Federated States of Micronesia

Fiscal Year 2011 Economic Review

PRELIMINARY REPORT

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Currency Equivalents

Currency Unit	—	United States Dollar (US$)

Abbreviations

ADB	—	Asian Development Bank
Amended Compact	—	The second phase, FY2004-2023
Compact	—	The Compact of Free Association
Compact I	—	First 17 years of the Compact, FY87-03
CTF	—	Compact Trust Fund
EPIC	—	Economic Policy Implementation Council
ERP	—	Early Retirement Program
ESC	—	Executive Steering Committee
FDI	—	Foreign Direct Investment
FPA	—	Fiscal Procedures Agreement
GDP	—	Gross Domestic Product
GFS	—	Government Finance Statistics (IMF)
IMF	—	International Monetary Fund
NPT	—	Net Profit Tax
PSD	—	Private Sector Development Program
PSRP	—	Public Sector Reform Program
PFTAC	—	Pacific Finance Technical Assistance Center
PSE	—	Public Sector Enterprise
SDP	—	Strategic Development Plan
SGS	—	Sustained Growth Strategy
GRT	—	Gross Receipts Tax
TA	—	Technical Assistance
US	—	United States of America
VAT	—	Value Added Tax

Note

The Government's fiscal year (FY) ends on September 30.

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FOREWORD

This report presents the preliminary findings and conclusions of the FY2011 FSM Economic Review. The purpose of the Review is to assist the government of the Federated States of Micronesia and U.S. Department of the Interior in fulfilling their respective reporting obligations under the Compact of Free Association. The FSM is required under Title One, section 214, to report to the President of the U.S. on the use of sector grant assistance and progress in meeting mutually agreed-upon program and economic goals. In the case of the U.S., under Title One, Section 104.h, the President is required to submit a similar report to the Congress concerning developments in the FSM.

This report has been prepared under a grant from the Department of the Interior and administered through the Graduate School USA. It is intended to assess the FSM's economic performance and policy environment and to compile a comprehensive set of economic statistics. Much of the material will be directly relevant to both governments in completing their respective reports. However, the reporting requirements of the two governments are different, and thus not all the material will be relevant to both reports.

This report is available online at http://www.econmap.org.

Mark Sturton

EXECUTIVE SUMMARY

Since the introduction of the amended Compact in FY2004, the FSM has experienced two distinct periods of economic activity. In the first phase FY2004-FY2008, GDP declined in four out of the five years, by an annual average of -1.2%. The reduction in resources from Compact I, capacity constraints in fulfilling the new fiscal procedures—especially with respect to infrastructure grant implementation—and the need to transition from the use of the capacity-building sector grant for general government operations, generated a harsh economic climate. In a second phase between FY2008 and FY2011 the economy over came the malaise of the first period and expanded by an annual average 1.8%. This improved economic performance was due to large investments in infrastructure emanating from increased use of the infrastructure sector grant and FAA funded airport renovation.

During the amended Compact real per-capita incomes have risen slightly from $2,332 to $2,377, an improvement of just 1.9% over the eight years. The overall weak economic performance has been accompanied by a reduction in employment—by 567 jobs, or 3.4% of those employed. As incomes have stagnated, the economy has failed to provide productive opportunities to the population, outward migration has continued at 1.8% per annum, and the population has declined by 0.4% per annum.

The reduction in Compact funding and the consequent difficulties in adjustment resulted in significant fiscal deficits during the first 5 years of the amended Compact. However, since implementation of the adjustment measures, the fiscal position has recorded an average level of surplus of 0.9% of GDP during the last three years. The FSM has maintained a favorable external debt position, which has eased the fiscal position.

The structure of the amended Compact resulted in the need for significant fiscal adjustment both in the near and long term. In the near term the new sector-grant approach favored education, health and selected sectors, but did not provide funding for the operation of general government. This required a substantial adjustment in the operation of non-Compact sectors to fit local revenues over a five year period. A reduction-in-force and other reforms required a painful adjustment in Chuuk and Kosrae.

Once implemented, focus shifted to the need for adjustment over the longer term to accommodate the annual decrement and partial inflation adjustment of annual Compact grants. JEMCO called for a long-term decrement management plan to provide an efficient means of adjustment. The national government responded with the preparation of a Long Term Fiscal Framework (LTFF), but this was not endorsed at the state level. The preparation of a second round of state generated LTFFs are now underway. A series of participatory state leadership meetings has been convened to generate budgets that will determine the allocation of public sector resources over the remaining period of the amended Compact. In the first instance the states will commit to a 6% budget cut over a three year period that will be presented to the mid-year JEMCO consultations in 2013.

On the revenue side fiscal policy has focused on the adoption of a modern tax regime. However, progress has been slow, and only now after many years has the process picked up speed. The national and state governments are deliberating the sizeable set of laws that are required to implement the reforms. The national government has enacted about half the laws required, while some states have completed their portions, and others remain in the process. While there is widespread agreement that the process is required and should go ahead, this view is not unanimous and implementation is not guaranteed.

In 2004 the FSM convened the 3rd Economic Summit and adopted a strategy for sustained economic growth based on adjustment and reform. It rejected a “dismal” scenario that relied on a status quo policy environment and resulted in a projection of substantial and sustained outmigration. In the initial years of the amended Compact FY2004-FY2008 economic performance was indeed dismal as the economy adjusted to the new provisions. In the last three years the economy has been on a higher trajectory. However, the recent acceleration in growth was been achieved from greater utilization of the infrastructure grant, and the sizeable investment in the FAA funded airport renovation program. The additional stimulus from these sources will not continue at the same rate in the future. Indeed the FAA program is nearing completion. The FSM needs to complete the existing reform programs in fiscal adjustment to the declining real value of Compact grants, and consolidate the FSM-wide tax reform to establish a sound macroeconomic environment. With a sustainable basis for development, the FSM will be in a stronger position to identify new sources of economic growth to maintain the recent improved economic performance. The scheduled Consultative Group of donors meeting in November 2012 will provide a good opportunity for the FSM to report on its reform progress, and seek donor assistance to promote new developments.

The Trust Fund for the People of the FSM was created "to contribute to the long-term budgetary self-reliance of the FSM… [and] to provide the Government of the FSM with an ongoing source of revenue after FY2023." The US Government has made it clear that the amended Compact and its subsidiary agreements contain no commitments that the Trust Fund will sustainably achieve distributions to maintain the real value of sector grants after 2023. It is thus important that the FSM Government assess Trust Fund performance against a sensible goal. That sensible goal is the projected ability of the Trust Fund to support a smooth and sustainable transition from US-appropriated annual grants to annual Trust Fund distributions.

Such a "sustainability estimate" is presented herein to inform key decision makers well in advance of the Trust Fund distribution period. The sustainability estimate for the end of FY2023 is $1.82 billion. In order to be precisely "on-track" to achieving that level, the value would have grown to $358 million as of June 30, 2012; however, the actual value of the FSM Trust Fund was $245 million. This difference of $113 million leaves the Trust Fund 31.5 percent "below track" after 8.75 years of the projected accumulation period. The growth rate required to "catch-up" is 13.6 percent. This rate of return is virtually unachievable over the remaining 12.75 years. It is recommended that policy makers mobilize additional contributions—from domestic and external sources—to the Trust Fund. It is further recommended that the parties to the Trust Fund consider changes to the Trust Fund Agreement. The current Trust Fund rules are likely to result in immense and repeated fiscal shocks that could be reduced in severity and frequency through better design.

I. Economic Performance

The Economy

At the start of the start of the amended Compact the economy went into a period of decline, as the level of external transfers fell to the new, lower negotiated levels: a reduction from $84 million (the trend Compact I level) to $76 million. A series of other factors also had strong negative impacts on the economy: (i) the loss of the Compact I energy grant; (ii) absorptive capacity constraints in the use of the new Compact sector grants; and (iii) the failure to use the infrastructure grant.

Implementation of amended Compact initiates a period of decline.

In FY2004 the economy fell sharply by 3.2% with the reduction in Compact funding (Fig. 1). Some of the lost ground was recouped in the following year, but growth turned negative in the following three years FY2007-FY2009 with GDP contracting by 4.7% over the period. In FY2007 both Chuuk and Kosrae were required to implement a sizeable Reduction-In-Force (RIF), amongst other fiscal measures, to restore fiscal balance as the capacity building sector grant was phased out from non-conforming purposes. While the year was a positive one for fisheries, the economy contracted by 2.1%. In FY2008 with the RIF on-going, the negative shock of the world recession had a strong impact on the state economies. Higher fuel and food prices eroded real incomes and GDP fell by a further 2.6%.

Economy contracts by 4.7% between FY2006 and FY2008 with the implementation of a Reduction in Force in Chuuk and Kosrae coupled with onset of world recession

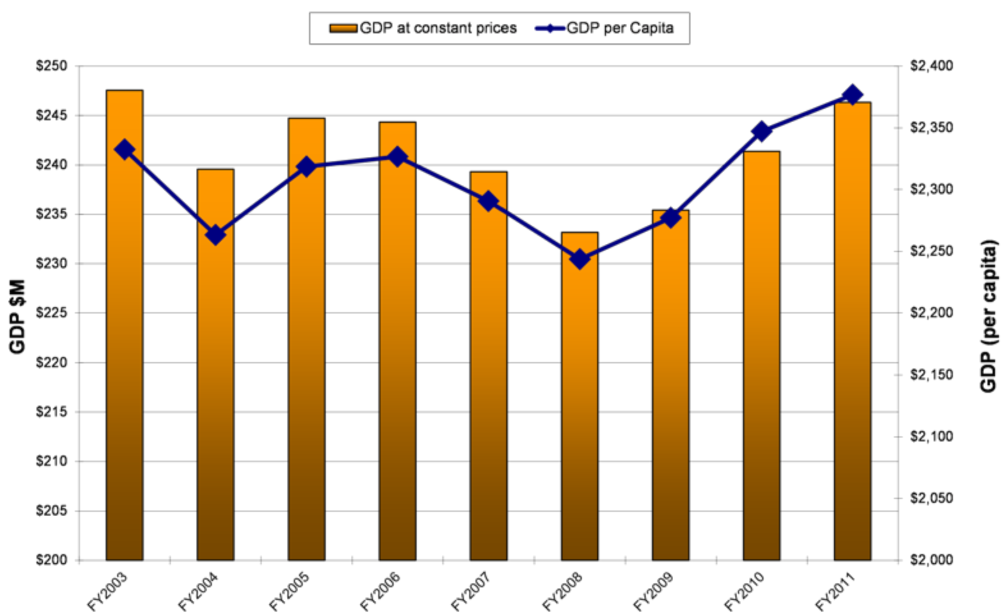


Figure 1 Real GDP and real GDP per capita

FSM economy performs well in FY10 and FY11 reflecting greater capacity utilization of the infrastructure grant and sizeable FAA airport improvement projects.

While the international economic conditions remained adverse in FY2009, strong growth in construction and FAA funded airport renovation resulted in a return to positive growth in the economy of 1.0%. FY2010 turned out to be a good year for the FSM economy. This reflected continuing expansion in construction as use of the infrastructure grant picked up momentum, and further injection of funds from the FAA projects. After several years of fiscal consolidation, FY2010 saw a return to growth in public administration and the economy expanded by 2.5% overall. These trends continued to exert themselves in FY2011 although good performance in fisheries replaced public administration as a source of growth, and the economy grew by 2.1%.

FSM economy dominated by large public sector.

The structure of the FSM economy is dominated by a large public sector, with a dependent private sector producing non-traded goods and services to the government and its employees (Fig. 2). The share of government has declined significantly, by 12.5%, since the beginning of Compact I. This reflects three major forces: (i) a reduction in the size of government due to the lower levels of Compact assistance; (ii) the restructuring of the public sector through the creation of Public Sector Enterprises (PSE); and (iii) adjustments required to conform to the new structure and lower levels of grants in the amended Compact. The increase in PSEs

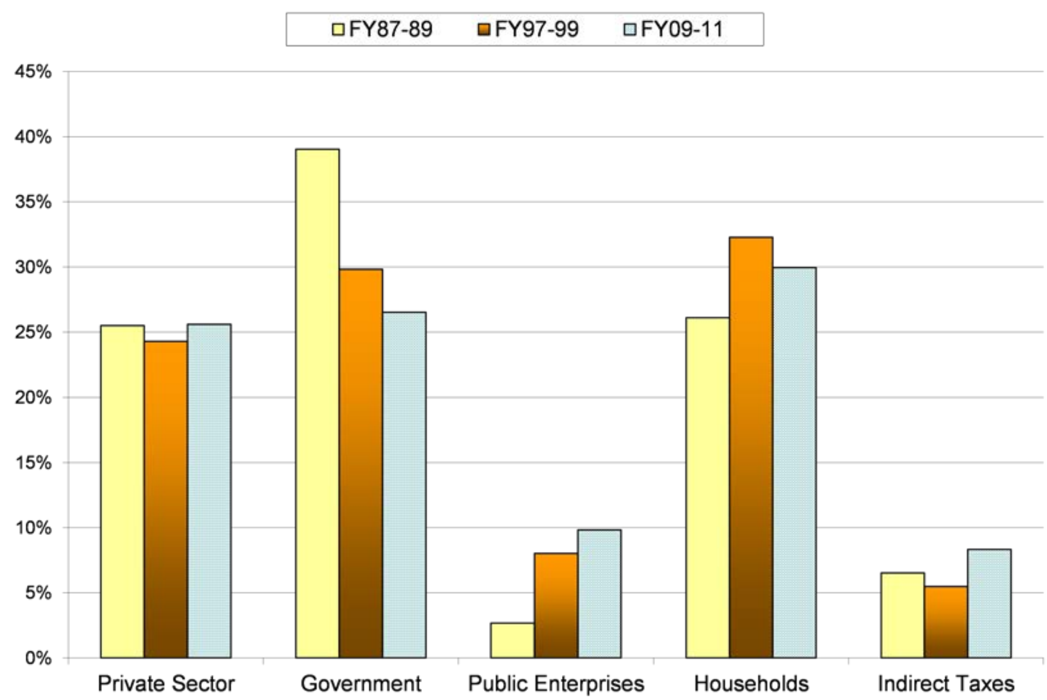


Figure 2 The institutional structure of the FSM economy (percent)

reflects the creation of utility services in power and telecommunications, as well as the creation of fishing enterprises. By the mid-90s, the growth in PSEs had largely run its course, and inefficient fisheries enterprises are now mostly defunct or consolidated under private sector management. Overall, combining government and the PSEs, the contribution of the public sector at large has fallen by 5% of GDP since the beginning of the Compact.

Size of government falls but offset by increased Public Sector Enterprises.

The share of the private sector since the start of Compact I has remained virtually unchanged at 25%. Given the reductions in the share of the public sector, including PSEs, this result is surprising. Even when compensating for the public sector decline, the share of households has increased. The household sector includes market production of commodities, non-market production (subsistence) and home ownership. The total share of households has risen by 3.9%, offsetting the decline in the public sector. In essence the failure of the private sector to become the engine of growth has resulted in households falling back on their own resources and devoting increase efforts to subsistence production.

Private sector fails to take up the void left by public sector decline and household subsistence production compensates.

Reflecting a small share of the private sector, economic performance in the leading sectors of market agriculture, fisheries and tourism has not lived up to expectations. In the early 1990s, in an attempt to develop the economy, the FSM embarked upon a strategy of substantial public sector investment in fisheries facilities and enterprises. However, none of the fisheries enterprises achieved profitability, and over time the surviving entities were transferred to private ownership or management. There were signs of large scale renewed interest in foreign investment in the fishing industry, but these have failed to come to fruition. Tourism, clearly a sector with comparative advantage for the FSM, has not fulfilled its potential, and sector GDP has declined by an annual average of -3.3% during the amended Compact. The current interest in tourism development in Yap state would bring significant economic benefits, but the scale of the investment may come with large social costs if not correctly managed.

FSM's sectors of comparative advantage—market agriculture, fisheries and tourism--have not lived up to expectations. Fishing industries have stagnated while tourism has declined.

Population, Migration and Employment

The change in GDP per capita and employment in each of the FSM states is indicated in Fig. 3. In all states, real incomes have remained largely stagnant since FY1995, and employment opportunities have fallen with the exception of Pohnpei, reflecting the poor economic performance during the last 15 years. As a result of the decline or stagnation in incomes, outmigration as measured by net movements of air passengers leaving the FSM during 2004-11 has

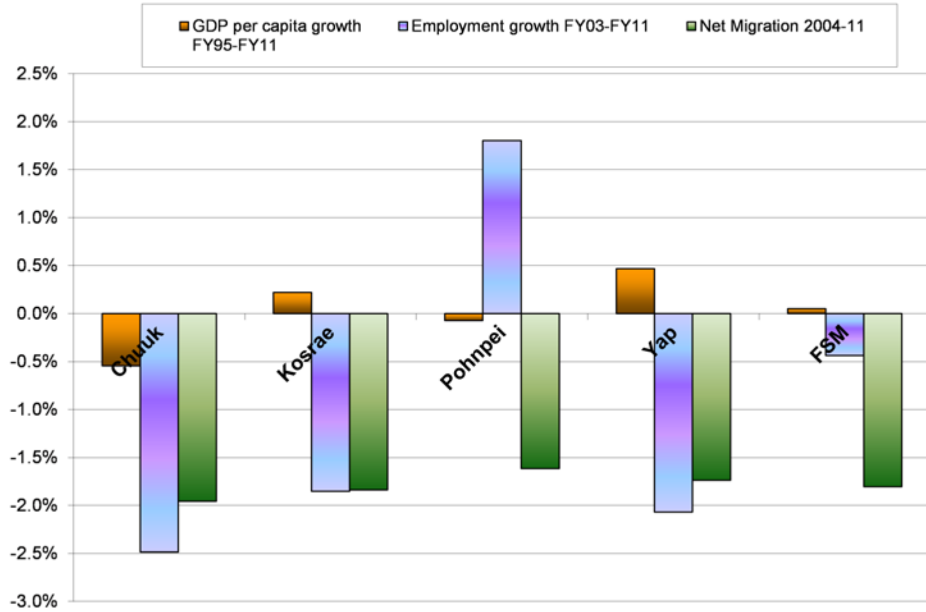


Figure 3 Growth in GDP in per capita, employment, and migration.

Real incomes stagnate and job prospects deteriorate during FY95-11.

Outmigration rises in response to the lack of economic opportunities.

Employment levels fall reflecting public sector downsizing. Private sector employment improves in FY10 and FY2011 with growth in construction, but fails to fill the gap.

Private public wage differentials remain little changed.

also been large. Clearly, there is a strong association between economic performance, employment prospects and outmigration. Even in Pohnpei, where real incomes were stagnant but job opportunities improved, outmigration was strong.

Reflecting weak economic performance, employment has stagnated with over 1,420 jobs lost between FY1995 and FY2011. Much of this loss is reflected in the reduction in the size of the public sector (Fig. 4). Public sector jobs fell by 1,785, following the reductions in public service as part of the fiscal adjustment required at the end of the Compact I. While public sector employment expanded in the early 2000s, it dropped by a further 338 jobs since FY2000 with the implementation of the RIFs in Chuuk and Kosrae. Private employment surpassed the public sector as the largest employer for the first time in FY2000, but subsequently contracted. However, FY2010 and FY2011 have been good years for private sector job creation as renewed construction activity has added 802 jobs since FY2008. Wage differentials between the private and public sectors remains substantial but at the FSM level have changed little since the mid-1990s. However, while the differential has widened in Chuuk (12%), it contracted significantly in Yap (22%), and also more modestly in Kosrae (9%) and Pohnpei (6%).

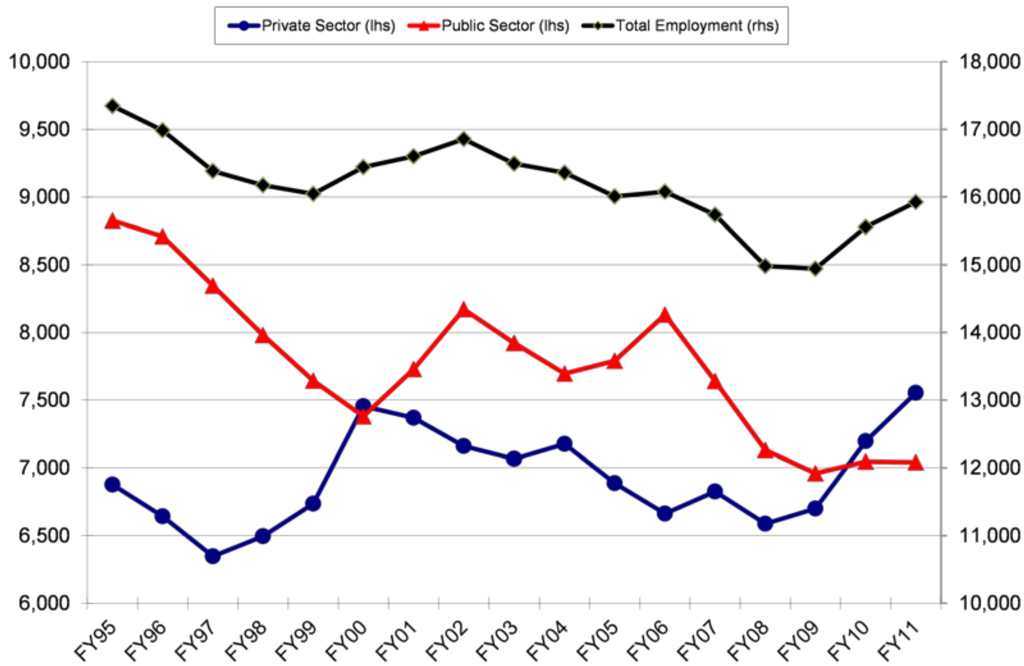


Figure 4 Employment by sector FY1995-FY2010.
Note lhs = left-hand side; rhs = right-hand side

Inflation

Inflation has generally been moderate in the FSM and has followed patterns in the U.S. However, recent increases in energy and food prices have altered these trends. Fig. 5 indicates changes in the CPI since the start of the amended Compact. In 2005 rising world energy prices caused a significant shock to the FSM economy. Inflation in the energy group of the CPI peaked at over 25% in the third quarter of 2005, and inflation in overall consumer prices rose to 5%, approximately 1% above U.S. rates. While this increase in the CPI was well above historical rates, the impact of increases in energy prices on the average household was not great, due to the low weight of energy in the CPI. Rather, the sizeable increases in world food prices during the second half of 2008 resulted in a radical rise of the FSM's traditionally low inflationary profile. Reductions in fuel and a leveling of food prices resulted in CPI moderation towards the end of FY2009. However, further increases in fuel and utility prices once again reasserted themselves in FY2010 with the CPI recording an annual inflation rate of 6.3%. During FY2011 continuing rising fuel and utility prices together with a resurgence of food prices towards the year end once again put upward pressure on inflation.

Higher world energy and food prices push inflation into double digits at the end of 2008.

Inflation moderated in FY2009, but continuing rising fuel prices together with a resurgence of food prices in FY2011 has kept inflation up.

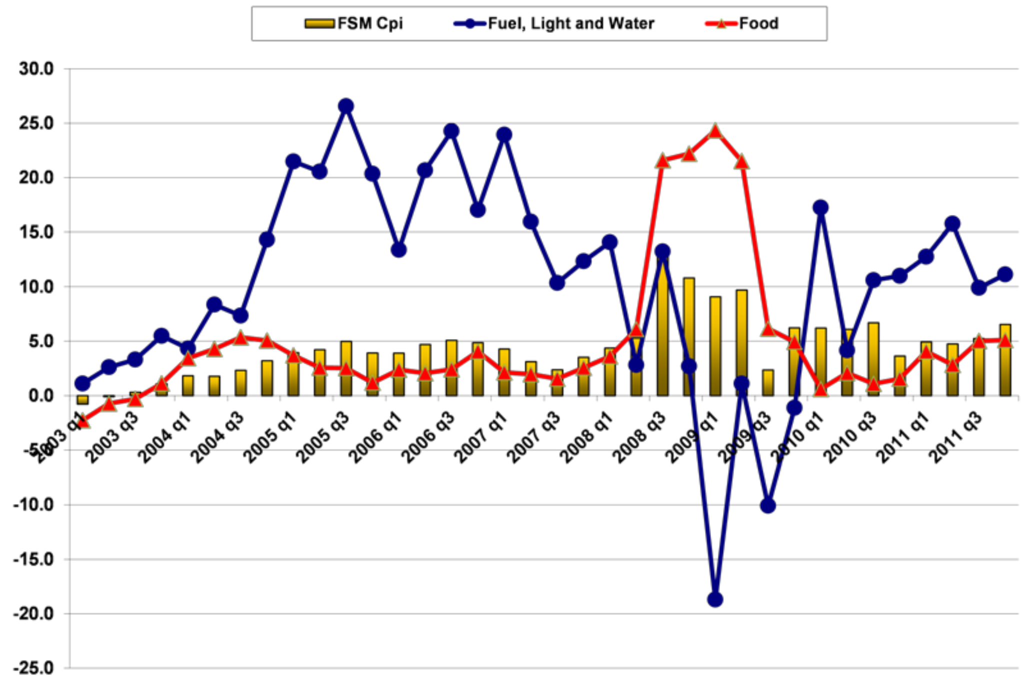


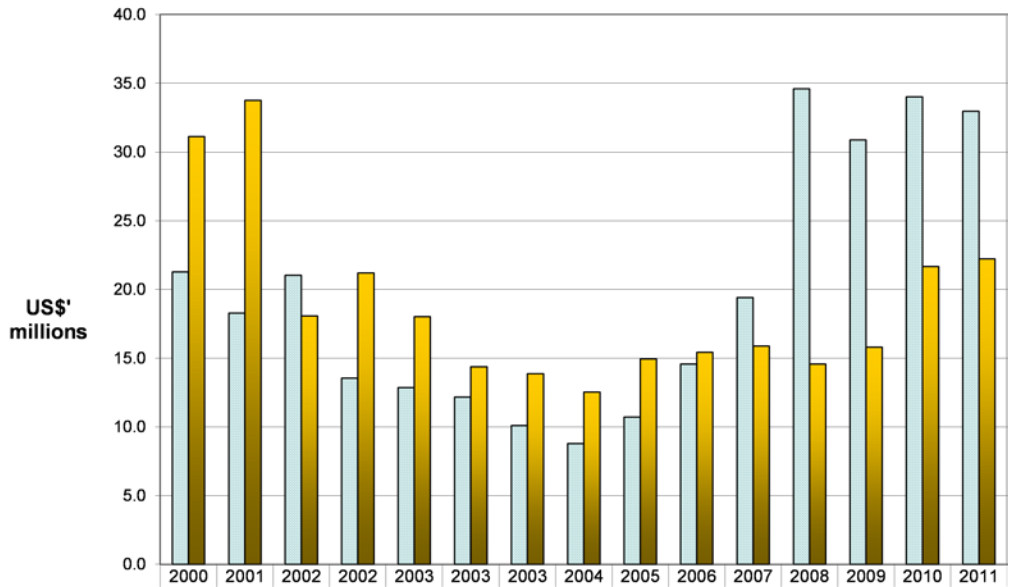
Figure 5 Inflation in consumer, food and energy prices (year on year percent change)

The Banking Sector

Lending to the private sector fell significantly in the early 2000s, but has recently shown signs of improvement.

A weak business environment and lack of bankable collateral inhibit lending.

Data from the banking sector have generally indicated a disappointing outcome. Total loans to the private sector (both commercial and consumer) fell from a level of $52 million in FY2000 to $21 million in FY2004 (Fig. 6). This reflects a variety of factors. The Chuck state financial crisis in the early 2000s led to a reduction in consumer credit. Early in 2002 the Bank of Hawaii, then the largest player in the FSM market, withdrew from the FSM as part of a corporate strategy to sell off its Pacific assets. Since that time the banking sector has shown signs of improvement, with lending to the commercial sector growing significantly, although this included a large loan to the newly formed Micronesian Petroleum Corporation (MPC), which has subsequently been paid down, and lending in Saipan by the Bank of the FSM. While consumer credit has been weak there was significant growth in FY2010. Despite these developments, the FSM banking sector remains highly liquid, and the loans-to-deposit ratio was 33% at the end of FY2011. This reflects the high level of perceived risk in the FSM and “lack of bankable projects.” Overall, lack of collateral, the inability to use land as security, and inadequate provision to secure transactions have inhibited development of the financial sector. With limited



	2000	2001	2002	2002	2003	2003	2003	2004	2005	2006	2007	2008	2009	2010	2011
Commercial Loans	21.3	18.3	21.0	13.5	12.9	12.2	10.1	8.8	10.7	14.6	19.4	34.6	30.9	34.0	33.0
Consumer Loans	31.1	33.8	18.1	21.2	18.0	14.4	13.9	12.5	14.9	15.4	15.9	14.6	15.8	21.7	22.2

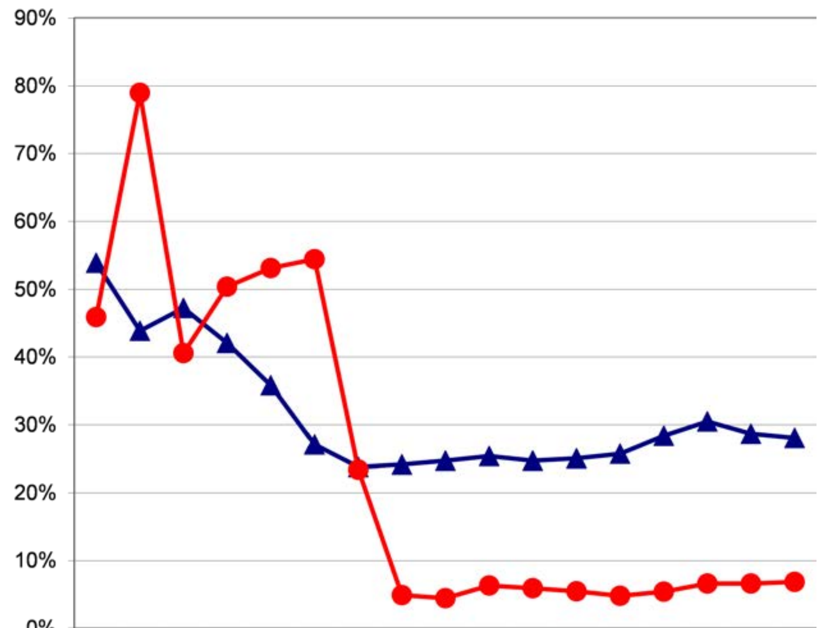
Figure 6 Commercial bank credit by sector, FY00-FY11.

opportunities, commercial banks have preferred to invest their assets off-shore in less risky and more secure markets.

External Debt

Although many of the indicators do not suggest a vibrant picture of recent economic performance, the FSM has maintained a favorable external debt profile (Fig. 7). After a period of sizeable borrowing in the early 1990s to finance development projects—many in the fisheries sectors—external debt has fallen significantly. Debt-to-GDP has fallen from 54% in FY1995 to 28% in FY2011, and debt service ratios remain very favorable by international standards, reflecting the concessionary nature of the remaining outstanding debt. There has been some increase in borrowing from the ADB in the amended Compact with drawdowns under the Basic Social Services and Private Sector Development Programs in FY2004-FY2009. More recently under the Omnibus Loan, the ADB has provided support to a series of infrastructure projects (FY2008-FY2011). In FY2009 the FSM Telecom borrowed $11.1 million to finance installation of a fiber optic connection to the U.S. backbone with a further small draw down in FY2010. As a result the ratio of debt to nominal GDP rose in FY2009, but decreased slightly in the following two years.

The FSM maintains a favorable external debt profile.



	FY95	FY96	FY97	FY98	FY99	FY00	FY01	FY02	FY03	FY04	FY05	FY06	FY07	FY08	FY09	FY10	FY11
External Debt, % of GDP	54%	44%	47%	42%	36%	27%	24%	24%	25%	25%	25%	25%	26%	28%	30%	29%	28%
Debt Service, % of Exports	46%	79%	41%	50%	53%	54%	23%	5%	4%	6%	6%	5%	5%	5%	7%	7%	7%

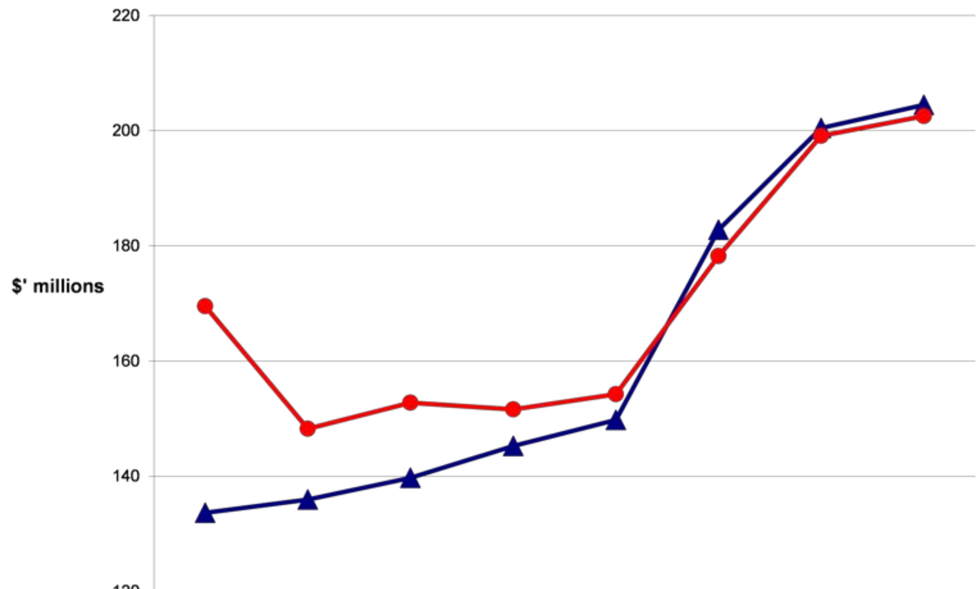
Figure 7 FSM external debt ratios, FY1995-FY2010

Fiscal Situation

The first five years of the amended Compact witnessed a difficult period of fiscal adjustment, as the nation was forced to adapt to the new arrangements (Fig. 8). At the start of the amended Compact in FY2004 the FSM recorded a deficit of $36 million (15% of GDP), reflecting the capital transfer of $30 million to the Compact Trust Fund and the return to funding levels below those prevailing before the pre-bump-up period. In the subsequent years FY2005 and FY2006, deficits of $12 and $13 million—or 5% of GDP in each year—were recorded. The amended Compact restricted the use of resources to specified sectors, and prohibited their use to fund general government. To ease the adjustment the U.S. permitted the use of the capacity building grant to fund specific activities, provided these were transitioned out over a five-year period. There was a gradual improvement in the fiscal position as the nation adjusted to the new requirements and implemented RIFs in Chuuk and Kosrae.

The FSM records significant deficits at the start of the amended Compact as the nation adjusts to the new arrangements.

By FY2009 the adjustment to the new sector grant approach was complete, and the FSM recorded a surplus of $4.6 million or 1.6% of GDP for the first time in the amended Compact period. In FY2009 the FSM was to receive significant FAA grants for airport improvement, which pushed up both revenues and expenditures



	FY04	FY05	FY06	FY07	FY08	FY09	FY10	FY11
Revenues	133.6	135.9	139.7	145.2	149.8	182.8	200.5	204.5
Expenditures	169.5	148.2	152.8	151.6	154.2	178.2	199.1	202.5

Figure 8 FSM consolidated revenues and expenditures, FY04-FY2011.

significantly. In FY2010 there was significant further FAA infrastructure investment, and a slightly smaller surplus of $1.4 million was achieved, representing 0.5% of GDP. Finally, in FY2011 the expansion in airport renewal continued and the nation as a whole achieved a surplus of $1.9 million or 0.6% of GDP. The major renovations at the FSM airports are nearing completion and it is anticipated that the upward trend in revenues and expenditures will be reversed in the coming years. While adjustment to the amended Compact has been painful and the fiscal position remains tight, macroeconomic and financial stability has been achieved and provides a sounder basis for future development.

FSM achieves fiscal surplus for the first time in the amended Compact in FY2009 indicating adjustment to the sector grant approach is complete.

II. Policy Developments, Prospects, and Issues

Government Payroll Issues

FSM embarked on a program of public sector reform in the late 90s and made significant achievement in reduction of the number of public servants that still stands today.

At the end of Compact I as the level of grants declined, the FSM embarked with ADB support on a program of public sector reform (PSRP). A major component of the PSRP was the compression of expenditures and reduction in workforce and payroll. In terms of numbers of public servants the PSRP set a target reduction of 27%. By FY1999 a 16% reduction had been achieved (Fig. 9). While there was significant growth in numbers in the early 2000s, this was balanced through subsequent RIFs in Chuuk and Kosrae in FY2007 and FY2008. As of FY2012, the reduction in public servants compared with original PSRP targets still stands at 16%, and remains a considerable achievement.

While reductions in payroll numbers have been sustained, achievements in reducing payroll cost have not succeeded.

The story, however, in terms of payroll cost, is significantly different. The PSRP targeted 35% savings in payroll cost and achieved 20% savings by program closed out in FY1999. Eleven years later, by FY2012, payroll costs have grown steadily and reverted to the levels prevailing before the program was initiated, completely eroding the progress achieved.

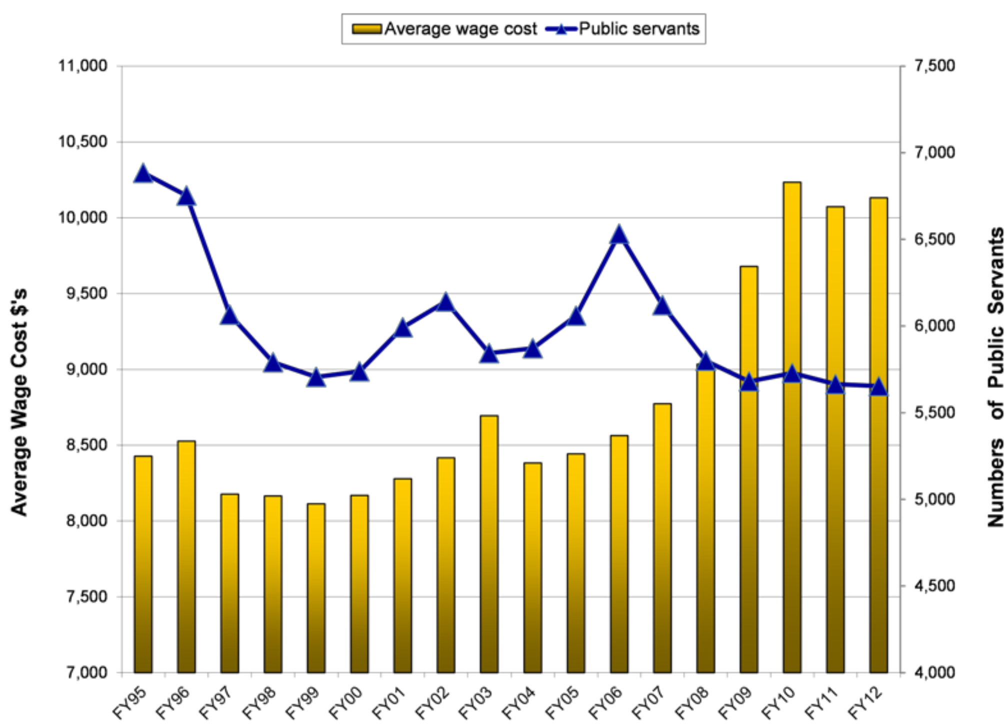


Figure 9 FSM public servant numbers and average wage cost FY95-FY11.

With employee numbers constant but payroll costs rising, average wage costs per employee rose strongly during the first six years of the amended Compact. Overall, average wage costs rose by 22% or by 3.4% on an annualized basis, and would have contributed to fiscal outturn and deficits described in the previous section. However, since FY2010 the upward trends has flattened and average wage costs have actually declined although not significantly. During the initial period a variety of factors were at play: restructuring of the work force with RIFs in Chuuk and Kosrea, return to the normal number of working hours in each pay period, upgrading of teacher skills, award of a COLA in the National and Pohnpei Governments, etc. These factors led to an increase in average wage costs although there was a general policy of wage freeze in most governments. Since FY2010 with adjustments to the amended Compact complete wage costs have stabilized and hopefully future increases will remain modest.

Average wage costs rose rapidly by an annual average of 3.4% during the first six years of the amended Compact, but stabilized through FY2010-FY2012.

These developments raise the issue of public sector wage policy, especially through FY2023 as the annual decrement and partial inflation indexation erode the real value of the annual sector grants. While adoption of holding nominal wage rates constant provides an adjustment strategy, this may not be a desirable if the FSM wants to retain better qualified staff and limit external migration. A policy of limited wage increases, offset by rationalization of the work force and efficiency gains, may be more appropriate in an otherwise ever-tightening fiscal envelope. This strategy has been incorporated into the Long Term Fiscal Framework or FSM response to the JEMCO requirement of a decrement management plan and is discussed below.

Development of a personnel and wage policy consistent with long-term financial stability is required.

Performance Management

The FSM adopted a strategic approach to implementation of the amended Compact sector grants expressed in the FSM Strategic Development Plan. The approach requires allocation of resources in accordance with performance criteria to measure both the delivery of services (outputs) and the results (outcomes) attained. However, the nation was not well prepared to implement the framework. While existing budgeting procedures adopted a performance approach and specification of outputs, these were largely hypothetical, as no monitoring or evaluation mechanism had been put in place. Although the U.S has emphasized results and monitoring of outcomes, little emphasis has been placed on deliverables, begging the question of how to respond to observed outcomes.

FSM adopted a strategic planning approach, but fails to develop a modern system of public financial management (PFM).

FSM adopts a uniform financial management information system, but fails to integrate economic and performance needs.

At the start of the amended Compact, the FSM had inherited a disparate set of financial accounting systems in the five governments. It was clear that the old systems would not be able to support the kind of financial and performance information required in the fiscal procedures of the amended Compact. Following an RFP and implementation of a new FMIS, all five governments were using the same system by FY2008. However, implementation of the system focused on the financial reporting requirements of the amended Compact rather than fiscal management of the five governments or performance in service delivery. While the focus on financial and accounting requirements was necessary, the systems now fail to provide the type of management information required for fiscal and economic management, or measurement of outputs and outcomes.

Develop of an integrated planning and budgeting system is underway. However, design flaws in the chart of accounts will limit the implementation of an effective PFM system.

Development of a softwear module to replace the existing stand alone Budget Preparation (BPS) and Performance Reporting Systems (PRS) that interfaces with the FMIS is underway (Integrated Planning and Budgeting (IPB) system). The new system would enable download of financial information into the budget module for budget preparation, and then upload approved budgets back into the FMIS for execution. The PRS reporting module would also utilize a direct download from the FMIS to enable monitoring. This process will improve the budgeting process and enable budgets to reference current financial performance. However, there is no plan to incorporate standard GFS reports as part of the system. Further, the chart of accounts adopted in the existing FMIS fails to provide a coding system of outputs (service delivery). Until the chart of accounts is revised to include output specification and correspondence with GFS, implementation of the IPB will not enable development of a modern approach to Public Financial Management (PFM).

Adjustment to the Amended Compact

As the Compact re-negotiations neared completion in FY2003, it became clear that the new structure of the amended Compact would entail significant adjustments, both in the short term and throughout the 20-year horizon. The new sector-grant approach resulted in a system that provided sufficient funding to maintain the operations of education and health sectors in particular, but was not designed to support the *status quo* operating levels of many government functions. In the near term the U.S. permitted the FSM to utilize the capacity building sector grant for this purpose, provided that this practice would be transitioned out over a five-year period. In the long term a reduction in the resources of the amended Compact was programmed through an annual decrement of $0.8 million and partial inflation indexation of the transfers.

The need to transition from the use of the capacity building grant to fund operations required painful adjustments: expenditure cuts entailing a substantial loss of jobs, as well as additional revenue efforts. In Chuuk and Kosrae each of the state governments was required to make substantial expenditure cuts. In the most extreme case of Kosrae, the state was required to compress non-Compact expenditures by 32% entailing the elimination of 110 positions, an across-the-board pay cut, reductions in non-payroll costs and tax increases. In Chuuk the compression was 28% and 317 public service positions were eliminated. In Yap the financing gap was 19%, but the state has made adjustment through holding operational expenditures within current revenues and funding non-recurrent and capital projects through use of the state's reserves. Only Pohnpei state and the national government have been spared the need to transition.

Chuuk and Kosrae undergo painful adjustments to restore fiscal balance.

With transition to the sector grant approach complete, attention switched to the combined impact of partial inflation indexation and annual decrements during the remaining years of the amended Compact. Over the next 11 years the accumulated reduction in real funding equates to approximately 20% of the current value of the Compact sector grants or an annual average real decline of 2%. The amended Compact was specifically designed to avoid the large impact of five yearly step-downs as seen in Compact I, thereby easing the adjustment process. However the relatively small adjustment of 2% per annum cannot be easily achieved year-after-year on a long term basis, without distorting and diluting the delivery of public services. In September 2009, in recognition of the impact of the annual real decline of Compact resources, JEMCO adopted a resolution that subsequently became known as the "decrement" management plan:

Annual decrement and lack of full indexation of sector grants imply a 20% reduction in real resource flows during remainder of the amended Compact.

JEMCO requests decrement management plan.

> *JEMCO resolves that the FSM National and State Governments shall develop plans for managing annual decreases in Compact direct assistance and/or general fund support, and shall use those plans as the basis for Fiscal Year 2012 budget decisions. The plans should include an evaluation of the ability of the health and education sectors to fulfill their strategic outcomes in fiscal years 2012-2014.*

The FSM rejected the need for a decrement management plan and did not comply with the JEMCO resolution. During the following annual JEMCO meeting in 2010, an extended version of the original resolution was adopted. This required the preparation of a report in greater detail, covering the remaining period of the amended Compact through FY2023. The resolution specified a participatory approach to include policy makers at all levels of government and across all sectors. The consideration of a long list of issues was specified:

FSM rejects the need for a "decrement management plan".

2nd resolution adopted by JEMCO requiring a participatory comprehensive long-term response to the decrement issue.

- unsustainable trends in health and education,
- unsustainable growth in wage bills,
- lack of progress with the tax reform initiative,
- decline in real value of Compact grants,
- stagnant or declining economic activity,
- need to find other contributors to the Compact Trust Fund, and
- Population trends, remittances, and levels of other donor assistance.

FSM prepares a first version of a Long Term Fiscal Framework (LTFF) and a National Economic Symposium (NES) is convened.

As a result of this JEMCO resolution, the FSM accepted the need for a Long Term Fiscal Framework (LTFF), and convened a National Economic Symposium (NES). The LTFF was prepared by SBOC (Office of Statistics, Budget, Economic Management, Overseas Development Assistance and Compact Management). The NES was convened in February 2011 and was an inclusive, widely attended meeting with participation of the FSM leadership. Four resolutions were endorsed by the NES, including adoption of the LTFF, which was to be returned to States for their endorsement.

States reject national government LTFF.

A second round of LTFFs is initiated at the state level to ensure participation and commitment.

However, the states did not endorse the LTFF. At the FY2012 JEMCO meeting the states indicated that the national government LTFF had been drafted without state level consultations and did not reflect their priorities or needs. In the absence of a credible LTFF, a new process was initiated with the prime intention to ensure that the final product or LTFF had local participation and reflected state level priorities.

A round of state leadership meetings was accordingly convened. Each state was informed that the annual decrement and lack of full indexation amounted to a 20% real cut in the sector grants over the FY2013-FY2023 period; approximately 2% per annum. The initial task falling on each state was to prepare budgets as if the 20% reduction would be effective from FY2014. The leadership meetings were required to prioritize the budgets prepared by each department/agency ranking the order of the cuts from highest to lowest priority. However, it was not intended that the 20% cut would take place immediately in FY2014, but rather in a set of three tranches of 6% each over a three year period (see Fig 10). Each state was then requested to identify the initial three year cut of 6%, which would be a firm commitment and reflected in the FY2014 budgets submitted to JEMCO.

States prepare LTFFs on basis of a 20% cut to be implemented over 11 years.

A 3 yearly cycle of 6% cuts is envisaged unless offsetting revenue measures can be found.

It is envisaged that the leadership process would be repeated in three yearly intervals. Identification of specific budgets and priorities over a 10 year horizon is not realistic as many factors and circumstances would be subject to change. Reassessment and prioritization over a three year medium-term horizon was considered more appropriate. It was further indicated that if offsetting revenue measure were identified and passed into law such as the FSM wide tax reform or "burden sharing" with the national government, the cuts in future rounds could be relaxed.

The intended LTTF framework provides for some inflation adjustment in the intervening years. Since the Compact provides for partial inflation adjustment, the nominal value of the annual sector

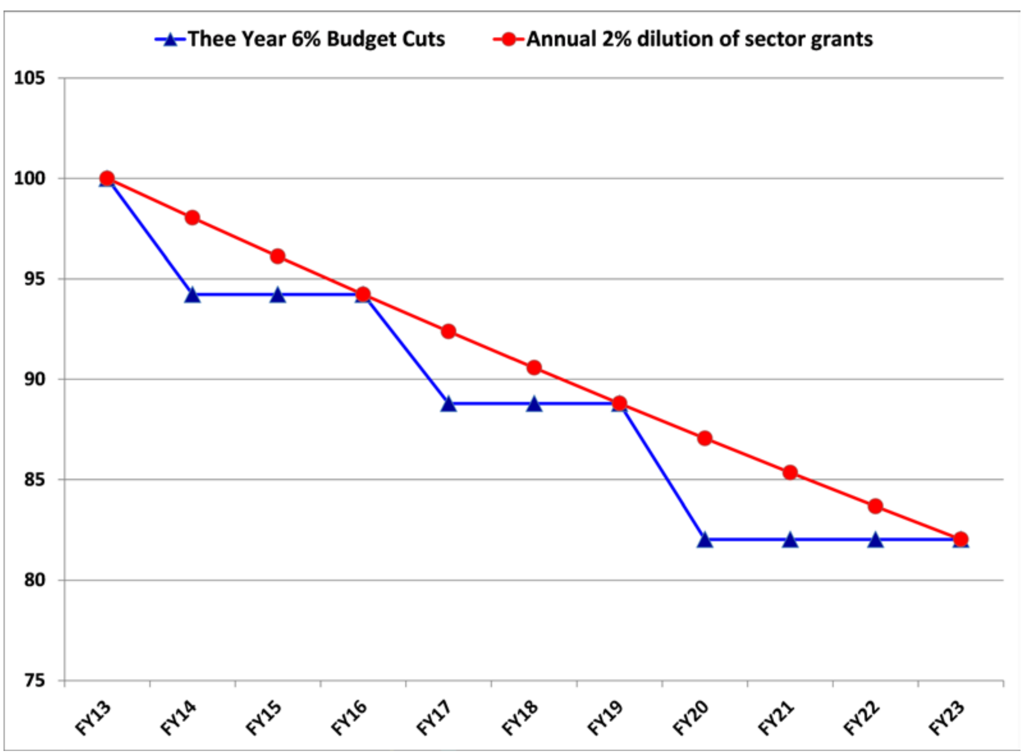


Figure 10 LTFF three yearly adjustment cycle.

grants remains approximately static; the annual decrement being offset by the inflation adjustment. Thus after each initial cut of 6% in the first year of each three yearly cycle, some allowance, up to 2%, can be permitted in each of the following two years.

Kosrae state commits to LTFF. Yap undertakes similar process but state legislature yet to endorse. Chuuk scheduled for mid-August and Pohnpei looking at September.

In June of 2012 Kosrae state was the first to complete the process with leadership endorsement. Yap state was to follow in July, although the state legislature has yet to confirm its commitment. Chuuk is undertaking the process in August and Pohnpei has indicated a desire to undertake a similar process in September. It is anticipated that budgets prepared by each state would be compiled in state level LTFFs, and presented to the JEMCO at the mid-year consultations in FY2013 in fulfillment of resolution 2010-2.

Tax reform

FSM adopts program of tax reform and modernization to implement a VAT and net profits tax.

A new tax administration will replace national and state tax offices.

During 2004, with support from ADB and PFTAC, the design and structure of a modern tax regime appropriate for the FSM was articulated. A task force with representation from both national and state governments, as well as the private sector, was created by the President in 2005 to promote a comprehensive approach to the issue of tax reform. The recommendations of the task force were endorsed by EPIC and the Congress of the FSM. The President created an Executive Steering Committee (ESC) to implement the reforms. The key recommendations included:

- tax reform and the introduction of a form of value-added tax (VAT);
- a tax package which includes the elimination of the current GRT and (state) sales tax and surtax;
- a form of net profit tax (NPT) or business income tax to replace the GRT, allowing for deductions of (some) business expenses from taxable revenues; and
- the establishment of an independent tax collection authority with operations nationwide.

Laws were subsequently drafted with the support of the IMF for the creation of a Unified Revenue Authority (URA), a Revenue Administration Act (RAA), state Value-Added Tax (VAT), and Net Profits Tax (NPT) laws. In June of 2006, at the inauguration of the ESC, a high-level implementation plan (or master plan) was adopted by the Committee together with the creation of a Technical Working Group. A Tax Reform Unit (TRU) was created in the Department of Finance of the National Government and supported by AusAid. However, progress in implementing the reforms has been slow. Elections in 2007 delayed the process, and it was not until March of 2009 the President transmitted the draft legislation to the Congress. After resolution of state and national jurisdiction issues, and a further election, the process was ready to move forward. At the current time all governments have signed the MOU concerning the creation of the URA and cost sharing arrangements:

Tax reform implementation has been painfully slow.

Finally progress is being achieved at the national and state levels, but much remains to be achieved before the process can be considered truly underway.

- FSM Congress has passed the URA and RAA laws,
- Kosrae has passed both the state level version of the RAA and VAT law,
- Chuuk has passed RAA and the VAT bill is with the legislature for consideration at the August session,
- Yap has passed an amalgamated version of the RAA and URA (referred to as the short URA and drafted by Pohnpei), but is still required to pass the RAA and VAT bills,
- Pohnpei is currently considering its short URA bill.

Table 1 provides the estimated impact of the FSM-wide tax reform on the FSM and state economies. It also indicates the estimated size of the real reduction in operations grants to the FSM due to the annual decrement and lack of full inflation adjustment. At the FSM level the estimated tax reform would result in a 4% increase in overall tax burden from the current 12% of GDP to 16%. By world standards this would still leave the FSM a relatively lowly taxed nation. In relation to the annual real reduction in operational grants, the reform is sufficient to completely offset the decrease. However, the impact is considerably different by state. While the reform is more than greater than the loss in real grants in Pohnpei and Yap, it is far from sufficient in Chuuk and Kosrae. The differences in impact are due to the current structure of existing taxes

Impact of tax reform would completely offset the reduction in real Compact operational grants.

However, the impact is significantly different by State.

Table 1 Estimated reduction in Compact transfers FY2014-FY2023, Impact of the Tax Reforms, FY2014 constant prices, $M's

	Real reduciton in operational sector grants	Tax Reform Impact	Tax reform % Decrement
National	1.1	1.9	166%
Chuuk	4.4	1.7	39%
Kosrae	1.3	0.5	40%
Pohnpei	2.9	5.5	189%
Yap	1.8	2.2	121%
FSM	11.5	11.8	103%

and relative size of the state economies. Unfortunately, the two states hit worst by the implementation of the amended Compact are also those that least benefit from the tax reforms. This in part reflects that both states have already increased state taxes to maintain public services.

The long process of the FSM wide tax reform is finally making progress, but it is still too early to say the nation is committed to the reforms. The need to implement the LTFF and expenditure cuts, if no other revenue sources are forthcoming, provides a significant incentive. However, while there is general agreement that the process is required and should go head, there is still significant dissention that could derail the process.

Third FSM Economic Summit and NES

3rd FSM Summit adopts a "sustained growth strategy."

The Third FSM Economic Summit was held in Palikir, Pohnpei, from March 29 to April 2, 2004. The Summit was presented with three economic scenarios that the FSM might experience over the next 20-year period of Compact support: a dismal scenario, a medium-growth scenario, and a sustained growth scenario. While noting that the FSM might face a truly "dismal" scenario if the country's leadership failed to make needed economic adjustments to offset the drag on economic activity resulting from the structure of Compact assistance, the discussion focused primarily on the "moderate growth" and "sustained growth" scenarios. The Summit adopted a six-part strategy for transition and accelerated growth:

- macroeconomic stability;
- good governance: improving effectiveness and efficiency of government;
- developing an outward-oriented, private sector-led economy;
- investing in human resource development;
- investing in infrastructure; and
- long-term sustainability.

For the first time in the amended Compact GDP per capita matches the dismal scenario in FY2010, and rise above in FY2011.

The FSM Strategic Development Plan (SDP) examines the three growth scenarios in detail and makes projections of the likely economic growth and development patterns. Under the sustained growth scenario, economic growth is held back initially, as the economy adjusts to the structure of the amended Compact. However, as the benefits of the sustained growth strategy take hold, the economy is projected to accelerate and attain an annual average rate of 2.6% over the whole period. On the other hand, under the dismal scenario, economic growth is weak, and the economy is projected to grow only 0.1% over the period.

Fig. 12 compares the projected dismal scenario with the actual performance since FY2003. In the initial years of the amended Compact through FY2008 economic performance was indeed dismal as the economy adjusted to the new provisions; a long painful period that had not been envisaged. In the last three years the economy has been on a higher trajectory. However, the recent acceleration in growth has been achieved from greater utilization of the infrastructure grant, and the sizeable investment in the FAA funded airport renovation program. The additional stimulus from these sources will not continue at the same rate in the future. Indeed the FAA program is nearing completion. The FSM needs to complete the existing reform programs in fiscal adjustment to the declining real value of Compact grants, and consolidate the FSM-wide tax reform to establish a sound macroeconomic environment. With a sustainable basis for development, the FSM will be in a stronger position to identify new sources of economic growth to maintain the recent improved economic performance.

Recent stimulus from infrastructure projects has put the nation on an improved trajectory, but new sources of growth need to be found to maintain the momentum.

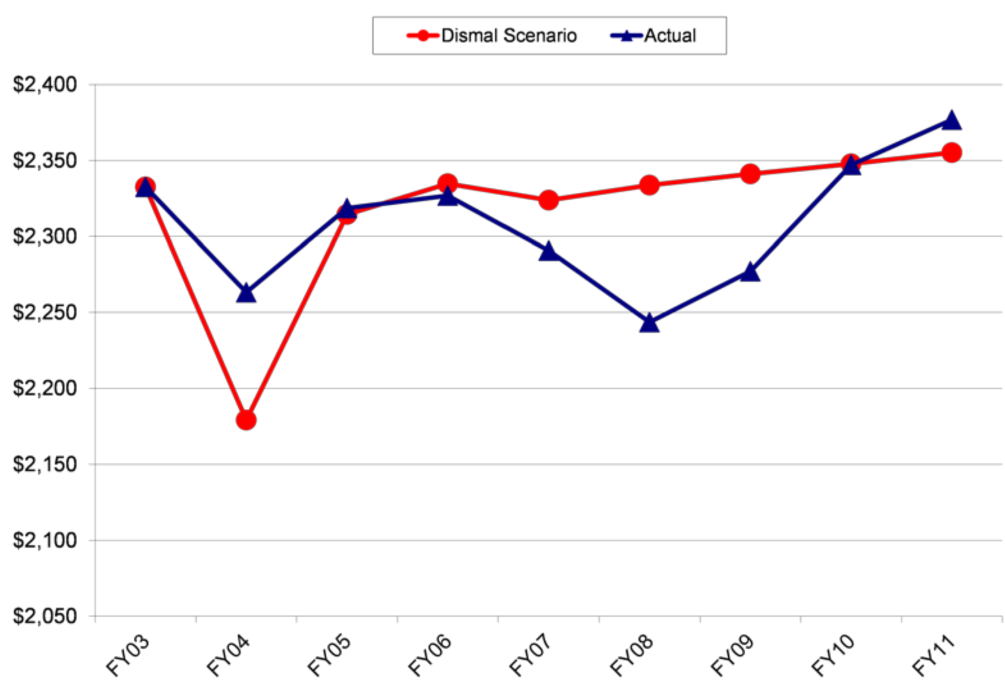


Figure 12 Comparison of the Third Summit dismal scenario with performance—GDP per capita.

III. THE COMPACT TRUST FUND

Background

The establishment of the Trust Fund for the People of the FSM (the Trust Fund) was a major feature of the amended Compact. The Trust Fund was created "to contribute to the long-term budgetary self-reliance of the FSM… [and] to provide the Government of the FSM with an ongoing source of revenue after FY2023." The design of the Trust Fund specifies distributions from FY2024 forward that are explicitly tied to the fully inflation-adjusted value of the Compact annual grant assistance provided in FY2023. Notwithstanding this design feature, the U.S. Government has, on several occasions subsequent to the outset of the amended Compact period, made clear their position that the amended Compacts and their subsidiary agreements contain no commitments, either express or implied, regarding the level of revenue that will be generated by the Trust Funds, nor is there any commitment regarding the degree to which the revenue will contribute to the long-term budgetary self-reliance of the FSM and RMI.

The Compact and its subsidiary agreements include no guarantee that that the Trust Fund will achieve any specific level.

Given that the U.S. Government is not underwriting the investment risks associated with the Compact Trust Fund, it is important that the FSM Government makes every effort to monitor the progress of the Trust Fund and to assess performance against a sensible goal. That goal is suggested by the authors of this report to be the projected ability of the Trust Fund to support a smooth and sustainable transition from direct, U.S.-appropriated, annual grants to annual Trust Fund distributions to the FSM. Such a "sustainability estimate" is presented herein to inform key decision makers well in advance of the beginning of the Trust Fund's distribution period. A monitoring procedure is presented below—for the third consecutive year through this report—that estimates the sustainability value at the end of FY2023.

There is only one variable that affects the actual annual contributions and the projected direct grant level in FY2023 — the rate of inflation. More precisely, that one variable is the cumulative inflation adjustment, pursuant to Compact Section 217, for the 20-year period beginning in FY2004. In the projections below actual inflation adjustments provided to the FSM through FY2013 are included, and thereafter a U.S. inflation rate of 3.0 percent is assumed.

The FSM began the amended Compact period with an annual direct grant drawdown rate of $76.2 million. That stream of direct grants is adjusted annually in two countervailing ways: annual grant levels are adjusted upward by the addition of two-thirds of inflation, and adjusted downward by the subtraction of the so-called "decrement" of $800,000. For the FSM, the late stages of amended Compact negotiations led to an increase in the starting level of the annual grant coupled with a corresponding decrease in the initial amount of the contribution to the Trust Fund. In addition the size and timing of the decrement were also modified. Specifically, the initial annual grant level was increased by $2 million and the initial annual contribution to the Trust Fund was reduced correspondingly. The decrement, which had been proposed and discussed at $1 million annually, was reduced to $800,000, and the effective date was delayed from FY2005 until FY2007. Taken together, these modifications reduced the size and immediacy of the fiscal adjustment that the FSM faced throughout the early period of amended Compact implementation; however, these same modifications resulted in roughly 20 percent less in U.S. contributions to the Trust Fund over the 20-year period and to an increase in the target level of FY2023 grants to be replaced by Trust Fund withdrawals that is roughly 10 percent higher than what it would have otherwise been.

The negotiated outcome of the FSM Compact resulted in additional annual operational funds, but smaller annual contributions to the FSM Trust Fund.

In effect, the careful calculations that were utilized for financial projections for both the FSM and the RMI were superseded by the negotiated outcome in the case of the FSM. As a result, the FSM—in contrast to the RMI, where the amended Compact negotiations had fewer and less profound late-stage financial changes—faces a much higher probability that its Trust Fund will not reach the level estimated for sustainability.

As described below, the required annual rate of return from FY2004-23 based on actual inflation adjustment data through FY2013 and projected inflation thereafter would be 10.9 percent. The same calculations show that the rate of return required for the RMI is a much more likely to be achieved 8.0 percent. Had the late-stage modifications not been made to the FSM amended Compact—or had they been fully offset in terms of impact on sustainability—the nominal annual rate of return required would have been 8.1%. This is not surprising since the negotiations for both nations were informed by similar technical calculations and projections.

In order for the FSM Trust Fund to reach the sustainability estimate, the Fund would have needed to grow at 10.9 percent annually from FY2004 through FY2023. To-date, it has averaged 3.9 percent annually since the outset of FY2005.

Using actual inflation adjustment data through FY2013 and projecting forward based on inflation at 3.0 percent, a direct grant level of $90.2 million is projected for FY2023. Using that value, allowing for full inflation adjustment of subsequent withdrawals, and maintaining the real value of the Trust Fund *corpus*, there is one other variable required in order to determine the size of the Trust Fund at the outset of FY2024, namely the rate of return on investments in the combined "A" and "C" accounts (essentially, the primary and buffer accounts).

The Compact Trust Fund is valued at $245 million as of June 30, 2012, $113 million short of being "on track" with the sustainability estimate.

It is assumed that the FSM investment strategy at that time would need to provide for a prudent balance of risk while allowing for long-term growth. From FY2024 onward, a balanced investment allocation is assumed, with 65 percent of assets in equities with an assumed real rate of return of 6.5 percent annually and 35 percent in fixed income with an assumed real rate of return of 2.5 percent annually. The blended real rate of return for the distribution period is thus estimated at 5.1%. If inflation were to average 3 percent, a nominal rate of return of 8.1 percent would thus be required. All rates are assumed to be net of investment and Trust Fund management costs.

Trust Fund Performance Monitoring

The projected growth path to achieve sustainability by FY2023 is presented along with actual results through June 30, 2012, in Figure 13. The sustainability estimate for the end of FY2023 is a

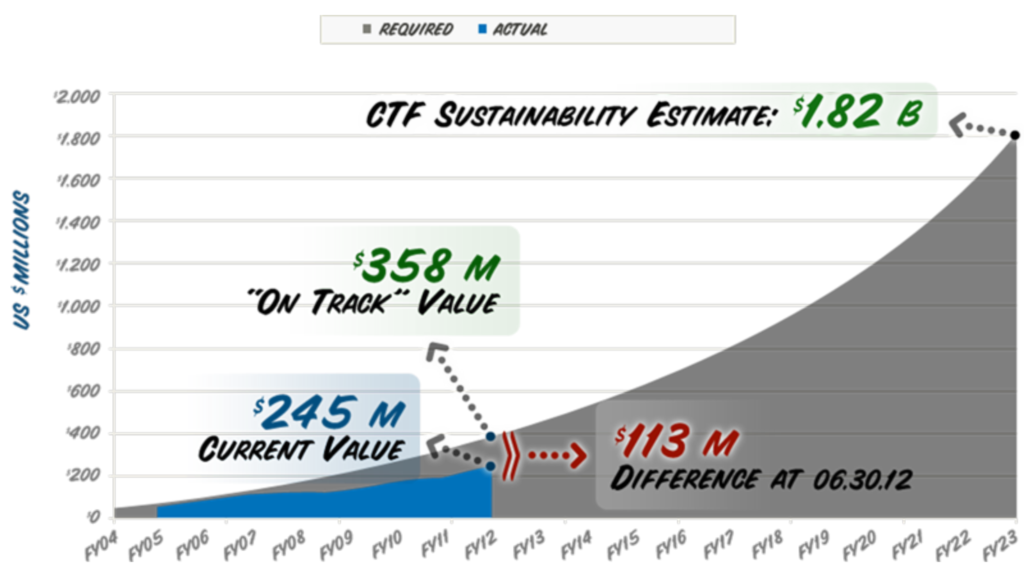


Figure 13 FSM Trust Fund Values, Current and "On Track" Levels at June 30, 2012.

Compact Trust Fund value of $1.82 billion. The current value of the FSM Trust Fund is significantly below the level consistent with a smooth growth trend line. In order to be precisely "on-track" to achieving that level as of June 30, 2012, the value would have grown to $358 million; however, the actual value of the FSM Trust Fund at that date was $245 million. This difference of $113 million leaves the Trust Fund fully 31.5 percent short after 8.75 years of the projected 20-year accumulation period. Even if the returns from this date forward were to average the (initially required) trend line rate of 10.9% annually, the final value of the fund at the end of FY2023 would be just 80.6 percent of the sustainability estimate, falling short by $353 million. And if the returns over the remaining period simply average 8.1%—a more achievable rate of return over the remaining accumulation period—the difference would be $654 million, and the fund would achieve just 64.5 percent of the sustainability estimate.

Given actual Trust Fund performance to-date and assuming an 8.1% rate of return for the remaining Compact period, the Trust Fund is projected to fall short of the sustainability estimate by $654 million.

A range of factors have combined to result in an FSM Compact Trust Fund value that is below the projected path to achieve the sustainability estimate. The most important factor is the investment climate that prevailed for the entire period from FY2004 through June 30, 2012. During that period the relevant benchmark return from assets invested according to the prevailing FSM Trust Fund policies would have delivered a 5.1 percent rate of return—well below the 10.9 percent annual compound rate of growth required to achieve the sustainability estimate.

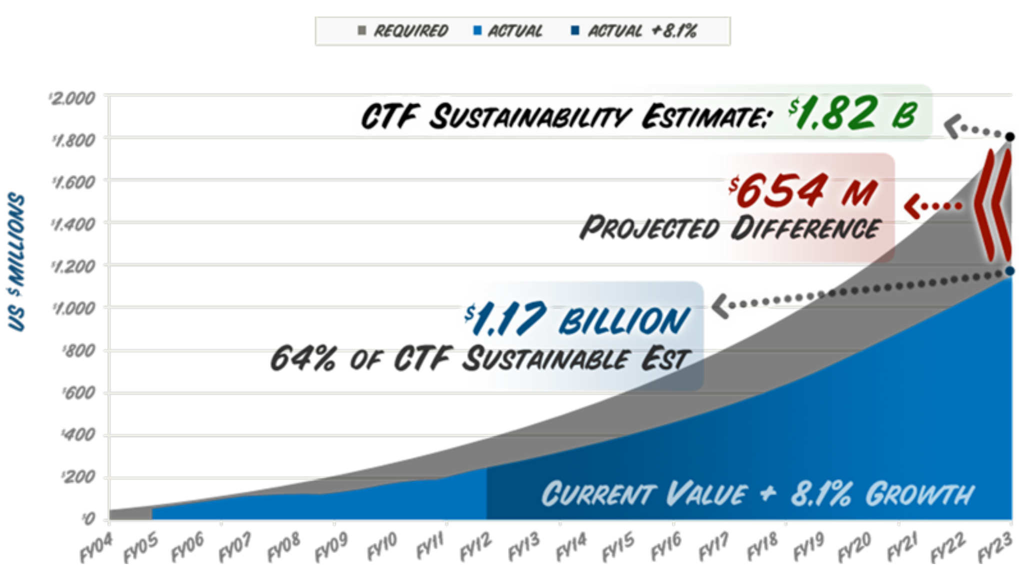


Figure 14 Projected FSM Trust Fund value through FY2023.

What is also clear from the performance analysis undertaken by the authors of this report is that the performance of the market was favorable in the early period—during which the FSM Trust Fund assets were either not yet deposited or not yet exposed to the identified investment strategy. Conversely, the performance of the market turned extraordinarily negative in the middle period from FY2008 through the first half of FY2009. During this period the Trust Fund assets were fully invested, and thus fully exposed to extraordinary losses through that market period. Finally, there has been substantial market recovery throughout the period after March 2009 through June 30, 2012. It is, of course, unfortunate that the Fund has experienced such a historically volatile and negative period so early in the 20-year accumulation period planned for the Trust Fund. This type of risk is called “sequence of returns” risk and the impact of the unfortunate timing will persist throughout the accumulation period as there is a smaller *corpus* upon which to achieve the initially projected compound rate of growth.

Several other factors that were not “market-driven” follow below.

- The FSM failed to deposit in a timely manner its required $30 million contribution. Although the sum was anticipated to be available on October 1, 2003, the FSM deposited $30.3 million exactly one year late. The US chose to delay its deposit, awaiting the FSM contribution and made its initial deposit of $16 million on October 5, 2004.
- The US and FSM did not establish the Trust Fund on schedule. Although anticipated to be established on October 1, 2003, the amended Compact did not go into effect until June 25, 2004, and the Trust Fund was incorporated as a non-profit corporation on August 17, 2004. It should be noted that a 20-year accumulation period has been truncated to less than nineteen years as a combined result of legal requirements and technical implementation issues.
- The allocation of deposited funds to the asset classes identified in the FSM Investment Policy Statement did not occur until August 10, 2006, fully 34 months into the amended Compact period. This failure to invest according to the FSM’s investment policy was ill-timed, as the markets performed well during the period of delay.
- Finally, one factor that has not been in effect for the FSM Trust Fund (and that has significantly aided the RMI Trust Fund) is third-party contributions. The parties to the FSM

Trust Fund have yet to mobilize any official third-party contributions; however, recent efforts show promise that this may soon be addressed in some measure.

A decomposition of the negative and positive factors is shown in Figure 15. As noted above, the most important factor over the initial 8.75-year period is the fact that actual market performance was far below the required 10.9 percent annual return. The market analysis utilized index comparisons against the initial and subsequent investment strategies adopted by the Trust Fund Committee.

The FSM Trust Fund has outperformed its benchmark by a total of $3.3 million.

It is worth simply presenting the basic return performance of the FSM Trust Fund as of June 30, 2012. So far, contributions received have been $203.4 million, while the market value of the Trust Fund was $245.1 million, reflecting a total gain of $41.7 million. This computes to a compound annual growth rate of 3.9 percent which is similar to the 3.7 percent achieved by the RMI Trust Fund, though the two funds have differed in terms of exposure to the markets and timing of additional deposits for the RMI. The authors estimate that the FSM Trust Fund actually outperformed its benchmark by a total of $3.3 million. The benchmark would have delivered a compound annual rate of return of 3.6 percent versus the actual rate of 3.9 percent.

As shown in Figure 16, the catch-up rate required for the FSM Trust Fund to achieve the estimated sustainability level by the end of FY2023 is projected as a 13.6 percent compounded annual return for the remaining 11.25 years of the originally projected 20-

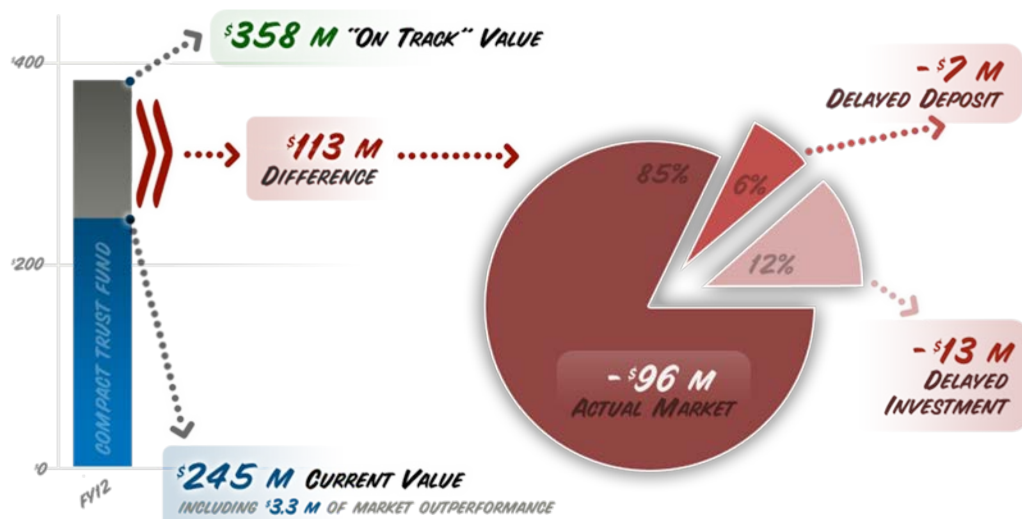


Figure 15 Decomposition of factors resulting in "below track" value..

year accumulation period. Even given the historically poor initial period—and the likelihood of a sustained period of above-average performance following the downturn—it is highly unlikely that the FSM Trust Fund will achieve such a result.

Trust Fund governance and administration improved over recent years.

Trust Fund Administration and Design

Over the past two years the Trust Fund Committee has successfully streamlined the management of the Trust Fund for the FSM (and for the RMI) by switching to the use of the same custodian (State Street Bank and Trust) for each Trust Fund and by utilizing the same investment advisor/manager (Mercer Global Investments) as well for each Trust Fund. While consolidating the service providers, there was no loss of flexibility to enable the two funds to implement differing investment strategies. The administration and governance of the funds also appear to have improved, based on the quality and comprehensiveness of the annual report (since FY2011) and the timeliness of the audits of the funds.

Trust Fund needs to grow at the virtually unachievable annual rate of 13.6 percent for the remaining 11.25 years to meet the sustainability estimate.

Still substantive technical issues remain for consideration by the Trust Fund committees looking forward. First, the accounting for the "C" account within the Fund, is now being addressed, albeit in a way that results in a consistent downward bias in the amount that is periodically recorded in the "C" account. The rationale for the technical methodology undertaken should be revisited; however this is not a matter of great urgency. As noted below, the authors of this report recommend that the "C" account be examined as part

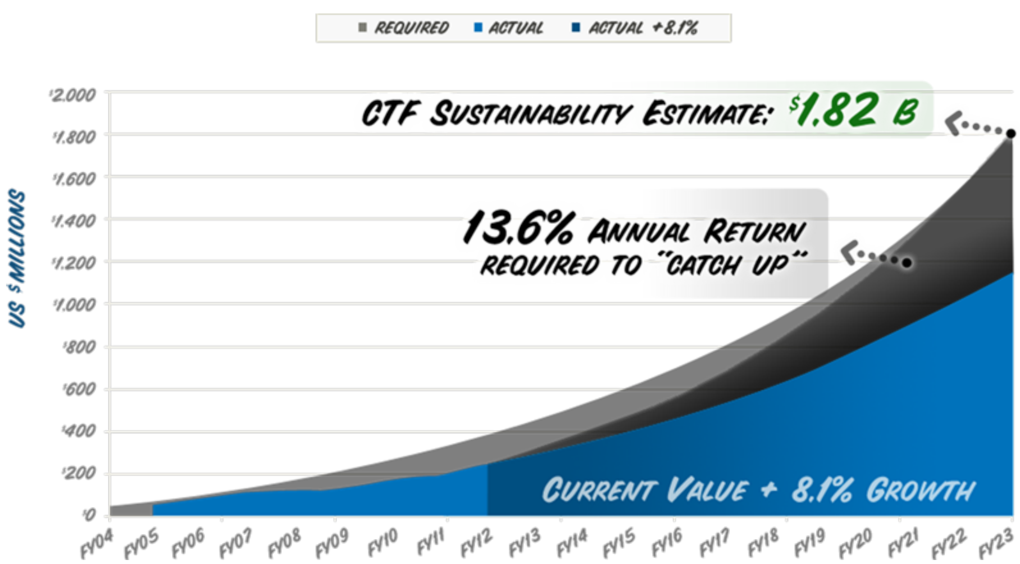


Figure 16 Projected Rate of Return for the FSM Trust Fund to "Catch Up.".

of a broader reform of the Trust Fund procedures for both the accumulation period and the distribution period.

Second, while the FY2011 Annual Report represents an impressive improvement in terms of professional presentation, comprehensiveness of the information shared, and the responsiveness of the report to the requirements of the Trust Fund Agreement, the final section of the report could be improved through better guidance to the service providers involved in providing the analysis. Specifically, the section addressing "Effectiveness to Achieve Purpose" provides insufficient background on the calculations to be useful to readers outside of the core Trust Fund committee members. The value of the professional analysis by Mercer is diminished by the use of comparisons to unrealistic and poorly specified FY2023 grant levels.

The current Trust Fund rules will likely result in immense and repeated fiscal shocks that could be reduced in severity and frequency through better design.

Finally, the authors want to repeat an earlier call for the parties to the Trust Fund to consider changes to the Trust Fund Agreement. The current Trust Fund rules are likely to result in immense and repeated fiscal shocks that could be reduced in severity and frequency through better design. Specifically, consideration should be given to modifying the operations of the "B" account which, as described now, provides no benefit, and of the "C" account, which would be more reliably functional if it were created by *fiat* at the outset of FY2024, perhaps at a higher level. Most importantly, consideration should be given to amending the basic annual withdrawal rule, which provides no feedback mechanism to relate the annual withdrawal rate to the actual size—and therefore sustainability—of the Trust Fund. Clearly it would be better to protect the real value of the Trust Fund while also ensuring greater stability of the projected annual flows from the Trust Fund. As currently structured, only the nominal value of the Trust Fund is likely to be protected, while instability of annual distributions is virtually assured.