professional and contractual services. Food expenses increased during COVID for school lunches and outer island food baskets, while travel expenses contracted due to restrictions. By FY24, the use of goods and services exceeded pre-COVID levels[17].

Subsidies to the SOE sector fell during COVID but were offset by private sector subsidies for COVID mitigation. Rapid increases in SOE subsidies during C-03 fell in FY21 due to favorable world coconut oil prices. SOE subsidies remained stable through FY23 but rose to former levels in FY24. Private sector subsidies of $1.7 million, $3.9 million, and $2.7 million were provided in FY20-FY22 respectively, financed by ADB CPRO. By FY23, the economy had reopened, obviating the need for further private sector support. Total subsidies to both SOEs and the private sector fell through FY23 but rose in FY24.

The US compensates the RMI for the loss of trade and investment provisions of the original Compact on the condition that funds are deposited into the CTF. During FY20-FY23, the government deposited $5 million annually into the Compact Trust Fund, reflecting matching compensation from the US for lost trade and investment provisions. COVID-related US CARES Act provisions for unemployment benefits led to fiscal payments of $1.6 million

17 In FY19 there was an exceptional large item for repairs and maintenance which is excluded in the discussion.

in FY20, $5.4 million in FY21, and $0.5 million in FY22, when the program was terminated. Grants to government entities were largely unaffected by COVID, though the annual transfer to MISSA declined reflecting improved Social Security Fund performance. Since FY23, notable expense increases include transfers to households, nonprofits, and schools (including hot lunch program expenditures).

Capital expense

Public investment held steady during COVID despite fears of contraction. Despite the impact on the economy and concerns about reduced investment due to skill shortages, expenditures on nonfinancial assets rose above trend, particularly for health-related equipment. In FY24, fixed investment dropped from the FY23 high.

Financing

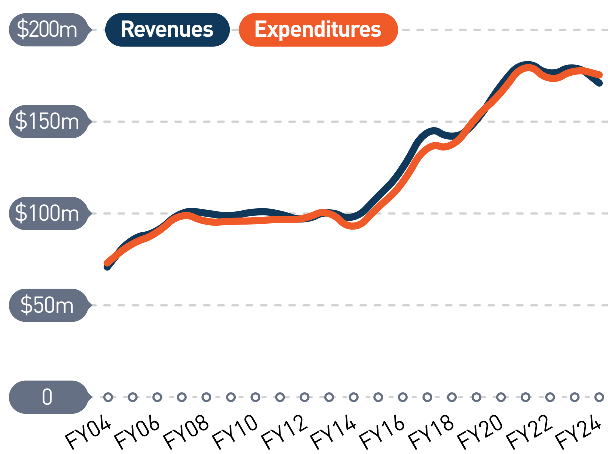
The RMI ran a fiscal surplus from FY20 through FY23, with an estimated deficit for FY24 to cover the shortfall from the late implementation of C-23. Fiscal balance was restored in FY20 with a 2.5 percent surplus, as grant inflows increased deposits. In FY21, the surplus fell to 0.2 percent of GDP as capacity limitations were overcome and cash balances drawn down. Improved surpluses of 1.4 percent and 1.1 percent of GDP were achieved in FY22 and FY23, respectively. An estimated FY24 deficit of 1.7 percent reflects a scramble for revenues to meet the shortfall due to C-23 delays.

Fiscal responsibility

The passage of the Fiscal Responsibility and Debt Management Bill was a key trigger for World Bank and ADB support. Analysis of recent fiscal trends indicates rapidly rising expenditures catching up with expanding

Figure 11: Revenue and Expenditures, $'m

Subsidies and transfers have grown rapidly since FY2014



revenues (see Figure 11). Fiscal discipline to restrict expenditure growth and build reserves for business cycle downturns was absent. Expenditures grew to match the available funding envelope. In 2019, a committee chaired by the RMI Chief Secretary designed a fiscal strategy and considered a fiscal responsibility framework. In late 2019, a Fiscal Responsibility and Debt Management Act (FRDMA) was drafted, adopted by the cabinet in early 2020, and passed into law in May 2021. The adoption of FRDMA-related regulations triggered World Bank Development Policy Operation support and ADB's Performance and Policy Actions (PPA) for continued grant support.

Proposed modifications to FRDMA would better address the RMI's needs. The sudden appearance of COVID in early 2020 left FRDMA with an incomplete technical review. The new law would benefit from adding key elements to better fit RMI's circumstances and fiscal risks.

The Proposed Fiscal Responsibility and Debt Management Act fails to place a hold on runaway expenditures and requires reform.

Most importantly, FRDMA does not restrain expenditure growth within the medium-term revenue envelope or the economy's size. The FRDMA establishes a short-term fiscal anchor related to revenues, compounding prevailing Marshall Islands practices. With a new, reform-minded administration, there is an opportunity to modify FRDMA to reflect the 2019 RMI-vetted fiscal strategy's key principles and set a fiscal anchor in relation to the medium-term outlook and unique RMI fiscal objectives. Revising FRDMA to these principles would create an environment for responsible fiscal operations as intended by World Bank and ADB PPAs.

Tax Reform

The RMI tax regime is inherently inelastic relative to economic growth and in need of modernizing reforms. The RMI, along with its sister FAS states of Palau and FSM, inherited a tax regime from Trust Territory days. Palau has replaced its old regime with a modern system, but the Marshall Islands' regime remains unchanged, outdated, distortionary, and in need of reform. Figure 9 shows the decline in the tax/GDP ratio and the current taxes' inelastic nature: wage withholding tax, gross receipts tax, and import tax. From an average of 17.3 percent of GDP in the first three years of C-03, the ratio fell to 15.3 percent in the last three years, with some discretionary changes. A tax reform process supported by IMF and PFTAC started in 2012, with a legislative package and implementation program prepared. Unfortunately, the package did not gain support and was not passed into law. The business community opposed the introduction of a Value-Added Tax (VAT), even though the tax incidence would fall on consumers.

Graduate School proposes reignition of the tax reform initiative. With a new reform-minded administration in 2024, the time was right to reconsider the tax reform initiative. The favorable Compact negotiations outcome, strong sovereign rent performance, and lack

> *The government re-initiates the 2012 tax reform proposal and legislates removal of wage taxes for low income earners.*

of fiscal stress suggest the conditions were well-suited for reconsideration of the earlier tax reform proposal. A Graduate School policy note[18] outlined the reformed regime's structure. The concept was not to propose a new tax system but to lay down the broad principles of the early IMF/PFTAC proposals. The policy note did not propose specific tax rates, as these should be determined through the political process in the Marshall Islands.

The main features of the tax reform proposal include:

- Replacing the BGRT and general import taxes with a modern broad-based consumption tax to eliminate cascading, strengthen compliance, and simplify the tax system
- Introducing a business profit tax for large businesses while retaining the BGRT for small businesses
- Replacing existing specific import duties and local government taxes on alcohol, tobacco, motor vehicles, and fuel with similar excise taxes
- Modifying the wages and salaries tax by broadening the tax base, expanding the current tax-free threshold, and introducing a higher tax rate for high-income earners

A Marshall Island Consumption tax rate of 10 percent was chosen with a Business Profit Rate of 16 percent. The original 2013 reform

18 Graduate School USA, *RMI Policy Note: Tax Reform Options for the RMI and Estimation of Fiscal and Economic Impact*, May 2024, Honolulu. https://pitiviti.org/storage/dm/2024/05/rmi-tax-reform-paper-5-20240510011033193.pdf

proposal rates were included for illustrative purposes. After reviewing the reform proposal, the Minister of Finance responded favorably, and the reforms were adopted in broad outline. The Marshall Islands Consumption Tax (MICT) was proposed at 10 percent, with a $100,000 threshold for inclusion in the MICT and BPT system. The BPT was set at 16 percent, equivalent to the top wage tax band and above the OECD 15 percent threshold denoting tax haven status.

The Minister of Finance proposed a two-part process. In addition to the Graduate School's outlined reforms, the Minister proposed (i) immediate tax relief for those at or below the minimum wage ($160 a week or $8,320 a year) and (ii) adopting the full reform proposal by FY26 and extending the minimum wage allowance to all taxpayers. The initial phase was estimated to cost $1.8 million, with a total cost of $4.3 million for the full reform package. Efficiency gains were expected to offset revenue reductions, with other revenue increases covering any shortfall.

After initial apprehension, the business community warmed to the tax reform proposals. In June 2024, the cabinet approved creating a Tax Reform Modernization Committee (TRMC) to steer the process. TRMC was chaired by the Chamber of Commerce President, with the Secretary of Finance as Vice Chairperson and other members from Nitijela and the business sector. Initial apprehension was expressed in parts of the business community. However, after an IMF staff visit in October and a subsequent workshop in Majuro, where Palau's Minister of Finance and the Director of Tax and Revenue explained their tax reforms, the Marshall Islands business community better understood the merit of the proposals, which received general, though not unanimous, support.

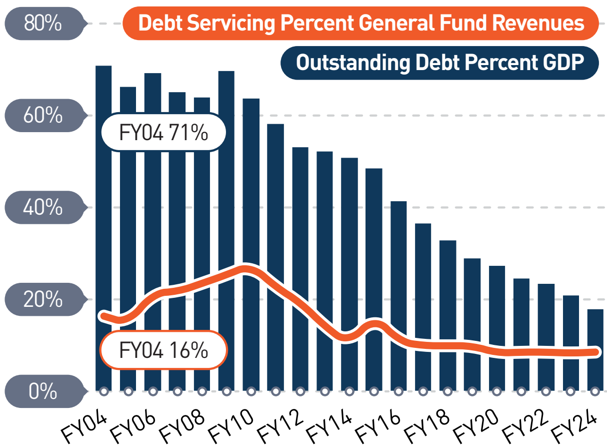
IMF fields a tax reform mission to review the proposed reforms and broadly agrees with the approach. In December 2024, an IMF tax reform mission in Majuro analyzed the proposed reforms and made recommendations. The mission supported the proposed regime changes but suggested modifications to specific taxes and rates. The main focus was the proposed income tax exemptions for those earning less than the minimum wage. These proposals reduce the take-home pay of those just above the threshold, making it lower than those below the threshold. The IMF team proposed addressing this anomaly and introducing a more progressive regime to cover the revenue shortfall. While the IMF's progressive proposal may meet resistance, the anomaly's distortionary nature is clear. Next, RMI officials and private sector representatives will visit Palau to review their similar tax regime changes.

External debt management

External debt and debt service fall to low levels. The IMF/World Bank's former Debt Sustainability Analysis (DSA) designated the RMI at high risk of debt distress, putting it on a "grant-only" basis, making it ineligible for multilateral loan financing. This high-risk assessment was based on the historically high debt-to-GDP ratio and potential resource shortfalls in adverse scenarios after C-03. External debt stress posed significant risk to the RMI fiscal position in early C-03, including periods of delinquency in the late 2000s. However, the current position has improved significantly, with external debt falling from 71 to 18 percent of GDP (see Figure 12). Debt service as a ratio of payments to general fund revenues has also fallen significantly from over 16 percent during the global financial crisis to just 8 percent in FY24.

Following agreement with the US on the terms of the 2023 Amended Compact, the RMI may lose its favored "Grant- Only Status".

Figure 12: RMI external debt (percent GDP) and debt service (percent general fund revenues)
External debt has been falling rapidly with the adoption of grant-only status



The "grant-only" designation served the RMI well under the 2023 Amended Compact, but this status is at risk of termination. External debt has sharply fallen to sustainable levels due to the "grant-only" status, which inhibits third-party debt at non-concessional rates. This requirement has prevented the debt surge seen during the original Compact and early C-03. However, pressure to incur new debt remains. The DSA provision and analysis have imposed a useful brake on past debt-financing trends. With the favorable 2023 Amended Compact outcome, RMI's reclassification to "eligible for both grants and loans" would remove its "grant-only" status.

A well-articulated Fiscal Responsibility and Debt Management Act is essential should the RMI lose its "grant-only" status. During the next IMF Article IV consultations, likely in early 2025, the RMI will be reassessed. While the expiration of Compact economic provisions no longer justifies "grant-only" status, the RMI remains vulnerable to climate change, and past debt trends suggest retaining this status. If the RMI loses this designation, implementing a well-specified FRDMA reflecting RMI's needs is essential for managing sustainable debt levels and well-vetted purposes.

Countercyclical policy, fiscal buffers, and climate events management

The RMI needs countercyclical fiscal buffers and reserves, which could be established and maintained through the use of MIMRA surplus funds. The fiscal policies adopted during C-03 resulted in periods of substantial cash-flow shortfalls and led to fiscal and economic instability. This issue was evident in the failure to service accounts payable and the temporary default on external debt repayments during the late 2000s. The RMI, unlike more financially developed nations, has no access to capital markets. Furthermore, the adoption of the US dollar and the lack of a central bank remove the availability of a domestic source of funds for cash-flow management. Under these circumstances, the RMI needs to build a pool of savings for funding government operations during cyclical downturns and periods of illiquidity. In the previous section, the discussion on the management of MIMRA surplus funds suggested that transferring the surplus to a cyclical reserve would provide a more efficient means of investment and a principled approach to their use.

Target levels of cyclical reserve funds may be set in relation to domestic revenues. Many Pacific Island Countries (PICs) with their own currencies, fixed exchange rates, and central banks operate on the principle of maintaining foreign reserves at a defined level of imports. In the RMI's case, this objective would translate into maintaining a minimum level of resources equivalent to a target number of months of domestic revenues. This could be determined with reference to historical periods of cyclical volatility. One source of funds to establish a cyclical reserve, as discussed above, is the MIMRA reserve, but it could be augmented on a matching basis with donor funding. Once established, the fund would need periodic augmentation to ensure the reserve target was met, and a mechanism to replenish the fund after it had been drawn upon would be identified. Clear rules would need to be adopted to specify the conditions under which the reserve funds could be accessed.

A Climate Resilience Fund is likely to become increasingly necessary. In the case of periodic climate events and natural disasters, the RMI could establish a climate resilience fund to help mitigate adverse impacts. While the RMI does have access to climate event insurance funds from the World Bank and ADB, there may be events and circumstances for which these funds may either be unavailable or not available on a timely basis. Contributions from domestic revenues and from donor partners could be set aside into a resilience fund until a target amount is reached. The exact target amount might be based on the World Bank's Pacific Catastrophe Risk Assessment and Financing Initiative (PCRAFI). In the RMI's case, the risk and cost of an annual climate event have been estimated at about 2.0 percent of GDP. The target for the fund might be set in relation to this risk and the availability of other donor contributions. Withdrawal of funds would be permissible once the president declares a state of national emergency. Commitment costs of the World Bank's and ADB's disaster funds, or premium costs for any other such insurance facility, could be drawn from the climate resilience fund.

4. The Financial Sector

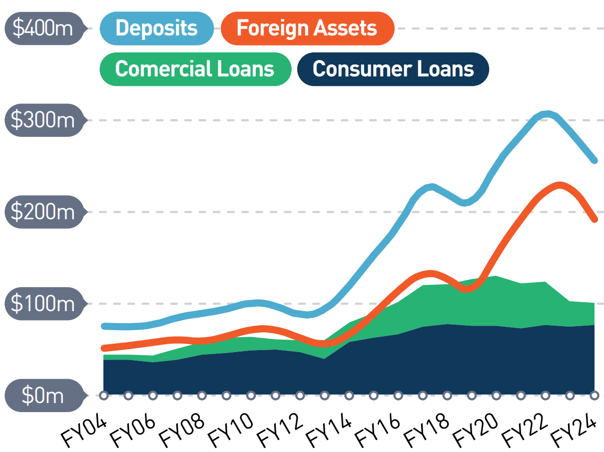
Banking

Bank sector developments

The RMI banking sector is limited to three commercial banks and a development bank. The banking system in the RMI is regulated by the banking commissioner, whose role includes licensing domestic and foreign banks, on- and off-site supervision of all commercial banks, and consumer protection. The Marshall Islands Development Bank does not currently fall under the regulatory inspection of the banking commissioner. There is one US bank, the Bank of Guam, operating as a branch of its parent registered in the United States, which comes under US federal supervisory requirements and is insured by the FDIC. There are now two locally owned banks, the Bank of the Marshall Islands (BOMI) and Pacific Regional Bank. Although the financial system has provided satisfactory and secure banking services, the marketplace, because of its small size and lack of a well-developed supervisory capability, requires careful monitoring.

Savings deposits grew rapidly during COVID as households accumulated savings but have now returned to former levels as households spent the excess. Deposit growth was sluggish during the first part of C-03 through FY12 but has been strong subsequently, growing by an average of 11 percent per annum through FY24 (see Figure 13). This coincided with improved financial conditions in the economy. While growth in demand deposits averaged 13 percent, time deposits were sluggish,

Figure 13: Commercial bank deposits, lending and foreign assets
Commercial bank lending remains weak, funds invested offshore



averaging 4 percent per annum. Savings deposits also grew rapidly by 12 percent. While there were some volatilities in the deposit base due to the timing of payments to Kwajalein landowners, the main notable factor was the rapid accumulation of savings deposits during COVID, which was common to many other economies. After the pandemic, households ran down their savings and have now returned to their former trajectory.

Commercial bank credit growth performance has been disappointing. On the lending side, private sector credit has been weak, averaging 5 percent per annum since FY12. Consumer credit grew rapidly between FY12-FY18 but was largely static during and after COVID, reflecting bank caution during the pandemic and the run-up to the renewal of the Compact. Commercial credit grew rapidly by 17 percent per annum after FY12 before the impact of COVID but fell back dramatically in FY22 due to the write-down of several large loans. Consumer credit was also affected during the same period by the collapse of KBE as 600 employees lost their jobs. Commercial bank non-performing loans are understood to have risen to over 10 percent but after corrective action, NPLs are now reported to have fallen to 3.5 percent.

Rapid growth in commercial bank foreign assets reflects weak private sector credit growth. On the flip side to the low and weak growth in commercial bank lending, foreign investments have risen strongly by 13 percent per annum since FY12 from a level of $62 million, attaining a value of $266 million in FY24. The large accumulation of foreign assets represents the lack of domestic lending opportunities reported by the commercial banks.

Constraints to commercial bank credit

While lending is considered weak, the banking sector operates a more proactive lending policy than its sister Freely Associated States (FAS), the FSM and Palau. The loans-to-deposits ratio attained a level of 39 percent in FY24 in the RMI, compared to ratios of 19 percent in FSM and 13 percent in Palau in FY23, respectively. The greater lending performance, especially in consumer credit, reflects the more active lending policy of the local bank: the Bank of the Marshall Islands (BOMI), which is not FDIC-insured and comes only under local supervision. The weak lending on the commercial credit side has been limited by the inability of businesses to prepare meaningful business plans and financial statements; lack of collateral; and the limited ability to use land as security. The introduction of secure-transactions legislation and a property registry has enabled lending against movable chattels (personal property). With limited perceived opportunities for commercial lending in the RMI, banks have preferred to invest their assets offshore in less risky and more secure markets.

Household Indebtedness

Households are at risk of high-debt stress due to large indebtedness to commercial banks. A further issue relating to banking is the high ratio of consumer debt to household income. Consumer debt represents 28 percent

Households remain at risk of high debt stress due to large indebtedness to the commercial banks.

of GDP and 40 percent of compensation of employees (including Marshallese workers at the Kwajalein US military base). Consumer debt attracts high rates of interest (11.6 percent in FY24) and is largely secured against the payroll of public sector employees through direct allotment, which guarantees repayment. Analysis of government payroll[19] for FY24 indicates average net take-home after-tax pay averages 29 percent of gross wages. While allotments for debt repayment average 32 percent of gross wages, 25 percent of employees allocate 47 percent of their gross wages and 50 percent allocate 31 percent. As a result, government employees are reported to be at high risk of debt stress. Many national government employees have such low levels of net take-home pay that they are unable to meet their basic family needs.

Correspondent Banking Relationships

The RMI banking sector remains at risk due to the possible loss of BOMI's correspondent banking relationship. A particular issue for the RMI has been the worldwide phenomenon of "de-risking" by international financial institutions. To reduce exposure to money laundering, the financing of terrorism, or the stiff penalties imposed by regulatory authorities, international banks have limited Correspondent Banking Relationships (CBR). BOMI has been under threat of losing its correspondent bank, First Hawaiian Bank. The Office of the Banking Commission has upgraded its banking regulations regarding Anti-Money Laundering (AML) and Countering the Financing of Terrorism (CFT) procedures and it is understood that First Hawaiian has been satisfied with recent progress at BOMI. However, a permanent CBR solution is needed. While the de-risking issue has receded, the financial system in the RMI remains at risk until a permanent solution is found. In the case of the Pacific Regional Bank, it has no CBR and thus is severely limited in the services it can provide.

The Credit Guarantee Proposal

RMI considers a credit guarantee scheme to overcome some of the constraints to commercial bank lending. As part of the government's effort to develop small business activity to compensate for some of the constraints to commercial lending, it is proposing the creation of a Credit Guarantee Mechanism. The concept is for the government to guarantee bank lending from both commercial banks and the MIDB to SMEs and construction companies. The proposal includes providing guarantees for MIDB to borrow from commercial banks. SMEs are defined as entities with a turnover or capital investment of less than $50,000. Eligible entities would be in the agricultural, fisheries, and tourism sectors. For construction companies the limits would be raised to $500,000. The scheme would be operated by the OBC or the RMI Monetary Authority once that comes into existence.

The credit guarantee scheme would cover 60 percent of SME defaulted loans and 50 percent of construction operators. The guarantees for SMEs would cover up to 60 percent of defaulted loans with a limit of $100,000 per business and for construction companies, the limit would be 50 percent of a max defaulted loan of $1,000,000. Funding for the scheme has been proposed from the private sector C-23 grant. The scheme would be managed by the OBC or the RMI Monetary Authority if that comes to fruition. Applicant SMEs would be required to complete the Start Your Business course offered by the Small Business Development

19 Derived from the Bisan Financial Management Information System

Centre. All applicants would require a business plan and 3 years of financial statement for construction companies. Recommended interest rates would be 5 percent for SMEs and 8 percent for construction companies.

The credit guarantee scheme has a variety of outstanding issues to resolve but could play an important role in SME development. The loan scheme is currently at an early conceptual stage. While the commercial banks have shown interest, they are asking for greater coverage of risk. The use of C-23 private sector small-sector grant to fund a credit guarantee scheme is a novel concept and has not been considered before. However, it falls outside the normal range of eligible criteria for C-23 grant application. The involvement of the MIDB is also not well developed. It is unclear whether the guarantee applies to MIDB borrowing from commercial banks or MIDB lending to eligible businesses. The definition of SMEs is closer to micro-business and may be a closer fit to the normal business of the MIDB than commercial bank lending. It is also unclear why the scheme is limited to specified sectors of the economy and not open to all SMEs regardless of the area of activity. However, while there are a range of issues to resolve, implementation of the scheme could assist in improving commercial bank lending and SME development.

Social Security sustainability management

An actuarial study in 2011 projected the collapse of the Social Security System in 2023, motivating a series of important reforms. The financial position of the Marshall Islands Social Security Administration (MISSA) was a long-standing issue. MISSA had been identified as being at significant risk and in need of reform. In 2011 an actuarial study projected the threats to the system and the exhaustion of its reserve investments by 2023. As a result of these dire predictions, a series of reforms was proposed in 2013 but were not acted upon by the Nitijela.

Earlier reforms to the Social Security system have improved financial sustainability.

However, given the imminent collapse of the system, a revised version of the reforms was enacted in 2017. The reforms increased the employer and employee contribution rate from 7 to 8 percent, increased the maximum tax wage from $5,000 to $10,000 per quarter and cut benefits by 10 percent. Compared with the original reform list, it was recognized that these reforms would likely be insufficient to restore long-term sustainability. The Nitijela acted to provide annual transfers of $3.6 million in FY17, but these transfers have been gradually reduced to $1.24 million in FY24.

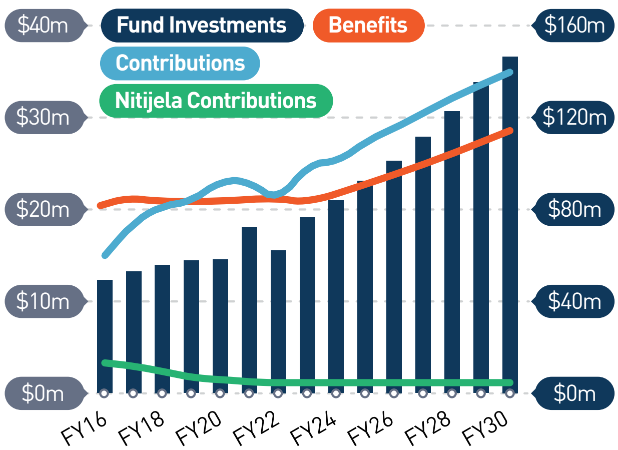
Recent financial data indicates MISSA contributions now match benefits. The impact of reforms and cash transfers appears to have been significantly greater than originally projected. Since FY18 contributions have closely matched or exceeded benefits and in FY23 contributions exceeded benefits by $4.3 million or 21 percent[20]. This suggests MISSA is now on a financially sustainable trajectory, which will allow funds to accumulate from both the excess contributions and annual earnings on investments. Based on the current financial position of the fund, projected contributions (derived from recent economic projections prepared by GSUSA for this review), and projections of benefit streams from prior actuarial assessments, the outlook for MISSA appears favorable.

Projections indicate MISSA's financial position has improved significantly but requires careful monitoring. Figure 14 suggests that the excess of contributions over benefits will continue to expand through FY30. The projections (which are based on a 4.5 percent return on invested assets, the rate assumed in the 2017 actuarial assessment, but including

20 Based on unaudited financial statements.

Figure 14: MISSA benefits, contributions, fund investments and Nitijela contributions

Social Security Funds now projected to rise after recent reforms



the current transfer from the government of $1.24 million) indicate that reserves will continue to rise and attain a value of close to $150 million by FY30, that is, an increase of $72 million on the current fund balances. Without government transfers, fund balances continue to expand and grow through FY30. The results indicate that the financial position of MISSA is out of the danger zone. However, the projections presented here are based on unaudited financial statements and a now outdated actuarial assessment that is overdue for updating. Under these circumstances, it is recommended the government continues to support MISSA through the annual transfer and encourages updates of the actuarial position and benefit projections over the longer term.

MISSA initiates a pilot project for a Social Support Scheme. In addition to the Social Security system that provides benefits on retirement to former employees, the RMI has initiated a pilot Social Support Scheme that is designed to provide a $100 per month benefit to all retired Marshallese who are not members or beneficiaries of the Social Security Scheme. This will be funded through an annual transfer from the government and maintained financially independent of the main SS investments. The Social Support Scheme should assist in supporting old-age households without other support and alleviate poverty.

Corporate and Shipping Registry

The Trust Company of the Marshall Islands is one of the world's largest shipping registrars in the world. TCMI indicates its legal formation and functions on its web site[21] the *TCMI its parent company, International Registries, Inc. through a joint venture agreement with the Marshall Islands government, is authorized by legislation to administer the maritime and corporate programs for the Marshall Islands*. The TCMI acts as registrar and registered agent for Marshall Islands non-resident companies. TCMI currently has registered about 41,000 entities of which close to 5,800 are part of the Marshall Islands-flagged fleet, with a carrying capacity of just over 200 million gross tons. The remaining non-vessel registered entities are largely associated with the shipping industry.

The IMF indicates the nonresident corporate sector is not subject to the AML/CFT framework. In recent IMF Article IV consultations,[22] the Fund indicates that financial integrity risks remain in the nonresident corporate registration sector. Under a long-standing and confidential agreement, the operation of these registries has been delegated to the Trust Company of the Marshall Islands (TCMI), which is a subsidiary of a US company, International Registries Inc. TCMI is subject to limited oversight by the Banking Commission and other government agencies. The Fund indicates that *corporate services provided (by TCMI) to foreign entities registered in the RMI are not subject to the AML/CFT framework, undermining the authorities' ability to properly understand and oversee the sector, obtain*

21 See https://marshallislandslawyers.com/hello-world

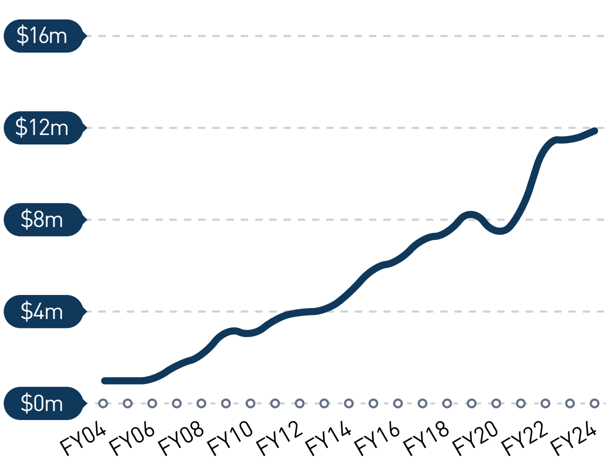
22 IMF, Republic of the Marshall Islands: 2021 and 2023 Article IV Consultation, IMF, Washington DC, October 2021, and 2023.

accurate information, and combat illicit activity linked to offshore activities. In 2019 the EU placed the RMI on its blacklist of "non-cooperative jurisdictions for tax purposes". This was removed later in the year only to be placed and removed from the blacklist in 2023. For the time being at least, the RMI is no longer on the EU list.

A transparent evaluation of the costs and benefits of the Corporate and Shipping Registry remains needed to ensure that the RMI is receiving its fair share of royalties. In addition to the financial integrity risks associated with TCMI, there is concern regarding the distribution of sovereign rents accrued from the activity. At the start of C-03 the RMI government received $1 million annually from the registry, and this gradually grew to $11.9 million in FY24 (see Figure 15). However, there is a general lack of transparency and publicly available financial information on TCMI operations. As a result, the question arises whether or not the RMI receives its fair share of the royalties. However, it is known that in similar jurisdictions the host nations receive a far higher return. There is thus a need for a transparent evaluation of TCMI in light of perceived unfairness and possible underpayment of royalties that are due to the RMI. It is understood that the government commissioned a study to evaluate this issue and to recommend a range of actions, but these findings are also not publicly available.

Figure 15: Royalties (sovereign rents) derived from TCMI, $'m

Revenues derived from the shipping and corporate registry have gradually risen



Fintech Initiatives

The SOV

RMI announced its intention to issue a digital currency, the SOV, in the RMI as legal currency. In late February of 2018, the RMI passed legislation to issue a digital currency based on blockchain technology to be known as the SOV. The SOV was to act as legal currency in the RMI in addition to the use of the US dollar. The passage of the law to issue the SOV resulted in widespread concern. While many countries have considered issuing Central Bank Digital Currencies (CBDC), in the RMI's case the intention was that the SOV would be similar to other cryptocurrencies, which are subject to high price/value volatility. Such volatility could prove highly destabilizing, undermine balance sheet integrity, and disrupt payments. Further, the anonymity of transactions has been one of the major concerns, especially with regard to the facilitation that cryptos afford to both money laundering and the financing of terrorism (AML and CFT). Further, the adoption of the SOV in the RMI could place at risk the Correspondent Banking Relationship (CBR) of the Bank of Marshall Islands with First Hawaiian Bank.

While there was considerable opposition to the SOV, the legislation remains part of the legal framework. There was considerable opposition to the issue of the SOV and in March of 2020 under a new government, a bill was introduced to repeal the SOV legislation. It is known that the initial intent was not to repeal the legislation but to put the process on hold while the then-new administration had time to commission a comprehensive study on whether to proceed with the implementation

Fintech initiatives pose high risk to financial integrity and threaten BOMI's correspondent banking relationship.

of the law. Since that time, no further action has been taken. There has been a further election, and a new administration came into office in early 2024. In their recent Article IV staff report,[23] the IMF "strongly encouraged" the government to complete the repeal of the SOV legislation, something the current administration may wish to fulfill.

Decentralized Autonomous Organization (DAO)

The Nitijela passed the DAO Act, but the new initiative is largely unregulated and subject to the loss of financial integrity. In 2022 the Nitijela passed the "Decentralized Autonomous Organization Act". Investopedia defines a DAO as "*an emerging form of legal structure that has no central governing body and whose members share a common goal to act in the best interest of the entity. Popularized through cryptocurrency enthusiasts and blockchain technology, DAOs are used to make decisions in a bottom-up management approach.*"[24] A subsidiary of a Delaware-incorporated entity, MIDAO Directory Services, acts as a registered agent for the government and comes under the oversight of the Attorney General. To date, 142 DAOs have been approved of which 43 are for profit with the remainder being nonprofit. The regulatory environment for DAOs is still under development but will be supervised by the FIU.25 While MIDAO applications are subject to criminal record checks by a third-party vendor and the Financial Intelligence Unit (FIU) undertakes a due diligence check on initial members, the government has little information on the sector and MIDAO has been assessed as a high risk by the APG. As in the case of the other fintech initiatives, the IMF recommends caution and that a moratorium should be imposed on new registrations until needed oversight can be implemented.

Establishment of an RMI Monetary Authority

RMI is considering the establishment of a Monetary Authority to address gaps in itsfinancial system. The country's financial infrastructure is underdeveloped, lacking the breadth of services and regulatory oversight necessary for a modern economy. With only three commercial banks, and government services concentrated in one bank, the system poses considerable risk. Digital services are limited, with cash or check being the primary methods of transaction, and the check clearing process remains manual. Remittance transfers, which are crucial for the RMI, are slow and costly. Additionally, two of the banks lack secure Correspondent Banking Relationships (CBR), threatening the stability of the banking sector. The emergence of fintech initiatives, including the SOV, DEZRA (now defunct), stablecoin, and DAOs, further underscores the need for a robust supervisory framework, which is currently absent. In response, the RMI is moving forward with plans to establish the RMI Monetary Authority (RMIMA).

The Cabinet has approved the creation of a Monetary Authority Establishment Taskforce to advance the development of the RMI's Monetary Authority. The

RMI prepares for the establishment of a Monetary Authority with IMF support.

23 IMF, Republic of the Marshall Islands: 2023 Article IV Consultation, IMF, Washington DC, October 2023.

24 See, https://www.investopedia.com/tech/what-dao/

25 See IMF Article IV report, October 2023

establishment of a monetary authority has been under consideration for over a decade, initially driven by the need to address issues related to Correspondent Banking Relationships (CBR) and de-risking, which posed a significant threat to the financial system. Concerns over Compact renewal also contributed to the push for such an initiative. Although a bill to establish the Monetary Authority (MA) was drafted in 2015, the RMI lacked the capacity and resources to move forward at that time. In 2022, a policy paper was prepared, and the concept gained momentum in 2023 with support from IMF technical assistance. This process outlined the responsibilities and structure for the MA, including legal frameworks for its governance and operations[26]. In March 2024, the Cabinet formally approved the recommendation to create the RMI Monetary Authority Establishment Taskforce, which subsequently prepared a white paper to increase public awareness of the new institution's objectives and functions.[27]

Many normal central bank functions would be severely restricted in the RMI. The IMF TA paper defines the main objectives of a central bank or monetary authority to be: (i) price stability, (ii) financial stability, and (iii) supporting the general economic policy of the government. However, since the RMI uses the US dollar as its legal tender, several key central bank functions, such as issuing currency, conducting monetary or exchange rate policies, and serving as the lender of last resort to the government, would be unavailable. Consequently, the RMI Monetary Authority (MA) would focus on maintaining financial stability, ensuring price stability where possible, and supporting government policy within the constraints of these limitations.

Despite these restrictions, the MA would still retain several important functions, including:

1. **Regulatory and prudential supervision** are currently implemented by the OBC and would remain so. However, these functions need to be strengthened given the large number of fintech interests focused on the RMI.
2. With the adoption of the US dollar, the MA will have limited capacity to undertake **Market Operations** or influence monetary or exchange rate functions. However, the MA will still have some capacity to influence domestic credit and reserve requirements.
3. The MA could act as a **lender of last resort** to the government in a limited capacity by drawing on international reserves or credit lines.
4. The MA could be given the mandate to manage the RMI's **international reserves**. A key feature would be the establishment of a bank account within the US Federal Reserve System and IMF.
5. The MA could take over the oversight and management of the **payments, settlements, and financial market infrastructures** between local financial institutions. At present, this function is carried out informally among the domestic banks.
6. The MA would implement **cash management** to ensure a sufficient supply of notes and coins, together with the authenticity and fitness of the banknotes in circulation.
7. The MA could provide **banking services to the government**. It could also provide investment services. For example, should the RMI establish either Cyclical or Climate Reserve Funds, it could take on management of MIMRA reserves,

26 IMF, Republic of the Marshall Islands Establishing Monetary Authority, Washington DC, November 2023.

27 Monetary Authority Establishment Taskforce, *Establishing a Monetary Authority in the Republic of The Marshall Islands, Majuro*, August 2024.

which are, in essence, part of the RMI's international reserves.

8. An important function of any monetary body is **financial development and inclusion**. The high liquidity, lack of bankable projects, weak financial literacy, and financial stress experienced by many Marshallese households suggest the need for a broad-based strategy of financial inclusion.

9. An important element of central banks is to undertake **research, policy analysis, and statistical compilation** to formulate sound and effective monetary and financial sector policy.

The MA taskforce has identified an appropriate organizational structure. The organizational structure outlined in the MAET white paper reflects the main features of a central bank available in the RMI and indicates those areas it intends to focus on:

1. **Banking and Payments Department**: The Banking Operations Department will focus on providing banking and treasury management services to the RMI Government, operating the payment system, and managing currency in circulation.

2. **Financial Supervision Department**: This department will focus on maintaining financial system stability and promoting financial sector development, including financial inclusion activities. The Financial Supervision Department is, in effect, a transplant of the current OBC, but its functions will progressively expand beyond those currently undertaken by OBC.

3. **Policy and Markets Department**: This department will provide MA with a research capability, supported by the collection of statistics. The Monetary Stability Department will also monitor financial market conditions and recommend appropriate liquidity management operations when these are needed to underpin price stability.

4. **Corporate Services Department**: This department will provide essential internal organizational support to MA operations through a Human Resources Division, a Finance and Accounting Division, an IT and IT Support Services Division, and a Risk Management Division.

5. **Financial Intelligence Unit**: This unit will carry out the responsibility for AML/CFT supervision and associated national coordination tasks.

The establishment of the RMI Monetary Authority is currently under review by the Nitijela, with consideration expected in the coming session. The creation of the MA will require time to build capacity in the areas it intends to operate. It is crucial that this process does not lead to a reduction in capacity in other government agencies, particularly the Ministry of Finance, as is often the case when new entities are created. However, as demonstrated by the success of MIMRA, establishing an independent body with adequate resources can yield favorable results. The new authority will play a key role in maintaining financial stability and providing sound advice in a nation facing risks in both the traditional banking sector and emerging fintech initiatives. Currently, the Monetary Authority Bill is awaiting consideration for passage into law during the first Nitijela session of 2025. The MA Establishment Taskforce has already completed a set of deliverables to establish and operationalize the MA once the law is passed.

5. Public Financial Management (PFM)

Public Expenditure and Financial Accountability (PEFA)

An update to the Public Expenditure and Financial Accountability (PEFA) assessment is needed to reaffirm the RMI's commitment to Public Financial Management (PFM) reform. The original external PEFA assessment, conducted in December 2011, was followed by the cabinet adopting the report and requesting the government to collaborate with PFTAC to compile a PFM Reform Roadmap (PFMRR). In 2014, PFTAC, in collaboration with the government, prepared the PFMRR. During the first PFMRR review in 2015, a key weakness identified was the lack of prioritization of the adopted components and insufficient resource allocation for implementing the reform initiatives. As a result, progress was slow, and many components had seen little action. Despite this, PFM reform and prioritization have been implicitly expressed through donor-assisted resources over time. Given that it has been 14 years since the original PEFA assessment, an update is necessary. While progress has been gradual, it is essential to reassess priorities and for the government to reaffirm its commitment to PFM reform.

The 2011 PEFA assessment is in need of update to assess performance, reassess priorities and commitment.

ADB technical assistance (TA) has played a crucial role in supporting the PFMRR and ensuring financial stability in the Ministry of Finance. Since 2017, ADB has provided TA to support the Public Financial Management Reform Roadmap (PFMRR), significantly contributing to the Ministry of Finance's financial stability. As part of the 2017-2019 project cycle, a $2.0 million PFM project was initiated to support the Ministry of Finance, focusing on strengthening financial management, accounting, and controls. Key achievements include improving staffing levels within the Ministry and establishing an SOE monitoring unit, which was integrated into the ADB PFM project. The initial project was largely successful, leading to the launch of phase 2 in 2024, valued at $3.8 million, with a third phase of $3 million scheduled for 2027. The ongoing support reflects the difficulty of capacity building within the Ministry of Finance and underscores its critical role in maintaining sound financial management.

The National Strategic Plan 2020-2030

The NSP is a high-level aspirational document[28] *designed as a framework to coordinate the articulated long-term development goals and objectives of the RMI government at the national level. The NSP is intended to be used by government leaders as the roadmap for development and progress in the long-term (2020–2030)*. On May 29, 2019, the cabinet adopted the RMI National Planning Framework and reaffirmed the NSP as the apex planning document with a high-level strategic focus addressing all developmental activity both public and private, including external projects. The NSP includes the following key design components:

- Spans a 10-year timeframe

28 Republic of the Marshall Islands, Economic Policy, Planning and Statistics Office, *National Strategic Plan of the Marshall Islands*, June 2020.

The NSP is a high-level aspirational document and needs extension to include departmental policies, programs, a monitoring framework, activities and quantifiable outputs.

- Sets the national vision and long-term development goals
- Identifies sector over-arching goals
- Specifies the sectors, strategic areas, and related objectives
- Provides a high-level guide for the allocation of budget resources through the MTBIF and annual budget appropriations

The NSP is defined by 5 Pillars, comprised of 24 strategic areas. The five pillars include:

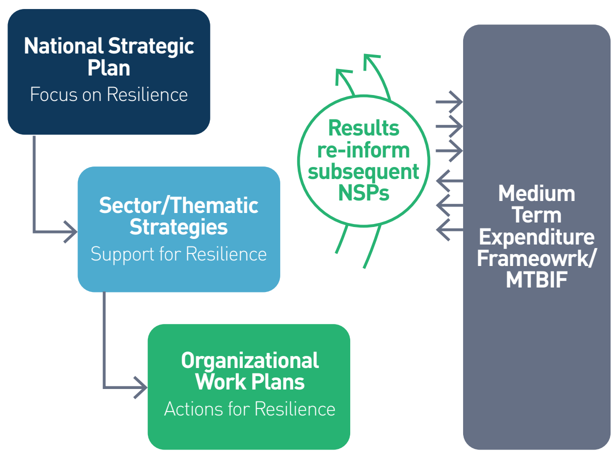
1. Social and cultural
2. Environment, climate change, and resilience
3. Infrastructure
4. Economic development
5. Governance

Each of the 24 strategic areas includes its own overarching goal and objectives.

A three-stage planning process is proposed and integrated into the MTBIF. The planning framework is defined at three levels or stages, see Figure 16. The first level of the NSP defines the goal and objectives of each strategic area but leaves responsibility for the design of sector strategies to the second level, which is not defined explicitly—presumably the relevant departments. The development of a results framework would be included at this stage of the process. At the third and lowest level of the NSP framework, organizational work plans are to be developed, but again the entity responsible is not specified. Medium-term budgets are to be specified at this level. Lastly, the annual medium-term expenditure framework (standard MTEF), or in the RMI case, the MTBIF, the medium-term budget and investment framework, is integrated into the NSP framework.

Figure 16: National Strategic Planning Framework

NSP defines objectives with sector strategies set at the sector level. These feed into the annual budget framework, MTBIF



The National Strategic Plan (NSP) fails to meet the requirements of a comprehensive strategic plan. While the NSP outlines goals and objectives for each of the 24 strategic areas or sectors, it only represents the first step in a typical planning process. A complete planning exercise typically involves two key elements: (i) a macroeconomic and financing framework, and (ii) sector-level plans and programs. This process involves optimizing objectives based on available resources, with a comparison of the financing of the plan against its costs to ensure alignment within the fiscal envelope. The NSP, however, defines objectives but lacks crucial elements, such as sector policies, projects, or activities to achieve these objectives. Additionally, it does not provide a list of outcomes for performance monitoring, nor does it detail sector activities and outputs that government ministries are responsible for delivering. As a result, the NSP does not serve as a guide for the annual budget process. While the NSP designates planning functions to other levels of government, it does not clarify where responsibility lies. In its current form, the NSP is more of a list of national objectives than a fully developed planning document.

The FSM Strategic Development Plan 2004-2023 serves as a strong example of a comprehensive strategic plan. While there is no established format in the design of a strategic/development plan, the FSM Strategic Development Plan 2004-2023[29] effectively meets the needs of the Compact. Similarly, Palau's recently prepared Palau Development Plan incorporates many of the same features.[30] The FSM plan is divided into two parts: macro and sector, although the FSM plan did not integrate the two. Discussion of each sector is divided into three parts: (i) sector review, (ii) strategic goals, policy, and outcomes (measures), and (iii) activities and outputs. For each sector, a set of goals or objectives is defined (as per RMI NSP). For each strategic goal, a set of outcome or performance measures is listed to monitor progress. This aligns with the Compact performance requirements. At the operation level, a set of activities and outputs are outlined for the services each ministry is tasked with delivering. Outputs, being the lowest level of the hierarchy, can be measured and monitored to assess whether ministries have fulfilled the planned or contracted services. This approach is consistent with a "performance management" model and provides a clear framework for the annual budget.

The NSP needs to be extended to incorporate the standard features of a strategic plan.

29 FSM Government, *Strategic Development Plan, 2004-2023, The Next 20 years, Achieving Growth and Self-Reliance*, Palikir, Pohnpei, December 2004. The Graduate School team assisted in the preparation of this document.

30 Republic of Palau, *Palau Development Plan, 2023 – 2026*, Ngerulmud, Palau, August 2023.

The RMI has adopted an incomplete planning system: (i) an NSP which only provides a list of objectives and fails to specify either performance measures or ministerial deliverables and (ii) an annual medium-term budget and investment framework that has no reference document to link activities and expenditures. In other words, there is no framework that aligns objectives with the annual budget. As such, the RMI planning system requires improvement. The NSP should be expanded to include the standard features of a strategic plan, such as strategic goals/objectives, outcome performance measures, activities, and quantifiable outputs. This process will require substantial donor TA assistance. In the FSM example, a series of experts were engaged to write the sector chapters, with a macroeconomic coordinator overseeing the plan. In Palau, a plan coordinator compiled the document based on ministerial programs, though it did not include the same level of review and analysis presented in the FSM case.

Financial Management Information Systems (FMIS)

With World Bank support, a new FMIS was identified, and the new system went live at the start of FY23. The original FMIS, which had been utilized throughout most of C-03, had reached the end of its effective life. The software company responsible was no longer operational, and support was unavailable. With $9 million in donor grant support from the World Bank for budget execution and financial reporting systems, an RFP for a new financial management information system was issued. While initial proposals were deemed unacceptable, a revised RFP was issued, and a vendor, Bisan, was identified. Implementation started in early 2022, and after user acceptance testing and training, the new system went live at the start of fiscal year FY23.

The Bisan system is operational, but compliance with US audit requirements will

be confirmed once the FY23 single audit is completed. During 2024, the Graduate School was requested to perform an assessment of the Bisan system. A set of general findings was outlined:

1. **System installation** was very aggressive. Legacy system transactions and reconciled fund balances were not brought into the new FMIS at the time of implementation but are required for audit and compliance with US federal programs. Considerable time has been allocated by the ADB PFM staff to rectify this issue. System implementation occurred during COVID, creating issues with on-site visits, project staff turnover, and the project manager being absent for a considerable part of the installation.

2. **Standard reporting**: A crucial weakness has been in producing a standard basic set of financial reports, which should have been available from day one. The underlying information is available, but adequate reporting has been absent.

3. **Government Systems**: The software company selected is based out of the Middle East with a client base of largely private sector Middle Eastern enterprises. Bisan provides business enterprise solutions, and the architecture has not been designed to deal with the requirements of either US government fund accounting or GASB.

4. **Limited installed base of users**: As the sole governmental entity with US accounting standards utilizing Bisan, the RMI government is alone both regionally and functionally and thus remains highly dependent upon Bisan for support. Support services are very rudimentary, and there is no online user group. The government should expect to need and budget for long-term support from the software provider.

The Bisan FMIS is up and running but compliance with US audit standards and requirements can only be ascertained once the FY23 audit is compete.

The ADB PFM team has played a crucial role in the development and viability of the FMIS. Their strong support and significant investment of time and effort have been essential in making the system "fit for purpose." Without this backing, the system's functionality and progress would likely have been in doubt. It is understood that a trial balance has now been generated for FY23. However, full testing to ensure compliance with generally accepted U.S. accounting principles will only occur once the FY23 audit begins.

No Changes to the system are recommended in the short term. While the question of whether Bisan is the right long-term solution for the RMI remains unresolved, the recommendation is to maintain the current system for now. This is necessary to bring the audits up to date and prepare for a potential migration if that path is ultimately chosen. The current system's basic architecture, tailored to business applications, its limited user base in government accounting, and its underdeveloped reporting system suggest that a more established solution with a large installed user base, such as those used in CNMI and Palau, might be a better fit for the long term.

The GFS coding in Bisan is inadequate for effective GFS compilation, and reporting is currentlybased on a journal listing. A key issue for the RMI Economic Review is deriving accurate GFS statistics from the FMIS. While it was anticipated a GFS reporting sub-system would have been incorporated into the new FMIS, the vendor only included a crosswalk between the chart of account codes (object class) and GFS. However, there is insufficient detail in the chart to clearly identify certain

GFS categories and additional items in the RMI GFS code set. This design of the chart, whichdid not include any dialogue with GFS specialists, has led to redundant codes in the chart. A practical solution would involve a further breakout of the chart where necessary and developing additional reports where coding at the transaction level is required. The GFS fiscal account included in the Review is based on a journal listing generated from the Bisan system but required a series of steps to produce the final statistics.

Public Sector Payroll

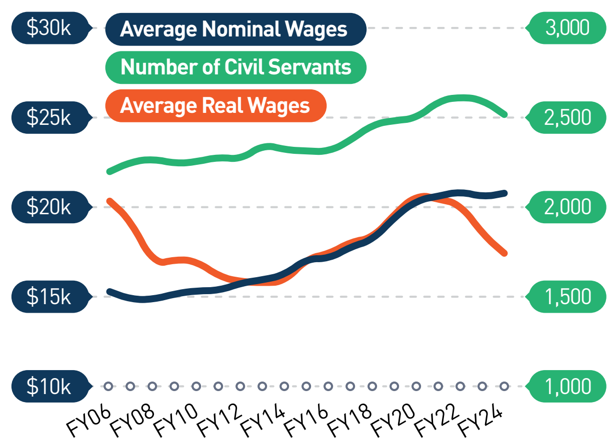
Civil servant numbers have grown modestly since the start of C-03 at an average rate of 0.9 percent per annum. The FY06-FY23 period after adjustment to the amended Compact in FY04-FY06[31] can be divided between the financially repressed period (FY06-FY14), an expansionary period based on rising sovereign rents (FY14-FY21), including the outbreak of COVID, and the post-COVID period (FY21-FY24). Between FY06 and FY14 there was a small increase in employment of 117 jobs at an annual rate of increase of 0.6 percent, which reflected the imposition of a wage and hiring freeze during much of the period, see Figure 17. However, since that time, the public service has expanded at a faster rate, adding an extra 277 jobs at an annual rate of 1.6 percent average growth. This included the COVID years when the government responded with additional hiring. Post-COVID public service jobs contracted as conditions returned to normal, and the workforce contracted by 1,099 people, reflecting a reported increase in outmigration.

Real wages have stagnated since the start of the amended Compact. Wage rates reflected similar forces growing by 1.4 percent per

31 At the start of the amended Compact there was an exceptional increase in 380 public servants or 20 percent in the first two years This was in response to the depressed levels of public employment after the reforms of the late 1990s and the incorporation of Head Start into government.

Figure 17: Government wage bill and share of wages in GDP

Numbers of civil servants remain stable in early Compact but then accelerated as the fiscal envelope eases, and drops back after COVID



annum in the initial period and rising to 5.2 percent from FY14 through FY21. In the post-COVID era, average nominal wages fell. Trends in real civil servant wages are similar to those analyzed in Chapter 1, section d. They fell with rapid inflation in the early period during the global financial crisis, rose in the subsequent period of stagnant prices and low inflation, but fell significantly in the recent post-COVID period as inflation spiked.

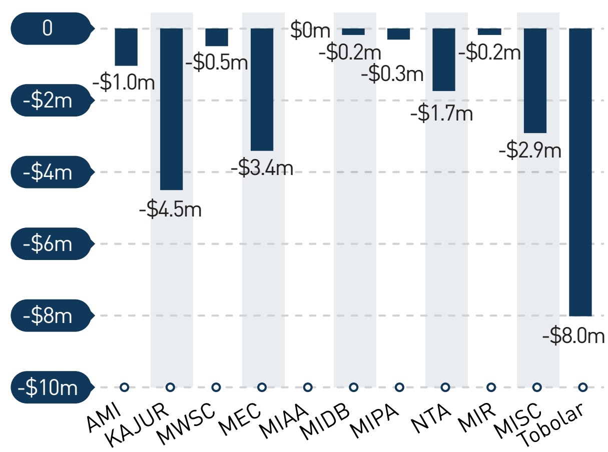
Government payroll declined as a share of GDP during the initial years of the amended Compact. Three important conclusions may be drawn from the above analysis. First, payroll costs as a percent of GDP fell from 25 percent in FY06 to 22 percent in FY14 and then stabilized. In FY23 and FY24, payroll costs fell significantly to 20 percent of GDP, lower than at any point since the start of C-03. Payroll has not been the driving force behind the recent growth in the share of public expense in GDP, see Figure 10. Second, average nominal wages have grown throughout the period despite the imposition of a wage freeze. Wage drift, due to annual increments embedded in civil service hiring conditions, imparts a gradual increase in cost despite attempts to control expenditures.

Lastly, real wages have fallen and grown largely reflecting the rate of inflation.

State-Owned Enterprise (SOE) Reform

The SOE sector, comprising a dozen public enterprises, has underperformed and poses significant costs and fiscal risks. Given the challenges posed by remoteness, small size, and dispersion, SOEs remain active in numerous crucial sectors of the RMI economy. While in many circumstances there are sound reasons for the state to support and subsidize the provision of key public services, the RMI's SOE sector has suffered from weak management, poor governance, and underperformance for many years, operating at an average annual loss of 6.9 percent of GDP and incurring average subsidies of 5.4 percent over the last three years, FY21-FY23. Figure 18 indicates virtually all of the RMI SOEs required significant support over the FY19-FY21 period (latest audits). Furthermore, rates of return on assets and on equity over this period were –10 percent and –16 percent, indicating both poor performance and a negative return on government investments.

Figure 18: State-owned enterprises subsidies and capital transfers, average FY19–FY21
Subsidies and capital transfers to the ailing SOE sector are a persistent drain on fiscal resources



The government of the RMI enacted the SOE Act, but it has been revised on several occasions. In response to these concerns, in 2015 the government introduced an SOE Act designed to focus public enterprises on achieving commercial viability and strengthening governance structures and accountability. The Act included requirements for the annual Statement of Corporate Intent (SCI), Business Plans (BP), and the introduction of Community Service Obligation (CSO) agreements. Unfortunately, the law was shortly amended to reverse reforms that had restricted the participation of government ministers and officials on SOE boards. The law was again amended in 2020 with further provisions concerning the appointment of public officials, requiring at least one but no more than three such appointments. In 2022, the law was again amended, removing both the Ports Authority and telecom provider, NTA, from the list of entities covered by the SOE Act. These entities, with majority public sector ownership, are functionally and clearly SOEs, and their removal from the SOE list was inappropriate. Additionally, the Office of Commerce, Investment and Trade, a government marketing and regulatory agency not involved in the delivery of commercial services, was inappropriately included. Both the removal and addition of these entities indicate a lack of awareness of the functions of the SOE sector.

Reforms to the weakly performing SOEs sector got off to a good start but were constrained during COVID and are suffering from lack of resources.

The SOE monitoring unit was created to implement the law and drive the reform process. In 2018, an SOE Monitoring Unit (SOEMU) was created as part of the ADB PFMRR. The unit started with training Ministry of Finance (MOF) officials and SOE key officials in the contents and implications of the SOE law. Once internal systems and templates were established to fulfill the unit's monitoring mandate, the SOEMU's consultant and three staff members began work on capacity building within each SOE. In FY19 and FY20, virtually all SOEs had completed SCIs for review by the Nitijela and prepared BPs as required by the SOE law. With the onset of COVID in 2020, the work program of the SOEMU was adversely impacted, and momentum slowed.

The SOE diagnostic report paints a dismal picture of SOE management capacity. In June 2023, an SOE diagnostic report was prepared under the ADB PFM TA[32]. The report provides a lengthy study of nine of the listed SOEs. It focuses on financial management capacity, asset management, and the identification of non-commercial activities. The report paints a largely dismal picture of both financial and asset management capacity. The report shows the absence of financial information prepared by CFOs, which is required by boards for the management of the business and for driving performance. The Ministry of Finance (MoF) has issued instructions for the timely presentation of financial information. However, when boards fail to demand the material and there are few consequences for noncompliance, it is not surprising if the MoF instructions are ignored. Asset management is also described as weak, with few SOEs maintaining plans. In the absence of asset management, capital is depleted, which will over time compromise service delivery.

Progress in developing CSOs has been slow. Another report on CSO Agreements was prepared in May 2023[33] by the SOEMU and elaborates further on the development of a CSO structure. Most SOEs engage in non-commercial activities that reflect public policy and prices set by the cabinet. This places the SOE in financial distress and in need of support. However, the identification of non-commercial activities, associated costs of delivery, and the establishment of appropriate pricing for the preparation of CSOs requires a degree of management capacity largely beyond the scope of many SOEs. At the early stages of the project, three SOEs were selected for the development of a CSO structure: Air Marshall Islands (AMI), Marshall Islands Shipping Corporation (MISC), and Tobolar Copra Processing Authority (TCPA). The exercise established that distinguishing commercial from non-commercial activity was subjective, given the range of policy and operational constraints. Furthermore, accounting systems were inadequate for accurately identifying costs. On the positive side, the Majuro Atoll Waste Corporation now operates a CSO, with the delivery of services specified by contract with the Ministry of Finance. It is understood that work is underway to complete the CSO relationship with the Marshall Islands Shipping Corporation.

Solutions to the SOE problem are long-term, but only with sustained support will the sector achieve improvements. After a positive start in 2018, a difficult period during COVID, and renewed effort in 2022, the SOEMU reports its performance has stagnated. Furthermore, the lack of resources allocated to the project has constrained progress[34]. The SOE sector has long presented the government of the RMI with significant fiscal risk and continues to do so. The lack of capacity in financial and corporate management seriously undermines the objective of developing an effective and efficient SOE sector. Solutions to the problem are clearly long-term, but without sustained government and donor support, the sector will continue to be a significant drain on public resources.

32 SOEMU, *State-Owned Enterprise Reform – SOE Diagnostic Study Report Draft*, Grant: 0795-RMI, June 2023

33 SOEMU, *CSO Agreement Report*, Grant: 0795-RMI, May 2023

34 Ibid

6. Private Sector Developments[35]

The World Bank's "B-READY" Survey

Although the World Bank's "Doing Business" survey has been discontinued, it painted a discouraging view of the environment for private sector growth in the RMI. The World Bank's ease-of-doing-business survey has now been discontinued due to certain weaknesses in the conduct of the survey[36]. However, the survey provided a useful broad indicator and yardstick on the attractiveness of the business environment. From the 2020 DBS survey, out of 190 countries, the RMI ranked 153, 81 percent down the list, indicating that there was much room for improvement. The RMI fared worse than Palau but better than the FSM, which were ranked 145 and 158, respectively. This is substantially below most South Pacific nations. Samoa was ranked 98, Tonga 103, Vanuatu 107, Fiji 102, and Papua New Guinea 120. Overall, the RMI's scores were weak. For example, their scores in the areas of registering property and protecting investors fell in the bottom decile of countries, while scores for providing electricity and resolving insolvency were also very weak.

The World Bank should be encouraged to extend the new B-READY business survey to include the Marshall Islands. While the World Bank's Doing Business survey has been discontinued, the survey is being replaced with a new survey titled B-READY, intended to measure the business and investment climate of 180 countries annually. The new survey has already been conducted in 50 jurisdictions with the intention of adding a further 58 in 2025 and 66 in 2026, although the list of countries does not include the Marshall Islands or other Freely Associated States of the FSM and Palau. Enlargement of the B-READY survey to cover the FAS should be encouraged; it enables the three FAS and RMI to benchmark their performance against their peers and form the basis of a roadmap for future private sector reforms.

Private Sector Registration and Licensing

Online upgraded business registration is needed for the transparent identification of business ownership. An unpublished assessment of the private sector[37] for the RMI provides a useful analysis of the regulatory environment for the private sector. Many areas need reform. In the RMI, corporate business registration is conducted through the Attorney General's office. The existing system relies on manual processes that are slow and time-consuming. A modern computerized business registration system in the public domain would allow businesses to be legally identified for commercial transactions. The RMI lacks a national business licensing law; however, local governments do have the power to issue licenses and collect fees under the Local Government Act. This has led to a lack of transparency as well as discretionary decision-making at the local level. Reforms could combine registration and licensing into a single process, but local governments would need to be compensated for their lost revenue due to such a change.

35 This section is largely similar to that in the 2022 Economic Brief, but the material remains relevant and is repeated in the current Review.

36 *"The World Bank's Doing Business Report"*, Congressional Research Service, October 29, 2021, Washington D.C.

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

World Bank's, now defunct, "Doing Business" survey 2020, places the RMI in the lowest 20 percent and indicates that the environment for private sector development is weak and needs reform.

Foreign Direct Investment (FDI)

The environment in the RMI for FDI is antiquated, overly bureaucratic, and in need of replacement with a modern system. FDI is implemented under the Foreign Investment Licensing Act 2005 but appears to have failed to simplify the process as the act was intended to do. FDI permitting is done manually, and licenses take weeks or months to process. FDI licenses are only issued after all other regulatory requirements, such as corporate registration, local government licensing, foreign work permits, Social Security registration, and others have been fulfilled. To reduce uncertainty, an automated process is needed to allow other legal requirements to be fulfilled on a parallel timeline, as is required for any domestic enterprise. There is a substantial list of restricted activities, which appears not to be enforced. This lack of enforcement encourages "front" businesses, which hide illicit economic activity. In a modern FDI regime, businesses are only required to submit information required for statistical and monitoring procedures, and licenses are issued in just a matter of days.

Land Tenure

The Land Registration Authority (LRA) was introduced to support voluntary registration, but start-up has been slow and needs reinvigoration. In the RMI, as in many Pacific Island economies, land is largely owned by customary groups with complex governance structures. Banks are reluctant to take customary land (either owned or leased) for collateral. Non-Marshallese are not allowed to own land, and even transactions between Marshallese are rare. A key objective of economic development is to improve tenure security (i.e., protection against eviction) for both landowners and leaseholders by accurately defining and protecting land rights. In 2004 (with ADB support), a Land Recording and Registration Act was introduced as a means for custom owners to voluntarily register land via an accessible registry of land transactions. The Land Registration Authority (LRA) was introduced to implement the new legislation, but use of the LRA has been minimal. Despite the slow start, the 2004 legislation and LRA are generally considered to provide a sound basis for land administration. The process of improving public awareness, with both government and private sector backing, needs a restart so that secure registration and leasing of land can support its critical role toward business and financial development.

7. Compact Issues

Background

The original Compact of 1986 was extended in FY04, known as the 2003 Amended Compact (C-03), for a further 20 years. The original Compact of Free Association between the US and the RMI was signed by the parties in 1983. A plebiscite was held in the same year and a majority of the RMI confirmed the desire to enter into the Compact of Free Association. The original Compact, which became effective in 1986, was for a 15-year period with a two-year extension through the end of FY03. In FY04, the Compact was extended for a further 20 years through FY23, known as the 2003 Amended Compact (C-03). C-03 contained funding for a series of annual sector grants, supplemental education grants, and support for audits, Kwajalein Atoll, infrastructure, disaster assistance, and funds for a Compact Trust Fund (CTF).

The terms and conditions of the 2023 Amended Compact (C-23) were agreed upon by the US and the RMI in October 2023 and became law on March 9, 2024. In January 2023, an agreement detailing the basic financial assistance to be granted to the RMI was agreed upon between the US Special Presidential Envoy for Compact Negotiation and the RMI Chief Negotiator. However, the agreement awaited passage by both houses of the US Congress. Fortunately, on March 6, the US House passed bill H.R. 4366, including mandatory funding for all three FAS Compact amendments. The US Senate passed the same bill on March 8, and the US president signed the bill into law on March 9, 2024. With the law enacted, a period of rapid mobilization involving both the US and RMI governments followed to achieve "entry-into-force" in a timely manner. Temporary funding that had been provided by the US government for the period from October 1, 2023 – March 8, 2024, was deducted from the grants to be provided under the new arrangements.

The 2023 Amended Compact

There are a series of important instruments that outline the new agreement between the US and the RMI: changes in the Compact law, the Fiscal Procedures Agreement (FPA), and the Compact Trust Fund (CTF) Agreement. These documents are interrelated and lengthy, and the implications have not been fully worked out. The following discussion describes the main features of C-23 as negotiated and enacted.

Direct Economic Assistance

Sector grants

C-23 provides an annual grant for 20 years of $50 million for sector grants with an annual 2 percent adjustor in lieu of inflation indexation. The sectors, see section 261(a), include the original list with some additions and modifications:

- Education: including those services previously undertaken under the Supplemental Education Grant (SEG). It also includes an allowance for partial inflation between FY04 and FY23 of $22 million, omitted during all but the final two years of C-03, referred to as Additional Education Assistance.
- Health
- Private Sector Development
- Capacity Building

2023 Amended Compact comes with a significant increase in grants for an extended range of sectors.

- Environment
- Public Infrastructure with the continuing proviso that priority is to be accorded to the social sectors with second priority accorded to economic projects. A minimum of 30 percent and maximum of 50 percent of the total value of the sector grant total is to be awarded to infrastructure.
- Enhanced Reporting and Accountability: This shall be no more than 2.5 percent of the total sector grants awarded.
- Enewetak Development: This grant shall constitute 4.8 percent of total sector grants awarded.

US Supplemental Health Fund and Joint Health Dialogue

In FY24 the US will provide $20 million for deposit into the Supplemental Health Fund to support efforts to improve health outcomes. A Joint Health Dialogue is to be established, and funds may only be used for programs recommended by the Dialogue. The US will also provide an annual grant for 20 years of $8 million to be deposited into the Supplemental Health Fund for health programs that are agreed upon mutually and may have been recommended by the Dialogue. The funds will be provided on a matching basis and are not subject to the annual 2 percent adjustor.

Climate Fund and Working Group

The US will provide $20 million for deposit into a new Climate Fund to obtain additional assistance to better enable the RMI to cope with challenges from climate impacts, including sea-level rise and other environmental challenges that could threaten the existence of the RMI. A Working Group will be established to obtain additional assistance for climate needs. The Climate fund may only be used to obtain additional assistance for climate needs that are identified by this working group.

Environmental assistance

The US will provide $30 million for additional sector grants for the environment, $20 million of which will be used for environmental feasibility studies and technical assistance and $10 million will be used for future environmental programs.

Kwajalein Development Plan Fund

The US will provide $132 million for deposit into the Kwajalein Development Plan Fund for projects described in the plan adopted in March 2022 by the Government of the RMI to facilitate resilience and healthy communities throughout Kwajalein Atoll.

Nuclear Testing Transparency and Museum

The US will provide $10 million in grants to improve the accessibility of documents and information previously provided to the Government of the RMI relating to the US nuclear testing program, including the subject of waste disposal. A further $5 million will be made available to the College of the Marshall Islands (CMI), to establish a museum and research facility related to the US nuclear testing program.

Infrastructure Maintenance

The government of the RMI will use local funds to make contributions to an infrastructure maintenance fund of $2.5 million in FY24 and adjusted annually by 2 percent through FY43. The US will match the funds contributed by the RMI from the annual $50 million sector grant. The funds may only be used to repair or maintain infrastructure provided by the US.

Annual Audit

Under C-03 the US provided a grant of $0.5 million for the conduct of the annual single audit. In C-23 the costs of the audit will be borne by the RMI from the $50 million sector grant.

Kwajalein Atoll – non-expiring provisions

The non-expiring provisions of the C-03 agreement for Kwajalein will continue as originally agreed. As of FY23 these grants amounted to $9.3 million, which is two-thirds adjusted for inflation as per the C-03 agreement. The grants address the special needs of the communities in Ebeye and Kwajalein. Part of these funds will be used to assist those Kwajalein landowners most affected by the US presence on Kwajalein.

Disaster Assistance Emergency Fund

The DAEF was initiated in C-03 with a fixed annual grant of $200,000. The fund continues under C-23, but funding is to be provided from the $50 million sector grant.

> *Compact Trust Fund is "repurposed" to allow for annual drawdowns and for individual income support.*

Federal Programs and Services

The US government will continue to provide access to US Federal Programs and Services as agreed upon in the original Compact. Federal services included but are not limited to:

- US Weather Service;
- US Postal Service;
- US Federal Aviation Administration;
- US Department of Transportation;
- Federal Deposit Insurance Corporation; and
- Federal Emergency Management Agency

Joint Economic Management and Financial Accountability Committee - JEMFAC

The nature and powers of JEMFAC have been modified since it was originally specified in C-03. In its current form JEMFAC is composed of a US chairperson, one other US member, and two members from the RMI. The FPA indicates that decisions shall be made by consensus. If consensus cannot be reached, decisions are to be made by majority vote, and in the event of a tie, the US chair will cast the deciding vote.

The major duties of JEMFAC are to review the:

- Budget and Investment Framework (BIF);
- Infrastructure Development Plan (IDP);
- Annual Implementation Plan (AIP);
- Annual Financial Report;

- Annual Performance Report;
- Annual Financial Audit; and
- Annual Trust Fund Investment Reports.

Provided the RMI has satisfactorily submitted the BIF, IDP, and AIP in the format and detail required, with conforming sector allocations, JEMFAC is required to review and concur. It can only reject proposals if they do not meet the conditions specified in the FPA. The role of JEMFAC has thus changed from *ex-ante* approval to a greater focus upon *ex-post* review of the annual financial and performance reports as discussed below.

Pre-award requirements

Budget and Investment Framework

The requirements for the MTBIF and BIF are mentioned in the Compact legislation and in the FPA. In the Compact law Appendix B the agreement indicates that the RMI shall *prepare and maintain an official Medium-Term Budget and Investment Framework (MTBIF). The framework shall be strategic in nature, shall be continuously reviewed and updated through the annual budget process, and shall make projections on a multi-year rolling basis*[38]. These provisions have not been changed since the original C-03.

In addition, the C-23 FPA further elaborates on the Budget and Investment Framework[39]. *No later than March 31 of the Fiscal Year after the Fiscal Year in which this Agreement enters into force, and thereafter at appropriate intervals, the Government of the RMI shall provide to the Government of the US and the Committee the Budget and Investment Framework. The FPA goes on to say: The Budget and Investment Framework must include, in addition to the requirements of section 26l(c) of the 2023 Amended Compact* (i.e. the MTBIF):

- The goals and broad strategies of the RMI to promote economic advancement, macro-economic goals, budgetary self-reliance, and economic self-reliance,
- Multi-year objectives for each of the grants included in C-23, and
- The BIF is to be formally adopted by the government of the RMI.

The MTBIF conforms to the original C-03 provisions which reflect the normal requirements of a Medium-Term Expenditure Framework prescribed in the PEFA framework. The BIF defined in the FPA elaborates further. It is only required infrequently and overlaps with the standard specification of a strategic development plan discussed earlier in this *Review* which provides the anchor for the annual budget preparation and the MTBIF (MTEF).

The process in the RMI departs from that normally adopted and included in the respective Compacts for the FSM and Palau. In the FSM and Palau, the two FAS are required to prepare a Strategic Development Plan and a National Development Plan, respectively. These plans provide the long-term framework and strategic directions of the nation. In the RMI, the BIF corresponds to the strategic plans required in FSM and Palau and the MTBIF correspondents to the Annual Implementation Plan (AIP see below). While this process defined in the RMI Compact documents is not without ambiguity, it would appear that extension of the RMI NSP to include the normal features of a strategic development plan would fulfill the requirements of the FPA.

Infrastructure Development Plan

The IDP is to provide a list of infrastructure projects that will be used to guide the selection and use of the infrastructure grant. The IDP

38 US Public Law 118-42-Appendix B, page 138 Stat. 452A-32

39 Fiscal Procedures Agreement between the government of the USA and government of the RMI, page 25.

is required to be consistent with the goals specified in the BIF.

Annual Implementation Plan

The RMI is required to provide by July 15 of each year an annual implementation plan (AIP or budget) to JEMFAC that compiles and details proposed uses of grant expenditures. The AIP is required to indicate:

- Proposed sector allocations;
- Actual expenditures in the most recently completed fiscal year;
- Appropriated grants in the current fiscal year;
- Proposed expenditures for the upcoming fiscal year by program and ministry portfolio, including a detailed breakdown of object classes, and
- Objectives, specific performance indicators, and assessment methods

The AIP, essentially the annual Compact budget, does not align with the standard PFM Medium-Term Expenditure Framework and as scored in the RMI PEFA. The Medium-Term framework is found in a combination of the BIF and the AIP.

Post-Award Requirements

Financial Reports

Quarterly and annual financial reports are required to provide:

- Statement of revenues and expenditures by fund types with a comparison of budget and actual expenditures by function and fund types;
- A report for all operational grants by function and major offices, cost centers, and budget activities, and
- A fund status report on the Health Care and Climate Funds that shows deposits, disbursements, and fund balances.

Monitoring and Performance Reports

A new feature of C-23 is the requirement for the RMI to monitor and provide performance reports. Ongoing monitoring is required to ensure program execution is in accord with achievement of the performance goals. The annual performance report is required to provide a comparison of actual accomplishments with the objectives and indicators established in the implementation plan. C-23 requires that budget execution is undertaken on a performance basis. However, the FPA fails to distinguish between outcomes/results and program outputs/deliverables. The same issue failed to be addressed adequately during C-03 with US wishing to focus upon outcomes and the FAS focusing to a limited extent upon project outputs or deliverables.

Third party assistance

Recognizing the weakness in the RMI to compile the required financial and performance reports, the US has required the RMI to retain a qualified third party to assist. However, choice of the third party requires consultation with the US. The responsibilities of the third party will be to:

- Assist in collection of the necessary material;
- Assist in analysis;
- Draft the reports, and
- Provide training and capacity building.

The FPA does indicate that in many cases material will not exist or be available to provide the information necessary to prepare the performance reports. In these cases, it will be necessary to develop data systems to provide the information that can best be used for monitoring and performance assessment.

Compact Trust Fund

The CTF agreement has undergone a total overhaul. The original objective was to provide a source of funds to replace the sector grants at a level consistent with the value of the sector grants at the end of C-03. Under C-23 the CTF has been "repurposed" to augment the revenue available to the RMI immediately rather than only after FY43. The rate of withdrawal at 4 or 5 percent is below average market rates of return on a balanced portfolio, which in many projected cases will support a growth in the real value of the *corpus*. In a significant number of cases the CTF would, however, be subject to significant declines in the real value of the *corpus*.

The Trust Fund Committee serves as Trustee of the Fund in accordance with the provisions of the CTF Agreement. The CTF Committee is comprised of three US members, one of whom is the chair. Two members are selected by the RMI and one from Taiwan. The Trust Fund Committee decisions are made by majority vote and in the case of a tie the chair gets the deciding vote.

The CTF has been "repurposed" into a series of Accounts:

Account 1 – Sector and Individual Support Fund.

Account 1 will initially consist of the resources in the CTF at the end of C-03, which recorded a value of $682.8 million at the end of C-03 that is FY23. The distribution cap is defined to be the average of the last 3 years of known fund corpus values multiplied by the distribution *percentage*, which is set at 4 percent.

Distributions from the fund can be used for any of the purposes defined under the sector grants or for individual income support. The RMI, in concurrence with the US, will determine who is eligible for income support. Such payments shall be paid on a per capita basis and on at least a quarterly basis.

The Trust Fund Committee is accorded powers to review and approve budgets submitted by the RMI for the use of the funds. In this instance the CTF Committee is accorded a similar function to that of JEMFAC. C-23 thus duplicates the function of review and budget approval between JEMFAC and the CTF Committee. While JEMFAC is established and staffed with the competence to review and approve budgets, the functions of the CTF Committee have to-date been fiduciary and financial in nature and not in budget approval or expenditure review.

Account 2 – Extraordinary Needs Distributions

Account 2 is to be funded through four US contributions in the amounts of $200 million in each of FY24-FY26 and $100m in FY27, providing a total of $700 million. The extraordinary needs account is to be used for exceptional hardships and needs through programs for people in specified atolls including: Ailuk, Aur, Bikini, Enewetak, Likep, Lib, Mejit, Rongelap, Rongerik, Wotje, Wotho, Ujelang and Utrik. The RMI is to determine the programs to be supported.

While the Extraordinary Needs fund covers the four nuclear affected trust funds, it is not provided in recognition of the nuclear compensation claimed by the RMI. Rather, many outer atolls are specified as eligible to participate in the programs chosen by the RMI government.

Trust fund distributions are to be calculated on a similar basis to Account 1 and are subject to the same issues. The Account 2 distribution cap is defined to be the average of the last 3 years of known fund *corpus* values times the distribution percentage set at 5 percent. In the initial years the distribution formula is complicated by the periodic contributions to the fund.

Account 3 - Unspent Economic Assistance Fund

All unused funds provided during C-23 are to be deposited in Account 3. This fund may be used to finance projects and programs permitted under the sector grants and is available at the full value of the fund provided they are in compliance with the CTF Agreement.

Account 4 – the "D" Account

Account 4 is to inherit the former funds in the "D" account of C-03. Contributions to the "D" account may be made by the RMI, Taiwan, or other benefactors and are to be used for unanticipated shortfalls or other purposes.

Issues relating to the 2023 Amended Compact

Perpetual COFA fund for later use or source of revenue for current use

While the stated purpose of C-03 was to establish a CTF to provide "a source" of funds for budgetary self-reliance, the implicit target was the provision of a perpetual fund. The purpose indicated in the original CTF subsidiary agreement Article 3 stated: The purpose of the Fund is to contribute to the economic advancement and long-term budgetary self-reliance of the Republic of the Marshall Islands by providing an annual source of revenue. However, the CTF subsidiary agreement also indicates in Article 16 section 7(a) that the CTF Committee may disburse in Fiscal Year 2024, an amount equal to the Annual Grant Assistance in Fiscal Year 2023, plus Full Inflation. The agreement then goes on to say in section 7(b) that in future years beyond FY24 the CTF Committee may disburse similar amounts fully indexed to inflation. In essence, C-03 indicated that while the purpose of the CTF was to provide "a source" of funds, the implicit target was to provide a (perpetual) yield equal to the FY23 sector grants plus full indexation.

However, C-23 is based on the assumption that reliance upon a perpetual fund at a later date is no longer needed. The rationale of C-23, which permits drawdowns from the CTF for current operational purposes or basic income support, is at odds with the objective of the (perpetual) fund as it was established in C-03. In essence, C-23 permits the RMI to withdraw from its CTF to support current levels of consumption. This is indicated in the C-23 legislation Appendix B: "The Signatory Governments may mutually agree to continue the provision of sector grants and federal programs and services beyond fiscal year 2043 at the same levels and subject to similar favorable terms." C-23 thus indicates that the relationship between the US and the RMI could exist in perpetuity and, therefore, obviates any need to establish a perpetual CTF to replace terminating grant levels.

RMI opts to utilize the withdrawal from the CTF to fund current consumption and a Universal Basic Income. The policy question for the RMI thus arose as to whether the nation wanted to maintain the original intent embedded in C-03 to establish a perpetual fund for future generations or draw down the available funds for government operations and current consumption. The RMI acted to accept the provision that the parties may mutually agree as an indication of intent and opted to utilize the CTF to fund a Universal Basic Income. In other words, the RMI has elected to utilize withdrawals from the CTF for enhancing current consumption.

While available funding from the CTF will be used for the UBI, in the longer term, additional earnings could be devoted to

capital projects in infrastructure and climate adaptation. Previous issues of the RMI Economic Review had proposed that the RMI should consider the use of the CTF for capital projects rather than consumption purposes. Clearly, at this time, the RMI has elected to use the available funds for the financing of the UBI. However, over time, the CTF is likely to grow and could provide resources for other purposes depending on the withdrawal rate of the UBI. This could release funds for other uses and potential projects in infrastructure and climate adaptation. After determining the withdrawal rate for the UBI, the RMI could allocate any remaining funding for capital projects thus adopting the principle of the use of a capital resource, the CTF, to finance capital projects.

Inflation adjustment

C-23 does not provide any provision for annual inflation adjustment, although it includes a two percent adjustor. C-23 incorporates a 2 percent annual adjustor in lieu of an actual inflation adjustment. The rationale for this specification would appear to be to shift the risk of the high inflation onto the RMI. In the RMI, the impact of a period of high inflation, like the recent 14.9 percent increase during FY22-FY24, could significantly undermine the operation of the government and jeopardize fiscal stability. The RMI's CPI rose on average by 2.6 percent annually between FY00 and FY19, before the recent spike in international prices. The 2 percent adjustor is below this rate. Thus, the RMI will need to prepare for an annual decrement in the real value of the Compact economic assistance of close to 1 percent per annum as well as possible periodic spikes due to inflation.

Universal Basic Income

RMI opts to use CTF to fund a Universal Basic Income but setting up administrative procedures will take time.

In 2023 the Nitijela announced its support for the creation of UBI for the Marshall Islands. In 2024 under a new administration the cabinet approved the creation of a task force to develop mechanisms for the distribution of a universal basic income that was approved in the C-23 Trust Fund agreement. The task force met for the first time in April 2024 and continues to have regular meetings since that time. Regarding the administration of the UBI the Compact Trust Fund agreement indicates:

> *The Individual Support Distribution may be used for the payment of individual dividends to Eligible Recipients, only after the establishment of a mechanism and procedures for the payment of individual dividends to Eligible Recipients has been established by the Government of the RMI with the concurrence of the Government of the USA. Such dividends shall be paid in equal amounts on a per capita basis to all Eligible Recipients on at least a quarterly basis. The criteria used to determine Eligible Recipients shall be mutually decided in writing by the Signatory Governments and may include such factors as citizenship, residency, or annual income requirements.*

Initial distributions have been delayed. The original intent of the government was to make the first distribution by the end of 2024. However, establishing the administrative procedures with the concurrence of the US proved to be time consuming. Proposals provided by the RMI included:

1. **Eligibility**: Citizens resident in the Marshall Islands were deemed eligible for the distributions with some special provisions. All recipients were to maintain residency in the RMI each year and required to have an SS#.
2. **Administration**: Administration is to be conducted through the Marshall Islands

Social Security Administration (MISSA). This will require modifications to the MISSA IT system to allow administration of the UBI. All citizens will need an SS#, including newborns.

3. **Timing**: The RMI expressed a preference to make disbursements on an annual basis, while the Trust Fund agreement indicates at least quarterly.

There are considerable administrative hurdles to be overcome before the UBI is ready for implementation. It is understood that MISSA has now registered all eligible recipients in Majuro and Ebeye. However, the outer islands are not yet fully registered. IT modifications are underway and are likely to cause delays. While distributions will be made through financial institutions, it is unclear if the commercial banks have the capacity to process close to 40,000 transactions quarterly. The question also arises of how payments are to be made to minors. While annual payments would be less onerous on payment systems, quarterly distributions would be more in line with the objective of providing a basic income to low-income households. Based on CTF values at the end of FY21, FY22 and FY23, total distributions would be $25.6 million in FY24 and $161 per individual per quarter. Clearly, the impact on the economy of quarterly payments of $6.4 million would be considerably less inflationary than a lump sum one-time addition to demand of $25.6 million.

Outer Island Support and extraordinary needs distributions

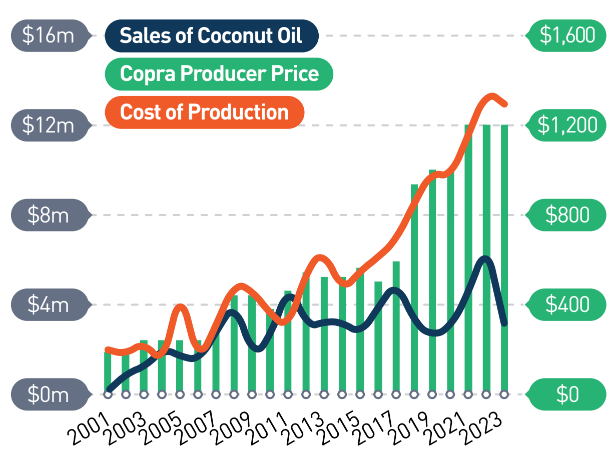
The Copra Support Program

The Copra Support Program, intended to provide income support to outer island producers, has become a significant fiscal burden. A major component of the government's income support for the outer islands has been the Copra price support program paid to producers. The industry

Copra subsidy is an efficient means of outer island income support and could be replaced with extraordinary needs distributions from the CTF to provide a basic needs rural income.

is organized through Tobolar, the copra processing plant, an SOE. Tobolar collects copra from producers in the outer islands at subsidized prices, processes it into coconut oil in Majuro, and exports the product to world markets at prices generally far below the cost of operations, see Figure 19. Initially the program was modest, and the level of subsidy was a minor element of fiscal operations. However, since 2015 (from what was originally intended as a temporary, pre-Christmas bonus), the increase in subsidy has become a permanent feature of the budget and represents a significant additional element of fiscal cost. Subsidies increased from $1.7 million in FY15 to $8.0 million in FY23, and the

Figure 19: Sales and cost of copra production & producer prices
Producer prices have risen rapidly and Tobolar runs large operating deficits since 2011



price paid to growers grew from $563 to $1,200 per short ton during this period.

The copra price support program is an inefficient method of income support, given the RMI's limited comparative advantage in the industry. Originally developed to support outer island incomes, the copra subsidy provided a simple delivery mechanism. However, the distribution mechanism encourages production in an area where the RMI does not have a comparative advantage. The copra and coconut industry has virtually disappeared in most Pacific Island nations, due to low international prices, price volatility, and senile tree stocks. In the RMI the high prices encourage continuation of an activity that has negative value added and reduces the level of GDP. The 2021 IMF Article IV[40] report argued for development of a more direct and targeted social protection system for outer island income support. The Fund observed that the current system of redistributing income *is inefficient and distortionary. Farmers are subsidized independently of their income level and a high copra price reduces incentives for farmers to change to other, commercially more viable crops*.

An outer island basic needs income

Utilizing the Extraordinary Needs Distribution Trust Fund would affer a more efficient way to support outer island incomes. The Extraordinary Needs Distribution (END) trust fund, established with US contributions of $700 million, could serve as a source for financing outer island basic income support, replacing the inefficient copra subsidy. The END is specifically set up to address exceptional, unmet hardships and needs in the outer islands, and does not require US concurrence. On September 17th, 2024, the Nitijela passed legislation to increase the minimum wage to ensure the average household would have sufficient income to sustain a basic standard of living. However, while the increase in the minimum wage will ensure wage-earning urban households have a basic needs income, the same is not valid for the outer islands where jobs are scarce. In urban areas, the average household has 1.5 workers, compared to 0.6 in rural or outer island households. The goal would be to provide rural households with basic income support, ensuring they meet the same standard of living as those in urban areas.

40 Ibid

Funding an Outer Island Basic Income Support program (OIBIS) would cost approximately $15 million annually. The recent technical note prepared by the Graduate School[41] estimates an individual needs a basic weekly income of $44.90, which on a quarterly basis equates to $584 per person. Deducting the $161 per quarter individuals are already entitled to under the UBI, the additional income required would be $422.7 per quarter. There were 8,963 people living in the outer islands at the time of the last census, thus the total cost of the program would be $15.2 million per annum. Once the END trust fund has been fully funded by 2026, potential annual drawdowns at 5 percent would amount to $35 million. The funding of an outer island basic income support program (OIBIS) would thus leave $20 million available for other projects, such as climate proofing, airport improvements, etc.

Using the fund for extraordinary needs would offer a more efficient approach to outer island income support than the existing copra subsidy. Current sales of copra by producers amounted to $8.7 million in FY23 with a subsidy to Tobolor of $8.0 million. With the creation of an OIBIS program the copra subsidy could be slowly phased out and the producer price would align more closely with the average medium-term world price. It is expected that farmers would gradually reduce copra production and gradually transition to more productive farming, fishing and handicraft activities. The removal of the copra subsidy

41 Graduate School USA, *Estimating an Appropriate Minimum Wage in the Republic of the Marshall Islands (RMI) Based on the Basic Needs Poverty Line*, Honolulu, March 2024.

would ease the fiscal burden of SOE subsidies from an average value in FY21-FY23 of $13.8 million to $6.5 million.

8. Statistical Issues

The RMI has significantly improved the nation's economic statistical systems. Since the start of the C-03, the RMI has developed a wide range of statistics to better enable the monitoring of economic performance. The 2023 IMF Article IV staff review found "*Data provision is broadly adequate for surveillance and the authorities willingly share available data, though some shortcomings tend to constrain policy analysis, including limited coverage and timeliness of data releases.*"[42] The annual statistical update has been timed to coincide with the release of the government audits and formally in time for the JEMFAC annual meeting. This implies a final set of estimates would normally be available eleven months after the end of the fiscal year. However, this cycle was disrupted by COVID and by the change in auditors from Deloitte to Ernst & Young. With both disruptions now over, the time sequence should get back to normal although the adoption of new FMIS, Bisan could once again delay issues if audit compliance issues arise. In recent years a preliminary set of statistics has been prepared by the end of April based on FMIS downloads, and before audit availability. This provides a more current set of statistics, supports budget preparation, and facilitates periodic International Monetary Fund (IMF) missions. A set of quarterly indicators has been prepared by EPPSO over the past few years in time for use in the regular session of the Nitijela in January and August.

42 IMF, Country Report No. 23/349, 2023 Article IV Consultation, Washington D.C. 2023

Asycuda has now been successfully implemented in the RMI and a full year of trade under the new system will be available for FY25. Asycuda, a computerized customs management system that covers most foreign trade procedures, has now been successfully implemented in the RMI. It handles manifests and customs declarations, along with accounting, transit, and suspense procedures. It also generates trade data that can be used for statistical economic analysis. Implementation will dramatically improve the provision of trade statistics and the compilation of many parts of the economic statistical system, including the balance of payments, supply and use tables, and GDP by expenditure.

The tax reform initiative, if adopted, will come with many benefits, both new data sources aligned with GDP concepts and modern IT software. If the RMI proceeds with implementation of the tax reforms and introduction of a VAT and business profits tax a range of new data will become available that will significantly enhance national accounts estimation. Tax reform is normally introduced alongside a modern tax administration system, which will aid in improving data management and integrity. However, this will require the development of new national accounts data systems. The introduction of the FMIS, Bisan, has led to recording of BGRT payments both directly on items purchased by government and by private sector revenues derived from other institutional sectors. This has led to a significant improvement from a prior excel-based system, which suffered data gaps and data entry errors. However, while Bisan is a considerable improvement over the excel system and comes with the benefits of database management software, it lacks the controls and integrity checks that would be part of a well-developed modern tax administration system.

9. The economic and fiscal outlook

Assumptions informing the outlook

The economic outlook and projections for the RMI are based on the GSUSA economic model: MTEF.mod. This section presents a set of projections for the economy based on the C-23 Compact provisions plus various reform initiatives currently under implementation by the government. The projections are based on the GSUSA Excel-based model of the economy (MTEF-mod), which is based on the standard set of economic accounts: GDP by industry in current and constant prices, employment, generation of income and household account, fiscal account, GDP by expenditure, financing, and price projections. The MTEF-mod provides a baseline scenario through FY30 and enables adjustment of variables to simulate the impact of different assumptions and policies. The assumptions of the baseline are discussed first, followed by the results.

Compact grant availability will grow strongly. Operational sector grants of $35.7 million, including the annual adjustor, will be available in FY25. This is a large increase from the FY23 level, the last year of C-03, of $17.4 million. While there are several offsets requiring deductions, such as Enewetak development of 4.8 percent of total sector grants, audit contribution of $0.5 million, disaster assistance of $0.2 million, plus $2.5 million with adjustor for infrastructure maintenance, the residual is a considerable increase in funds available for sector budgets. Additionally, there is an annual $8 million in funds for the supplemental health fund. In the projections, it has been assumed these funds are fungible and simply add to the general increase in resources. Various other funds for a variety of purposes are treated as off-budget.

Funds for infrastructure also represent a large increase. Compact resources for infrastructure have grown from $11 million in FY23 to $15 million in FY24. Part of the C-03 infrastructure funds remain unspent, close to $60 million[43] and are assumed to be drawn down gradually. Additionally, there are $132 million for capital spending on the Kwajalein Development Plan to be disbursed over an unspecified time. In FY24, work on the Amata Kabua International Airport under the FAA $34 million airport improvement project commenced and is expected to be completed in FY26. There is also a large volume of ADB and World Bank infrastructure projects planned for the RMI, as well as the Compact infrastructure maintenance program of $5 million annually. The impact of these projects is categorized by type, construction, plant, equipment, architectural and engineering design, and phased in over a period of years. There are clearly more projects and resources than the RMI can absorb from the outset, and capacity is programmed to grow slowly.

Government expenditure is assumed to gradually increase until it hits the fiscal envelope. It is assumed that government fiscal policy remains consistent with past practice, and there is a gradual expansion in the civil service, use of goods and services, and subsidies, grants, and transfers. It is assumed that general administration and services will grow by 2 percent per annum in real terms, while health services, reflecting an aging population, will grow by 3 percent, as do awards to students. Education, otherwise, is set to expand at the average rate lower, reflecting out-migration.

The minimum wage is scheduled to occur in line with the law and for the UBI to be implemented in FY25. A table of the estimated impact of scheduled minimum wage increases FY25-FY28 has been programmed into the model. The increase in wage costs has been estimated by industry and assumed will result in increased prices and inflation. The introduction of the UBI is assumed to take place in the last quarter of FY25, although this may be an ambitious target. Household incomes are set to rise by $7 million in FY26 and $32.0 million in FY27, or 2.9 percent and 12.7 percent of household disposable income in the two years, respectively. It is assumed that the increase in household consumption, spread over four equal installments, will have little inflationary impact given that most items are imported, and supply is elastic.

The tax reform initiative is assumed to be implemented in FY27. The tax reform initiative, as outlined in chapter 3, is programmed to be implemented in FY27 with a 10 percent MICT, 16 percent BPT, with reductions in wages taxes to offset some of the regressive aspects of the MICT. There is an assumed 10 percent efficiency loss when the MICT is introduced, but after two years the system settles down, and no further loss is anticipated. In the case of the BPT, it is assumed that there is a 20 percent loss in potential gains due to a low level of compliance. There is also a transfer to the local governments of MALGOV and KALGOV of $6.4 million in FY27 to compensate for the loss of local state sales taxes, which are removed during the reforms.

Outlook for the Economy

The economy is projected to grow by 4.5 percent in FY25 as the RMI expands fiscal policy, initiates the UBI, and households benefit from tax relief. The first year of C-23 was constrained by the delay in signing the Compact agreement to mid-year and the corresponding lack of disbursements of funds. Fiscal policy and the economy were thus constrained in FY24. However, in FY25, as funding from the considerable increase in grants becomes fully available, the pace

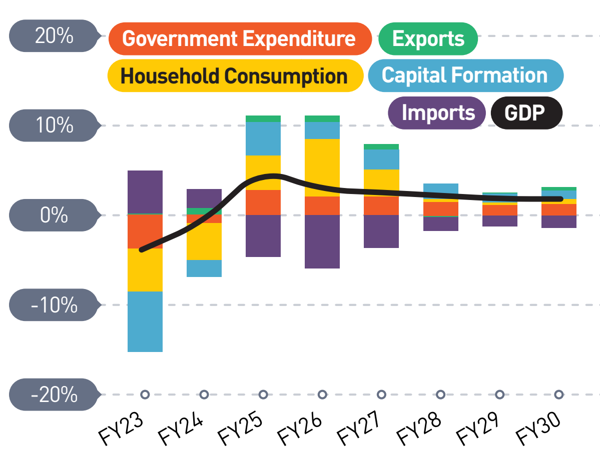
43 Difference between C-03 funds availability and use recorded in the audits/FMIS.

of economic activity is anticipated to pick up speed. Not only do the new funding levels become available, but the reductions in the wages tax and the introduction of the UBI come into force. GDP is estimated to grow by 4.5 percent, see Figure 20, driven by increases in household consumption demand due to the reduction in the wage's taxes (phase 1), the introduction of the minimum wage, and the assumed one quarter of UBI payments. Investment is also projected to provide a significant source of growth with the construction of the FAA airport improvement project and growth in the large number of Compact and other donor projects. Lastly, government consumption will grow with the increased revenue availability.

Economic growth continues favorably through the end of the decade as the RMI builds capacity to implement the increase in Compact grants and donor funding. In FY26, the same forces sustain the momentum, and the economy is projected to grow by 2.9 percent. Household consumption is the main driver with a full year's worth of the UBI and continued reduction in taxes. In FY27, the tax reform is assumed to be implemented with an extension of tax relief to all households.

Figure 20: Sources of growth by expenditure

In the short-term household demand is the main source of growth but in the long-term infrastructure and public services dominate.



Household incomes continue to rise strongly with an associated rise in real consumption levels. Through the remainder of the decade to FY30, government expenditure continues to rise as the RMI builds capacity in project implementation. In FY30, GDP is projected to grow by 2 percent. However, by this time, much of the fiscal space that arose from increases in the C-23 sector grants has been absorbed, and it can be expected that steady-state long-term growth would gravitate to historical averages.

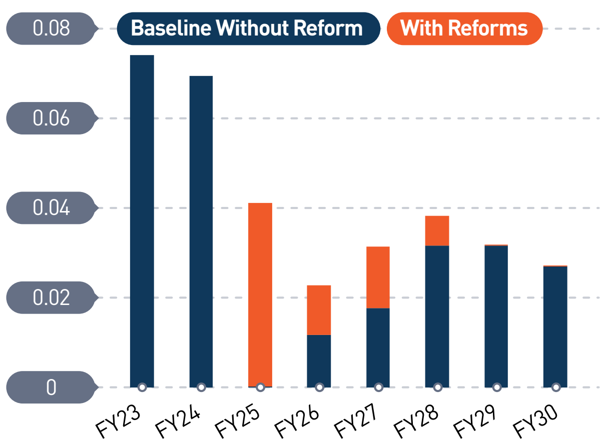
Inflation

Inflation, without the impact of the minimum wage increase, is expected to fall in the near term but rise thereafter. Underlying inflation (before the minimum wage increase) is based on a composite index of food and energy prices taken from World Bank near-term projections through FY26, imported prices based on US Congressional Budget Office US CPI projections, and a domestic inflation index based on local cost of production including RMI wages. Before the impact of the minimum wage increase, prices in FY25 and FY26 are projected to be low, reflecting the World Bank's projected reduction in energy and food prices. The underlying inflation is thus close to 0 in FY25 with a modest 1.2 percent in FY26, see Figure 21. Through the remainder of the decade, commodity prices are projected to return to their long-term averages, and inflation averages close to 3.0 percent.

Inflation is projected to fall from the highs of FY23 and FY24 but remain above previous long-term averages. The increase in the minimum wage from $3.0 to $5.25 in FY28 is significant and will generate domestic inflation. In FY25, based on the proportion of wages in total production costs, it is estimated that the CPI will increase by 4.1 percent and rise by a total of 7.3 percent by FY28 after all the annual adjustments are complete. The expected impact of the minimum wage increases in FY25 and FY26 is fortuitously offset by the low underlying commodity prices projected.

Figure 21: Consumer Price Index, percent change

The increase in the minimum wage has an inflationary impact; in the longer-term the tax reform initiative has a minor impact on inflationary



Nevertheless, the inflationary picture for the remainder of the decade is a reduction in the levels experienced in FY23 and FY24 but remains higher than the long-term trend during FY12-FY22.

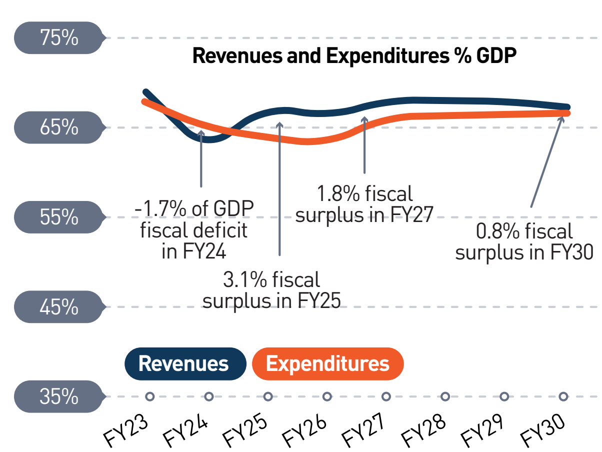
Fiscal

A large fiscal surplus is projected for FY25. After a constrained fiscal period in FY24, reflecting an in-between year when C-03 expired, but C-23 was yet to kick in, the RMI ran a fiscal deficit of 1.7 percent of GDP. With the influx of Compact resources in FY25, the situation will turn around dramatically: operational sector grants expand from $17 million in FY23 to $37 million in FY25, the first installment of the supplemental health fund of $8 million annually is due, plus an increase in the infrastructure grant from $9.8 million in FY23 to $12.6 million in FY24, coupled with an increase in the infrastructure maintenance fund. The government also legislated the increase in the minimum wage coupled with an increase in tax deductions for low-income earners. While the increase in wage tax deductions involves a loss of $1.8 million, this is offset by the minimum wage increase, and overall revenues are expected to rise by 20 percent. As noted in the introduction, it is not expected that expenditures will automatically increase by the same extent due to capacity limitations and thus a fiscal surplus of 3.1 percent of GDP is projected, see Figure 22.

With the intention to introduce a revenue-negative tax reform in FY27, a reduced fiscal surplus of 1.9 percent is projected. In FY26, the same forces exert themselves, although expenditure increases are projected to narrow the gap with revenues, and the surplus falls to 2.9 percent. In FY27, the government is planning to introduce the tax reform, which envisages the repeal of a set of legacy taxes, the introduction of the MICT and BPT, and an extension of wage deductions for higher income earners. While tax revenues are expected to expand by $3.2 million, this will be offset by the need for revenue sharing and transfer of $6.4 million to local governments for the loss of local sales taxes. Given that the tax reform was designed to be revenue-negative and intended to redistribute taxes to the household sector, a fiscal loss of $2.8 million or 0.8 percent of GDP, after allowing for other macroeconomic effects, is projected. However, overall, a fiscal surplus of 1.8 percent remains. In the remaining years of the decade

Figure 22: Revenue and Expenditures, percent GDP

RMI runs fiscal surplus in early years of C-23, but trends towards balance as capacity limitations are resolved

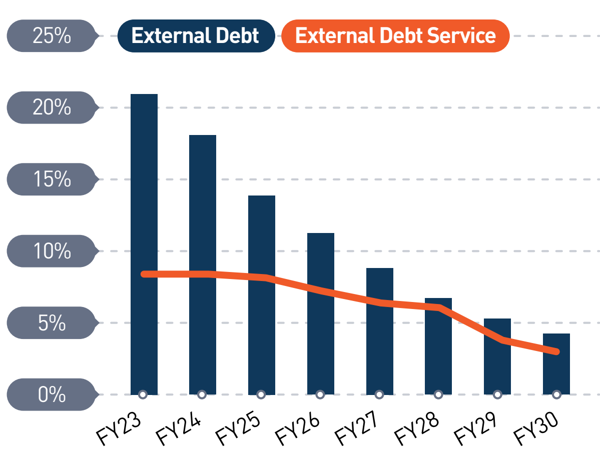


through FY30, a declining surplus is projected as expenditures slowly rise to match the fiscal envelope.

External Debt

External debt and debt service obligations are projected to virtually disappear by FY30. Finally, in this section, the implications for external debt are projected on the assumption that the RMI continues to benefit from "grant-only" status despite the renewal of the Compact on favorable terms. Figure 23 indicates that the debt-to-GDP ratio will fall from 14 percent to 4 percent of GDP, virtually clearing the backlog of debt. Similarly, debt service obligations are projected to fall from 8 to 3 percent of general fund domestic revenues. This will place the RMI in a very favorable and financially sustainable position by FY30. Given the vulnerability of the RMI to global warming and sea-level rise, plus the former disposition to incur new debt, it is to be hoped that the World Bank and IMF decide to maintain the RMI's "grant-only" status.

Figure 23: External debt (percent GDP) and debt service, (percent domestic revenues)
On a continuing "grant only" basis, external debt and debt servicing drop to very low levels



10. The Reform Agenda

Progress with Reform

Progress with the reform agenda during C-03 was limited, despite numerous commitments and initiatives. During the C-03 period, the RMI entertained numerous reform initiatives that failed to achieve substantial success. The expenditure proposals of the Comprehensive Adjustment Program (CAP) in 2009 were not implemented. At the same time, a Tax and Revenue Reform and Modernization Commission (TRAM) was established but failed to garner momentum to initiate the tax reform proposal. While the SOE Act became law and progress was made through the creation of the SOE Monitoring Unit, adoption of "best practices" enshrined in the Act has yet to be universally adopted in the sector. In May 2021, the Nitijela passed a draft of the Fiscal Responsibility and Debt Management Act into law, but due to the onset of COVID-19 and inadequate vetting, the bill failed to impose meaningful constraints on government budgeting and spending practices, thus limiting its impact on fiscal responsibility.

However, with the advent of a new administration in 2024, the government has initiated a series of reforms:

1. Increases in the minimum wage,
2. Tax relief for low-income wage earners,
3. A comprehensive tax reform package, and

4. Implementation of a universal basic income.

Minimum wage. In March 2024, estimates of a basic needs poverty line were made which was estimated to be $5.25 an hour. In September 2024, the government enacted legislation to increase the minimum wage to $4.00 an hour in FY25, with further increases of 50¢ in FY26 and FY27 and 25¢ in FY28, to bring the minimum wage to a level consistent with the basic needs poverty line. It was also estimated that increasing the minimum wage to $5.25 an hour would add 8 percent to inflation over the four-year period.

Comprehensive tax reform. The reforms include adoption of Value-Added Tax (VAT) and profits tax and repeal of the legacy and distortionary gross receipts tax, together with revisions to the wages tax. A Tax Reform Modernization Committee has been created by the RMI cabinet, and discussions have been held internally and with the IMF and Palau Ministry of Finance, which has recently completed successful implementation of a similar set of tax reforms. After some apprehension from the business community, the initiative has gained momentum, and there appears to be widespread, if not universal, support for the initiative.

Tax relief for low-income earners. In addition to the reforms outlined, a two-part reform process was proposed: (i) immediate tax relief for those on or below the minimum wage ($160 a week or $8,320 a year), and (ii) the adoption of the full reform proposal over a longer period starting in FY26 with the extension of the minimum wage allowance to all taxpayers. The two-stage process was introduced to minimize fiscal impact but comes with significant distortion at the $8,320 boundary. This is removed during stage two but carries a risk that the distortion remains if stage two is not implemented.

Universal basic income. C-23 provided the availability of individual support distributions from the CTF, which can serve as a foundation for the UBI. The government opted to execute this option, but it remains a revolutionary concept, and its impact on work incentives, provision of basic needs, and cost of living, remains uncertain. There are a range of administrative obstacles to be overcome. The UBI has already been delayed beyond the intended timeling, with further delays expected. It is crucial to monitor the program's impact to assess whether it achieves its objectives and whether it represents the most effective use of the resources.

Outline of a Reform Agenda

Despite the limited success of reforms during C-03, the current time offers a unique opportunity to advance the reform agenda. With the extended timeline of C-23, which includes significant funding increases over the next twenty years, the RMI is in a favorable position to reassess its development objectives and priorities. The assumption of office by a reform-minded administration provides a timely leadership opportunity as the nation embarks on new initiatives. The following list outlines potential reform options highlighted in this review that the administration may wish to develop:

Fiscal

1. **Fiscal Responsibility and Debt Management**. The current FRDMA does not provide an appropriate set of principles for the RMI to guide fiscal policy. The fiscal anchor embedded in the FRDMA, the requirement of a balanced budget, does not constrain the automatic rise in expenditures to match the fiscal envelope and set aside resources for future needs. The FRDMA also embodies a budget cycle that does not reflect RMI circumstances and elements that are not normally part of fiscal policy. A task force needs to be established to review the FRDMA and

Progress with reform in the RMI has been weak, but momentum has picked up with a new administration and favorable terms of the new Compact.

establish guidelines for the redrafting of the FRDMA legislation.

2. **Tax reform**. The tax reform process is now underway, and the momentum needs to be maintained and built on. Dissenting opinions need to be discussed, and the benefits of the reforms explained. However, it is to be expected that resistance will remain, especially with the introduction of taxes that have not been adopted in the US, which acts as a reference point on many issues. Tax administrative strengthening will be essential with donor support and adoption of modern standard IT systems.

3. **Fiscal Buffers**. Given the vulnerability of the RMI to fiscal and climate-related shocks, the nation would be well-served to establish both cyclical and climate funds to deal with unexpected events. MIMRA has built a large source of funds that could well form the seed money for such an initiative. Both funds could be established in a reformed FRDMA.

Financial

4. **Fintech and Digital assets**. This Review concurs with the IMF that the existing SOV legislation should be repealed. New initiatives like the stablecoin and DAO should be considered with care, and a comprehensive regulatory regime developed before implementation. The IMF recommends the DAO project be put on hold until an adequate regulatory regime is developed. This *Review* agrees that fintech initiatives in unsophisticated financial environments like the RMI carry greater risks and costs than the benefits frequently promised.

5. **Creation of a Monetary Authority**. The concept of developing a Monetary Authority for the RMI is a good one. While many of the functions of a central bank will not be available to an economy like the RMI, there remain important benefits. The MA would be able to take on the former role of the Banking Commission (OBC), manage the domestic payments system, assume the functions of banker to the government, open an account at the Fed, manage the nation's reserves, and provide financial advice to the government. It could also take on the function of investment of the cyclical and climate reserve funds. Passage of the legislation concerning the creation of the MA, currently in the Nitijela, should be encouraged.

Public Financial Management

6. **Public Expenditure and Financial Accountability**. In 2011, the government of the RMI commissioned an external PEFA assessment, and a PFM Roadmap was developed in 2015. In response to the program outlined in the Roadmap, a Reform Coordinating Unit was created with ADB support in the Ministry of Finance to improve PFM and financial reforms. While progress has been slow, a long period has elapsed since the preparation of the original PEFA and Roadmap, and there is a need to update the assessment, reassess priorities, and for the RMI to indicate its continued commitment to PFM reform.

7. **National Strategic Plan**. The 2019 NSP defines a set of objectives but does

not include any discussion of sector policies, projects, or activities designed to achieve the objectives. There is no list of outcomes corresponding to the plan objectives that would form the basis for performance monitoring. Further, there is no itemization of sector activities and outputs that government Ministries would deliver to achieve the objectives. The RMI planning system thus needs to be reworked and extended to include not only the strategic goals/objectives outlined in the present plan but also outcome performance measures, activities, and quantifiable outputs.

8. **State-Owned Enterprises**. While the momentum behind the SOEMU slowed during COVID, it provides a useful function and should be strengthened. The fiscal risk of the SOE sector is significant, and improving its performance will require substantial effort and time. However, abandoning the initiative and the progress made, or allowing it to fade into the background, should not be considered viable options.

9. **Universal Basic Income**. Implementation of the UBI is underway but will take time to fulfill all the requirements; delays should be expected. Once the scheme is fully functional and underway, the establishment of monitoring mechanisms is recommended to review its impact both on the economy and within households.

10. **Income support to outer islands**. The current outer island income support program, based on the copra subsidy, is inefficient despite being easy to administer. The renewed Compact C-23 offers an opportunity to replace the copra subsidy with drawdowns from the extraordinary needs distributions of the CTF. This review proposes that these distributions could be aligned with the basic needs income, as estimated in the recent minimum wage legislation. As a result, each individual and household in the outer islands would be guaranteed an income sufficient to cover their basic needs.

RMI Summary Economic Indicators, FY22-FY26

	FY22	FY23	FY24	FY25	FY26
Per Capita Income measures					
GDP current prices, $ million	253.4	261.5	269.9	306.3	325.9
Population	41,414	40,434	39,583	38,834	38,172
GDP per capita $	6,119	6,467	6,819	7,888	8,536
GNI per capita $	**7,028**	**7,717**	**8,483**	**9,582**	**10,298**
GNDI per capita $	9,024	9,641	9,203	11,444	12,259
National accounts					
GDP, at constant FY2015 prices, $ million	**221.1**	**212.3**	**210.7**	**220.3**	**226.6**
% growth	**-1.1%**	**-4.0%**	**-0.8%**	**4.5%**	**2.9%**
GDP less fisheries	**193.4**	**186.2**	**183.8**	**193.4**	**199.7**
% growth	**3.2%**	**-3.7%**	**-1.3%**	**5.2%**	**3.3%**
GDP production, $ million	**221.1**	**212.3**	**210.7**	**220.3**	**226.6**
Agriculture and fisheries	42.9	41.0	41.9	41.8	41.8
Manufacturing and utilities	11.6	11.0	10.8	11.2	11.9
Construction	12.7	13.6	14.6	16.8	14.7
Wholesale and retail trade	29.9	26.4	26.1	27.6	29.7
Transport	17.3	18.8	18.2	19.1	20.1
Accomodation & restaurants	4.5	4.8	5.5	5.7	5.8
Public admin, Health and education	68.5	66.0	64.0	66.0	68.2
Other services	25.2	24.6	23.5	24.2	25.0
Taxes less subsidies on products	8.4	6.1	6.1	7.9	9.3
GDP by Expenditure, $ million	**262.4**	**235.4**	**225.8**	**240.5**	**253.8**
Final consumption expenditure, government	126.4	116.6	114.9	121.4	126.6
Final consumption expenditure, households	166.4	153.6	143.4	151.7	167.3
Gross capital formation	67.1	49.6	45.1	53.9	58.4
Gross domestic expenditure	**359.8**	**319.9**	**303.5**	**327.1**	**352.2**
Exports	78.1	78.5	80.4	82.0	83.7
Less Imports	175.5	163.0	158.1	168.5	182.1
Descrepancy % GDP(P)	-19%	-11%	-7%	-9%	-12%
Prices (annual percent change)					
Consumer price index	103.6	111.3	119.1	124.0	126.8
Average wage	15,095	16,368	16,915	17,545	17,994
Export price Index	6.1%	-2.9%	2.6%	1.5%	1.4%
Import price Index	8.2%	0.6%	0.5%	2.4%	0.6%
Terms of trade	-1.9%	-3.5%	2.2%	-1.0%	0.8%
Employment and Wages					
Number of employees	**11,754**	**11,237**	**11,174**	**11,685**	**11,985**
% change	2.4%	-4.4%	-0.6%	4.6%	2.6%
Private sector	3,970	4,132	4,224	4,522	4,578
% change	-2.2%	4.1%	2.2%	7.0%	1.2%
Public sector	6,204	5,353	5,106	5,295	5,502
% change	6.3%	-13.7%	-4.6%	3.7%	3.9%
Other	1,580	1,752	1,845	1,868	1,906
Average annual wage	**15,095**	**16,368**	**16,915**	**17,545**	**17,994**
% change	-0.4%	8.4%	3.3%	3.7%	2.6%
Private sector	11,243	11,490	11,719	12,116	12,312
% change	5.1%	2.2%	2.0%	3.4%	1.6%
Public sector	16,114	18,408	18,850	19,681	20,137
% change	-3.6%	14.2%	2.4%	4.4%	2.3%
Average annual real wage (FY15 prices)	**21,672**	**21,873**	**21,129**	**21,047**	**21,101**
% change	-3.1%	0.9%	-3.4%	-0.4%	0.3%

RMI Summary Economic Indicators, FY22-FY26 cont'd

	FY22	FY23	FY24	FY25	FY26
Government Finance Statistics, ($ million)					
Revenue	173.4	180.3	170.6	205.1	216.3
Tax revenue	35.9	41.7	42.8	44.8	46.2
Grants	91.5	92.6	82.4	116.8	124.5
Other revenue	45.9	46.0	45.5	43.5	45.6
Expense	-153.4	-151.4	-157.5	-171.7	-179.1
Compensation of employees	-58.7	-56.9	-54.3	-57.8	-61.3
Use of goods and services	-44.5	-44.5	-51.0	-53.1	-55.7
Interest Payments	-0.5	-0.5	-0.3	-0.6	-0.5
Subsidies	-16.5	-14.4	-16.2	-16.8	-17.5
Grants	0.0	0.0	0.0	0.0	0.0
Other expense	0.0	0.0	0.0	0.0	0.0
Net Worth and its Changes	-2.8	-2.2	-6.9	-2.2	-1.8
Nonfinancial assets	-17.5	-30.1	-24.4	-33.4	-37.3
Financial assets	0.0	0.0	0.0	0.0	0.0
Financial liabilities	-2.0	0.0	0.0	0.0	0.0
Overall fiscal balance	20.4	29.3	13.4	34.0	37.7
(In percent of GDP)					
Revenue	68.4%	68.9%	63.2%	66.9%	66.4%
Taxes	14.2%	16.0%	15.8%	14.6%	14.2%
Domestic revenues	36.1%	35.4%	30.5%	38.1%	38.2%
Grants	18.1%	17.6%	16.8%	14.2%	14.0%
Expense	-60.5%	-57.9%	-58.3%	-56.0%	-54.9%
Compensation of employees	-23.2%	-21.8%	-20.1%	-18.9%	-18.8%
Use of goods and services	-17.6%	-17.0%	-18.9%	-17.3%	-17.1%
Interest Payments	-0.2%	-0.2%	-0.1%	-0.2%	-0.2%
Subsidies	-6.5%	-5.5%	-6.0%	-5.5%	-5.4%
Grants	0.0%	0.0%	0.0%	0.0%	0.0%
Other expense	0.0%	0.0%	0.0%	0.0%	0.0%
Non Financial Assets	-6.9%	-11.5%	-9.0%	-10.9%	-11.4%
Overall fiscal balance	8.0%	11.2%	5.0%	11.1%	11.6%
Balance of Payments					
Current Account balance	-5.6	19.3	-8.8	5.3	-22.1
Exports of goods and services	102.7	100.1	102.9	105.5	109.3
Imports of goods and services	228.6	209.1	206.2	238.3	273.5
Primary income balance	37.7	50.5	65.9	65.8	67.2
Secondary income balance	82.7	77.8	28.5	72.3	74.9
Capital account balance	18.4	12.8	43.8	53.7	43.3
Net lending/Borrowing (Curr + Cap)	12.9	32.1	35.0	59.0	21.2
Financial Account balance	-16.0	4.4	35.1	-3.0	-26.7
Direct investment	-7.8	8.7	8.9	9.1	9.3
Portfolio investment (increase in assets: -)	25.3	5.7	-1.2	-3.1	-4.3
Other investment (increase in assets: -)	-33.4	-10.0	27.3	-9.0	-31.7
Errors and omissions	3.1	-36.5	-70.1	-56.0	5.5
Errors and omissions (% goods and services)	1%	-12%	-23%	-16%	1%

RMI Summary Economic Indicators, FY22-FY26 cont'd

	FY22	FY23	FY24	FY25	FY26
External Debt, $ million					
Gross External Debt, total	59.6	54.7	48.5	42.2	36.3
National Government	46.9	43.9	39.7	35.4	31.7
State Owned Enterprises	12.6	10.8	8.8	6.8	4.6
Gross External debt as % of GDP	23.5%	20.9%	18.0%	13.8%	11.1%
Debt Service	4.5	4.7	4.9	4.7	4.1
Debt service as % of national government revenues	2.6%	2.6%	2.9%	2.3%	1.9%
Depositiory Coporations Survey ($ million)					
Net foreign assets	221.1	225.7	192.3	195.2	221.2
Domestic claims	111.4	102.7	102.6	108.3	115.6
Net claims on national government	-12.8	-9.4	-37.8	-43.3	-49.2
Claims on other sectors	124.2	102.7	100.2	108.1	115.5
Private non-financial corporations	48.2	28.0	24.0	24.8	27.7
Individuals	76.0	74.7	76.2	83.3	87.8
Broad money liabilities	297.3	279.2	217.8	224.5	251.3
Demand deposits	150.2	159.2	78.2	80.6	90.2
Other deposits	147.1	120.0	139.6	143.9	161.0
Capital and other accounts	35.2	39.8	39.0	35.5	36.2
Loans to deposit ratio, %	41.8%	36.8%	46.0%	48.1%	46.0%

RMI
ECONOMIC REVIEW 2024

Republic of the Marshall Islands

May 2025

The RMI Economic Review is produced annually to provide an independent assessment of the Republic of the Marshall Islands' economic performance and policy environment, as well as independently verified economic statistics. The Review has been developed to assist the governments of the RMI and the United States to fulfill their respective reporting requirements under RMI's Compact of Free Association with the United States.

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