Federated States of Micronesia

Fiscal Year 2010 Economic Review

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Office of Insular Affairs

Graduate School USA
PACIFIC ISLANDS TRAINING INITIATIVE
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CURRENCY EQUIVALENTS

Currency Unit	—	United States Dollar (US$)

ABBREVIATIONS

ADB	—	Asian Development Bank
AIP	—	Airport Improvement Project
Amended Compact	—	Second phase of the Compact, FY2004–2023
BoP	—	Balance of Payments
BPS	—	Budget Preparatory Software
BSS	—	Basic Social Services
c.i.f.	—	Cartage, insurance and freight
CIP	—	Capital Improvement Project
Compact	—	FSM Compact of Free Association with the United States
Compact I	—	First 17 years of the Compact, FY1987–2003
CPI	—	Consumer Price Index
CTF	—	Compact Trust Fund
DEA	—	Department of Economic Affairs, FSM
DOI	—	Department of Interior, U.S. Government
EPIC	—	Economic Policy Implementation Council
ERP	—	Early Retirement Program
ESC	—	Executive Steering Committee
FAA	—	Federal Aviation Authority
FDI	—	Foreign Direct Investment
FEMA	—	Federal Emergency Management Agency
FIAS	—	Foreign Investment Advisory Service
FMIS	—	Financial Management Information System
f.o.b.	—	Free on-board
FPA	—	Fiscal Procedures Agreement
GDP	—	Gross Domestic Product
GRT	—	Gross Receipts Tax
HIES	—	Household Income and Expenditure Survey
IIP	—	International Investment Position
IMF	—	International Monetary Fund
MTN	—	Medium Term Notes (Compact-backed bonds)
NGO	—	Nongovernmental Organization
SBOC		Office of Statistics, Budget, economic management, Overseas development assistance and Compact management

OIA	—	Office of Insular Affairs
PFTAC	—	Pacific Finance Technical Assistance Center
PIER	—	Pacific Island Economic Report
PMCB	—	Performance Management Capacity Building
PRS	—	Progress Reporting System
PSDP	—	Private Sector Development Program
PSE	—	Public Sector Enterprise
PSRP	—	Public Sector Reform Program
SDP	—	Strategic Development Plan
SEG	—	Special Education Grant
SGS	—	Sustained Growth Strategy
TA	—	Technical Assistance
TRTF	—	Tax Reform Task Force
U.S.	—	United States
VAT	—	Value Added Tax
YSPSC	—	Yap State Public Service Corporation

NOTE

The Federated State of Micronesia government's fiscal year (FY) ends on September 30.

TABLE OF CONTENTS

LIST OF TABLES

LIST OF FIGURES

LIST OF APPENDIX TABLES

FOREWORD

This report has been prepared to assist the Government of the Federated States of Micronesia (FSM) and U.S. Department of Interior to fulfill their respective reporting obligations under the Compact of Free Association with the United States. The FSM is required, under Title One, Section 214, to report to the U.S. President on the use of sector grant assistance and on progress in meeting mutually agreed program and economic goals. The President, under Title One, Section 104.h, is required to submit a similar report to Congress concerning developments in the FSM.

This report has been prepared under a grant from the Department of Interior and administered through the U.S. Graduate School. However, it is not intended to directly fulfill the reporting requirements of the two governments, but rather to provide an independent assessment of FSM economic performance and policy environment, as well as a set of economic statistics. Much of the material will be directly relevant to the two reports. However, the reporting requirements of the two governments are different; thus, not all the material will be relevant to both reports.

The report consists of three parts: (i) a descriptive section of economic developments in the FSM, (ii) a discussion of policy developments and issues, and (iii) a section on prospects over the medium term with economic projections. The descriptive section takes a standard macroeconomic approach and includes economic growth and employment; monetary developments and prices; the external sector; and fiscal developments. The policy discussion does not attempt a comprehensive policy review but rather focuses on key topical areas: public sector payroll, public financial management, tax policy, adjustment to the amended Compact, and viability of the Compact Trust Fund. The prospects section provides forecasts of GDP by industry and of the fiscal position over the medium term under current policy conditions. A comprehensive set of economic statistics follows the descriptive, analytical, and prospects sections.

This report and statistical appendix have been prepared by Mark Sturton, who prepared the economic report, and Glenn McKinlay, who compiled the statistics. The SBOC (the Office of Statistics, Budget and Economic management, Overseas Development Assistance and Compact Management) facilitated the preparation of the FY2010 economic report. Special thanks to Mathew Chigiyal, and Sancherina Salle of the Office of Statistics, who provided critical statistical information, and to Evelyn Adolph, Department of Administration and Finance, who provided important information on and insight into the tax reform initiative. Discussions were held with Lam Dam Legislative Council of the Congress of the FSM, with Tom Beckman, Legislative Council of the Pohnpei State Legislature, Anna Mendiola of the FSM Development Bank, Bob DeCourtney of the Bank of the FSM, and the Embassies of Japan and China, among many others.

This report is available online at http://econ.pitiviti.org.

Mark Sturton

I BACKGROUND AND SUMMARY

1 BACKGROUND

This review has been prepared to assist both the FSM Government and the United States in the fulfillment of their respective obligations under the Compact. In the case of the FSM, the amended Compact states, under Title One, Section 214, that:

> *"The Government of the Federated States of Micronesia shall report annually to the President of the United States on the use of United States sector grant assistance and other assistance and progress in meeting mutually agreed program and economic goals. The Joint Economic Management Committee shall review and comment on the report and make appropriate recommendations based thereon."*

The President of the U.S. is required to submit to the Congress a report on similar developments in the FSM. Title One, Section 104.h, of the amended Compact contains the following requirement:

> *(1) REPORT BY THE PRESIDENT.—Not later than the end of the first full calendar year following enactment of this resolution, and not later than December 31 of each year thereafter, the President shall report to Congress regarding the Federated States of Micronesia and the Republic of the Marshall Islands, including but not limited to—*
>
> > *(A) general social, political, and economic conditions, including estimates of economic growth, per capita income, and migration rates;*
> >
> > *(B) the use and effectiveness of United States financial, program, and technical assistance;*
> >
> > *(C) the status of economic policy reforms including but not limited to progress toward establishing self-sufficient tax rates;*
> >
> > *(D) the status of the efforts to increase investment including: the rate of infrastructure investment of U.S. financial assistance under the U.S.-FSM Compact and the U.S.-RMI Compact; non-U.S. contributions to the trust funds, and the level of private investment; and*
> >
> > *(E) recommendations on ways to increase the effectiveness of United States assistance and to meet overall economic performance objectives, including, if appropriate, recommendations to Congress to adjust the inflation rate or to adjust the contributions to the Trust Funds based on non-U.S. contributions.*

The report is presented in three main parts: (i) a review of economic developments, (ii) a discussion of policy developments and issues, and (iii) a set of medium term projections. While this report relates to FY2009, analysis of developments in that year alone would provide a limited and one-sided view. Accordingly, a longer-term perspective has been taken, and the report includes material dating back to the commencement of the original Compact, in cases where such information will aid a more informed assessment. The content of the review of economic developments follows a standard macroeconomic approach and provides a discussion of growth and employment; monetary developments and prices; the balance of payments and external debt; and fiscal developments.

The policy, prospects, and issues part of the report covers a selected group of topical issues and is not intended to review the whole range of public and private sector policies. The first section starts with a discussion of public sector reform and the question of whether the reforms initiated in the mid- to late 90s remain in force. In particular, the report examines trends in public sector payroll and performance management are. The second section is devoted to fiscal issues and attempts to reform and modernize the tax regime, as well as adjustments required to meet the conditions of the amended Compact in the initial part of the Compact and in the longer-term. The special section on the viability of the Compact Trust Fund in last year's report has been updated. The policy review concludes with long-term prospects and a comparison of recent performance with the "sustained growth strategy" adopted by the FSM at the Third Economic Summit.

The last part of the report, featuring economic prospects, is a new addition. It contains projections of GDP by industry and the fiscal account over the medium term, FY2011 through FY2014. The projection starts from consideration of likely developments in GDP by industry and of overall economic growth. This information enables a projection of government revenues, which are compared with expenditures, assuming no change in policy. The result is continuing fiscal pressure at the state level, but growing surplus at the national. Projections of the balance of payments and banking survey have not been included in this year's work and remain a project for the FY2011 report. Projections of the four macroeconomic accounts, once complete, will provide a first attempt at an integrated macroeconomic framework, which is well suited to budget preparation if information sources can be made available in time.

2 WHAT'S NEW IN THE FY2010 REPORT

The annual economic review of the FSM economy follows a format that is now well developed and reflects the annual reporting needs of FSM and the US. Much of the material is thus an update of former reports, with new data as it becomes available and a change in analysis when the situation warrants. The rest of this section identifies new features and topics for the reader who is already familiar with the report.

There were no new additions or major changes to the statistical series on which this report is based; thus, the first part of the report updates the former editions. In the policy part of the report, developments in public sector wages are highlighted, since unsustainable growth in payroll has been a growing concern. Adjustments to the amended Compact continue to be a topical issue as the real value of annual grants declines, reflecting the annual decrement and partial indexation. This year's report also highlights progress in tax reform and discusses the low rate of overall economic growth. As mentioned above, the last part of the report (featuring economic prospects) is a new addition.

3 SUMMARY

Since the introduction of the amended Compact in FY2003, the FSM has experienced considerable volatility in economic activity, with GDP declining in three out of the initial six years. Overall GDP has declined by an annual average of 0.3%. The current economic climate is harsh, because of (i) the reduction in resources from Compact I; (ii) capacity constraints in fulfilling the new fiscal procedures—especially with respect to infrastructure grant implementation; and (iii) the need to transition from the use of the capacity-building sector grant for general government operations. Real per-capita incomes have risen slightly from \$2,343 to \$2,368, an improvement of just 1.1%. The fall in economic activity has been accompanied by a reduction in employment—by 370 jobs, or 2.2% of those employed. As incomes have fallen, the economy has failed to provide productive opportunities to the population, outward migration has continued at 1.9% 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 a significant fiscal deficit during the first five years of the amended Compact. However, since implementation of the adjustment measures, the fiscal position has recorded an average surplus of 1.4% of GDP during the last two years. The FSM has maintained a favorable external debt position, which has eased its fiscal problems.

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. Thus, the FSM 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 the reduction was implemented, focus shifted to the need for incremental adjustments 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 FSM responded with the preparation of a long term fiscal and economic framework, and a National Economic Symposium was convened to endorse the framework.

On the revenue side, fiscal policy has focused on the adoption of a modern tax regime. However, progress has been painfully slow, and although the suite of reform bills was transmitted to Congress in March 2009, the first leading piece of legislation was only passed into law in April 2011. With elections out the way, the process is now in the do-or-die stage, as the state and national legislatures consider the remaining bills. An issue of particular concern has been the rising cost of public sector payroll. While the number of public servants remains at the levels of the late 1990s, average payroll costs per employee have risen sharply (by 2.7%/year) in the amended Compact period. The levels of Compact sector grants are expected to remain constant in nominal terms over the remainder of the amended Compact; consequently, current wage policy will cause fiscal pressure.

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 neither the terms of the amended Compact nor the terms of the Trust Fund Agreement make any guarantee, or even a commitment, that the Trust Fund will be able to sustainably achieve distributions of a size required to maintain the real value of the annual sector grants after 2023. It is thus imperative that the FSM Government make every effort to assess the Trust Fund's performance against a sensible goal. That goal, as proposed by the authors of this report, is the sufficiency of the Trust Fund to support a smooth and sustainable transition from direct, US-appropriated, annual grants to annual Trust Fund distributions to the FSM. The terminal condition for sufficiency of the Trust Fund is projected to be $1.82 billion at the outset of FY2024. According to a smooth trend line signifying "on-track" performance, the Trust Fund should have reached $299.9 million as of June 30, 2011; however, the actual value was just $224.5 million. The projected growth rate required to catch up is projected at 12.66%. This rate of return appears to be virtually unachievable over the remaining 12.75 years of the 20-year accumulation period. It is recommended that policy makers mobilize additional contributions—from domestic and external sources—to the Trust Fund to more reliably support the FSM's long-term fiscal stability and sustainability.

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. Nevertheless, although there have been some improvements in the last two years, economic performance places the FSM squarely on the dismal trajectory. Economic growth has stagnated, and there has been large-scale out-migration resulting in negative population growth. The recently held National Economic Symposium, convened to discuss and endorse a decrement management plan, did not reinitiate issues raised at the 3rd Summit; nor did it focus attention on the need to raise the rate of economic development. During the last seven years, the focus on adjustment to the amended Compact in both the short and longer term has diverted attention from the big picture and the challenge of improving the lives of average Micronesians. As a result, the FSM lacks direction, and there has been no policy debate, even though the nation urgently needs to reinvigorate its aspirations with a broad vision of reform that includes the development of the private sector.

As part of the FY2010 review, a medium-term macroeconomic framework has been prepared based on the national and fiscal accounts. Future editions will incorporate the balance of payments and monetary survey. Assuming no policy change, the projections indicate that there will be significantly different economic performance by state, but at the FSM level, the economy is likely to deteriorate over the medium term and will fail to raise the level of GDP above the dismal trajectory. On the fiscal side, the states will continue to suffer fiscal pressure with rising expenditures and the fall in real Compact transfers. However, the national government is likely to generate a significant surplus if the additional savings are not diverted to public projects. Although a reform scenario has not been developed in the framework, it might include the tax reform initiative, transfer of additional savings to the states or CTF, and reforms to develop the private sector to provide an exit strategy from the dismal scenario.

II REVIEW OF ECONOMIC DEVELOPMENTS

A Growth and Employment

1 DEVELOPMENTS IN THE FSM ECONOMY

i Overall trends in economic activity

1. Economic developments in the FSM economy have been dominated by the economic provisions of the Compact of Free Association with the United States, and the financial arrangements prevailing in the original period (Compact I) FY1987–FY2003 and the amended Compact period FY2004–FY2023. While analysis of economic performance in the FSM will focus on the amended Compact period and FY2010, a proper understanding is best obtained by taking a longer-term perspective. Many of the developments and outturns that occurred during Compact I remain relevant and have recurred during the amended Compact.

2. Economic developments since FY1995 are described in Table 1. From FY1995-2009, the economy grew marginally by an annual average 0.1%, reflecting economic performance in each of the FSM's four states. Growth in Chuuk and Kosrae recorded annual declines of -0.8% and -0.5%, with Pohnpei and Yap achieving positive but small rates of economic growth of 0.7% and 0.4%, respectively. Growth in the public sector reflected the economy at large, with both Chuuk and Kosrae recording negative growth, while Pohnpei and Yap achieved positive results. In Chuuk the private sector contracted strongly by -2.4%, with both Pohnpei and Yap also declining. Only in Kosrae did the private sector show some small improvement. Clearly, the public sector has been the major influence on economic performance, and the private sector has been a drag on the result (Kosrae excepted). The overall result is extremely disappointing: GDP growth declined, and the private sector has failed to keep pace.

3. The period FY1995-2010 comprises three separate intervals: (i) the impact of the second step-down, FY1995–97; (ii) recovery and the final phase of Compact I, FY1997–

Table 1 Average real GDP growth per annum by state and institutional sector[1]

	FY1995-FY2010			2nd Step-Down FY1995-FY1997			Final Phase Compact I FY1997-FY2003			Compact II FY2003-FY2010		
	GDP	Gov	Private	GDP	Gov	Private	GDP	Gov	Private	GDP	Gov	Private
Chuuk	-0.8	-1.1	-2.4	-5.4	-5.2	-18.2	2.3	3.3	4.7	-2.0	-3.5	-3.2
Kosrae	-0.5	-0.6	0.4	-2.1	0.5	-5.9	0.7	-0.4	3.6	-1.1	-1.2	-0.4
Pohnpei[2]	0.7	0.7	-0.6	-6.3	-4.2	-6.8	2.0	1.9	-0.3	1.6	1.1	1.1
Yap	0.4	0.6	-0.4	0.6	-0.8	3.4	2.5	-0.5	4.1	-1.4	2.0	-5.0
FSM	**0.1**	**0.0**	**-0.9**	**-4.5**	**-3.6**	**-8.0**	**2.1**	**1.8**	**2.0**	**-0.3**	**-1.3**	**-1.3**

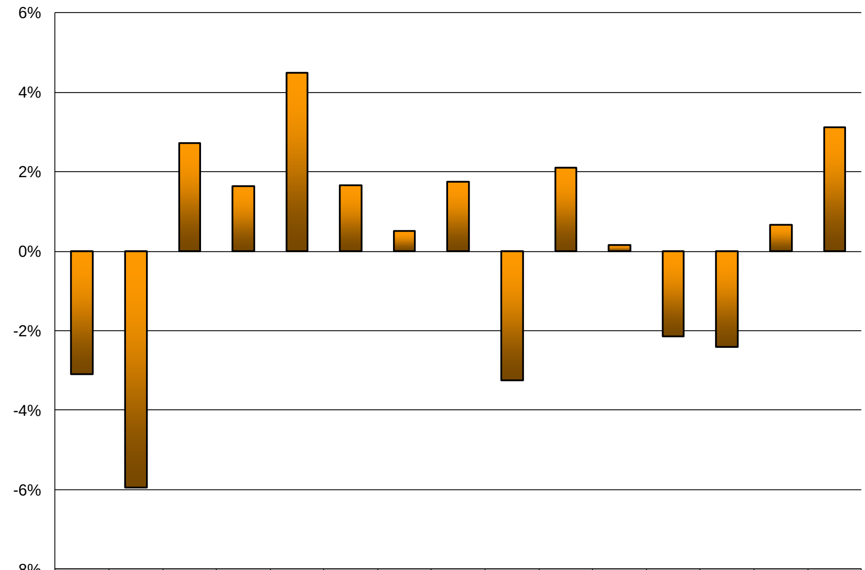
Notes 1 Growth rates annual averages based on period end points.
2 Pohnpei inclusive of national government.

2003; and (iii) the first seven years of Compact II, FY2003–10. The second step-down of Compact I in FY1997 was large and required a painful adjustment. Supported by an ADB Public Sector Reform Program Loan, an Early Retirement Program (ERP) was initiated to reduce the number of public servants to an affordable level. By loan close-out in December 1999, the work force had been reduced by 16%, against a target of 27%, and the wage bill had been cut by 20%, against a target of 35%, through reductions in the number of hours in the work week. While not fully meeting the targets, the program was successful in terms of fiscal adjustment, and it avoided a potentially destabilizing financial outcome. Balance with respect to recurrent operational expenditures was restored by the end of FY1998. Predictably, the adjustment that was required to restore balance after the second step-down had a significant impact on the economy. Between FY1995 and FY1997, government contribution to GDP declined by an average annual rate of -3.6%, while total GDP fell at an annual rate of -4.5%. The private sector was strongly affected and declined by -8.0% annually over the period.

4. While the second step-down in Compact funding imparted a significant downward shock in FY1997, the economy recorded positive growth in each of the following years from FY1999 through the end of Compact I in FY2003 (Fig. 1). During FY2002 and FY2003, the FSM benefited from the infusion of the bump-up funds, and the economy continued to expand, despite the US requirement that the nation set aside $30 million of the additional resources for contribution to the CTF. Overall, during the final period of Compact I, from FY1997-2003, the economy grew by an average of 2.1% per annum, with an expansion in the public sector of 1.8% per annum and an annual average private sector growth of 2.0%.

5. Fig. 1 describes economic developments during the first seven years of the amended Compact period, FY2004-10. After growth in FY2002 and FY2003, the economy went into recession in FY2004, as Compact receipts fell to the new, lower negotiated levels, i.e., a reduction from $84 million (the Compact I level without bump-up) 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. Projections in the Strategic Development Plan (SDP) had anticipated a reduction in GDP of 6% in FY2004, but the actual outturn reveals a decline of 3.2%. The transition to the amended Compact thus turned out not to have been as severe as anticipated.

6. In FY2005 and FY2006 the economy recouped some of the lost ground, but growth turned negative in FY2007 and FY2008. In FY2007 both Chuuk and Kosrae were required to implement a sizeable reduction-in-force (RIF), among other measures, to restore fiscal balance as the use of capacity building sector grant for non-conforming purposes was phased out. The economy contracted by 2.1%. There were some positive developments in the fisheries sector, but by FY2008 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 2.4%. While international economic conditions re-



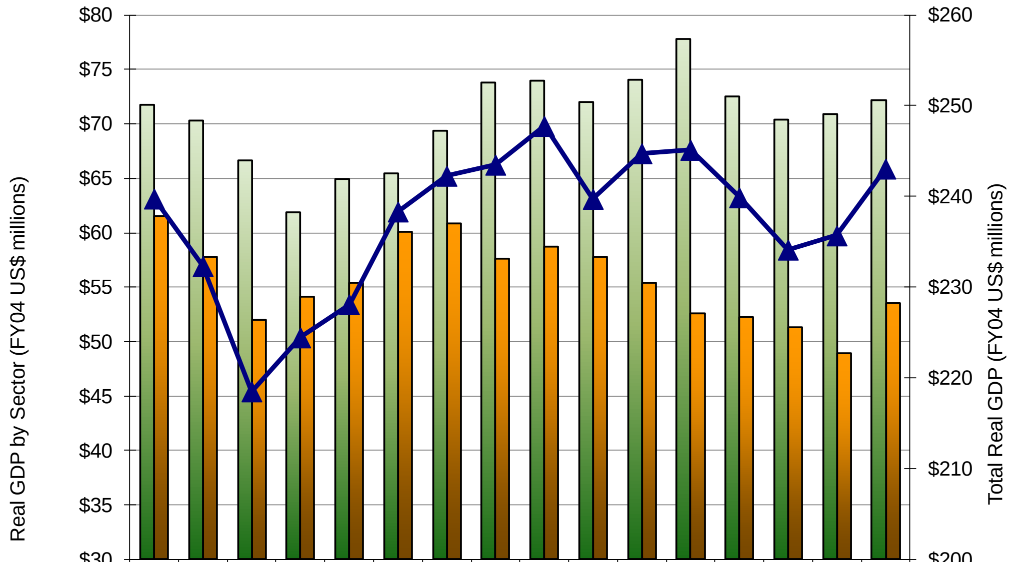
	FY96	FY97	FY98	FY99	FY00	FY01	FY02	FY03	FY04	FY05	FY06	FY07	FY08	FY09	FY10
GDP at constant prices	-3.1%	-5.9%	2.7%	1.6%	4.5%	1.7%	0.5%	1.8%	-3.2%	2.1%	0.2%	-2.1%	-2.4%	0.7%	3.1%

Figure 1 GDP at constant prices of 2004 (% annual change)

mained adverse in FY2009, strong growth in construction and airport renovation resulted in a small but positive (0.7%) growth in the economy. FY2010 turned out to be the best year for the FSM economy in many years, and GDP grew by 3.1%. This reflected continuing expansion in construction, as well as growth in public administration, health and other dependent industries. However, overall economic performance since the beginning of the amended Compact has been poor, reflecting Compact implementation problems and lack of a positive response from the private sector.

ii GDP by institutional sector

7. Fig. 2 provides further information on recent economic developments by sector. The public sector declined in the first year of the amended Compact, reflecting reduced grant levels, but grew in the subsequent two years, reflecting additional hiring in Yap and Chuuk. Thereafter the public sector contracted in FY2007-08, reflecting the phase-out of the use of the capacity-building sector grant to fund non-conforming purposes in Chuuk and Kosrae. Both states implemented a RIF and made significant reductions in public expenditures. With the contraction in Chuuk and Kosrae complete, the provision of public sector services expanded in FY2009-10. Fig. 2 indicates the negative growth in the private sector in each year of the first six years of the amended Compact through FY2009. Overall the private sector contracted by 17%, or an annual average of 3%, reflecting the lower levels of demand in the economy. This lower demand was the result of reduced levels of the Compact sector grants, failure to implement the infrastructure grant, and, in FY2008-09, the impact, on real incomes, of the world recession and higher food and fuel



	FY95	FY96	FY97	FY98	FY99	FY00	FY01	FY02	FY03	FY04	FY05	FY06	FY07	FY08	FY09	FY10
Government	71.7	70.3	66.6	61.9	64.9	65.4	69.4	73.8	74.0	72.0	74.0	77.8	72.5	70.4	70.9	72.2
Private Sector	61.5	57.8	52.0	54.1	55.4	60.1	60.9	57.7	58.7	57.8	55.4	52.6	52.3	51.3	49.0	53.6
GDP	239.8	232.3	218.5	224.5	228.1	238.3	242.3	243.5	247.8	239.7	244.8	245.1	239.9	234.1	235.7	243.1

Figure 2 FSM constant price GDP by sector (FY2004 prices, US$ millions)

prices. In FY2010, with the passing of the recession, along with lower levels of inflation, greater use of the infrastructure grant, and large volumes of FAA Airport Improvement Projects (AIP), the private sector rebounded and grew by 9%.

iii GDP by industry

8. Review of the economy by industrial sector provides useful additional information on recent developments (see tables S1 through S5 of the statistical appendix). Estimates for agriculture (largely for home consumption) indicate a long-run upward trend of 0.9% percent, which, after allowance for the recent decline in population growth of 0.4%, will come as a surprising development The agriculture estimates are based on the two most recent household income expenditures surveys and are interpolated on the basis of population growth and adjusted for weather conditions. The implications are that in the absence of gainful economic opportunities or emigration, households have returned to subsistence production to support themselves. While this is an important result suggesting underdevelopment of the economy, one should be cautious of overreliance on the statistical surveys on which the estimates are based. The fisheries sector has remained largely stagnant in real terms and has not displayed any trend growth, despite its identification as a leading sector with comparative advantage. In the case of manufacturing, activity fell sharply during the final years of Compact I, with the closure of the Yap garment factories. Since that time, production has been for the home market, and manufacturing makes only a small contribution to the economy.

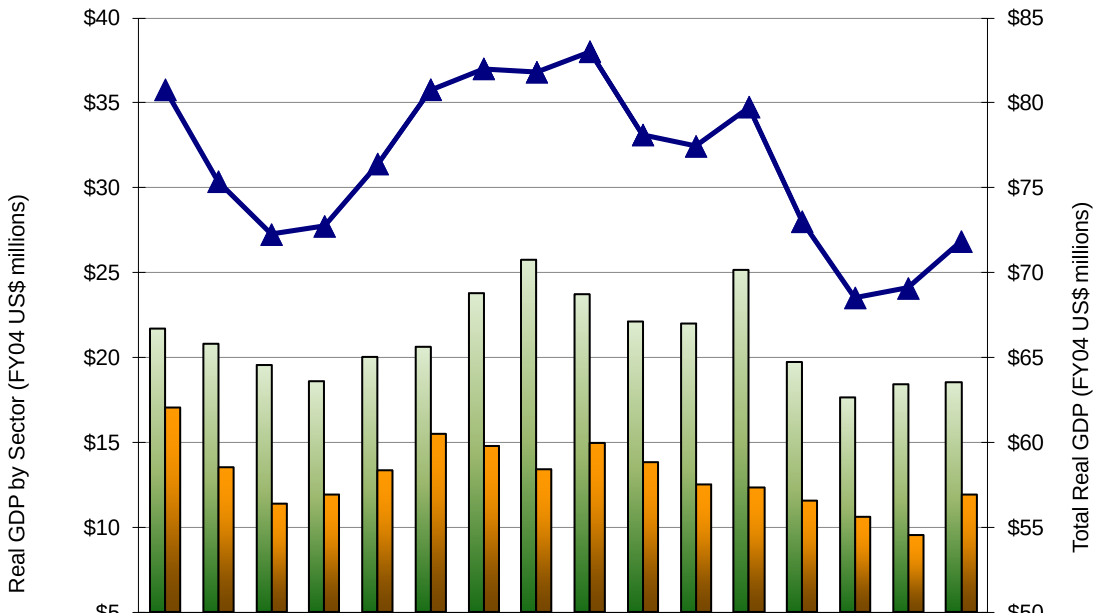
9. Electricity generation has trended downward during the amended Compact, averaging -3% since FY2003, the result of price increases per unit; these in turn were due to the loss of the Compact I energy sector grant and high world fuel prices in the last three years. Construction activity declined at the end of Compact I as well as in the early years of the amended Compact but perked up in FY2009-10 because of the FAA-financed airport renovation in each of the states. Given the low level of capacity utilization of the infrastructure grant and a large backlog of unused funds, construction has the potential to provide a major source of growth and employment in the medium term. The wholesale and retail sector has declined by an average annual -1.4% during the amended Compact, reflecting the weak economic conditions in the FSM. Wholesale/retail is the main determinant of the very poor performance of the private sector noted above. Value-added in the hotels and restaurants sector has fallen by an average annual rate of -4.1% during the amended Compact. This is a disappointing result, given that tourism has been identified as a sector with the potential for major development.

10. In the public sector, provision of general government services has fallen significantly, by an annual average rate of 4.5% during the amended Compact, and reflects the adoption of the sector-grant approach to grant disbursement. Apart from the minor sector grants in capacity building, private sector development, and environment, the resources for general government have been severely constrained. The FSM needs to execute RIFs in Kosrae and Chuuk, to phase out the use of the capacity building grant from non-conforming purposes, and to reduce payroll levels to fit within the fiscal envelope. These are three major factors in the decline in provision of general public services. However, while general government activity has declined, economic activity in education and health has risen. Education services grew rapidly in the first two years of the amended Compact, but since FY2006 have remained constant. Health services, on the other hand, have expanded in each year by an annual average of 4.8%. Overall, provision of public services in general government, including education and health, has fallen by 0.3% in the amended Compact, reflecting the reduction in overall funding levels.

2 STATE ECONOMIC DEVELOPMENTS

i Chuuk State

11. Economic developments in Chuck have been characterized by cycles of weak financial management followed by periods of fiscal stabilization and adjustment. The fortunes of the private sector have risen and fallen in tandem (Fig. 3). In the mid 1990s, the state underwent a severe period of weak management, but in FY1996 initiated a program of recovery supported by the ADB public sector reform program, which rapidly reversed the adverse fiscal position. By the start of FY2000, the state had repaid essentially all of its recorded arrears and was running a significant structural surplus in its recurrent operations. The return to fiscal discipline in Chuuk lasted only four years. The state's fiscal position deteriorated rapidly as a result of the elections in March 2001, and it was estimated that the state had run up arrears of $9 million, compounded by as much as $6 mil-



	FY95	FY96	FY97	FY98	FY99	FY00	FY01	FY02	FY03	FY04	FY05	FY06	FY07	FY08	FY09	FY10
Government	21.7	20.8	19.5	18.6	20.0	20.6	23.8	25.8	23.7	22.1	22.0	25.1	19.8	17.6	18.4	18.5
Private Sector	17.1	13.5	11.4	12.0	13.4	15.5	14.8	13.4	15.0	13.8	12.5	12.4	11.6	10.6	9.5	11.9
GDP	80.8	75.4	72.3	72.7	76.4	80.8	82.0	81.8	83.0	78.1	77.4	79.7	73.0	68.5	69.1	71.8

Figure 3 Chuuk State constant price GDP by sector (FY2004 prices, US$ millions)

lion owed to complete the land purchase agreements entered into without adequate authorization and appropriation.

12. At the start of the amended Compact in FY2004, the Chuuk economy fell by a substantial -5.9%, reflecting a variety of factors. First, the state had to adjust to the reduction in Compact transfers after the “bump-up” funds ran out in FY2003. Second, in FY2004, the additional resources received in FY2003 for cyclone rehabilitation from Typhoon Chata’an were no longer available, and economic activity declined. Third, the amended Compact entailed a loss of the energy grant, which resulted in reduced public enterprise value-added. Finally, the state continued to suffer from the financial crisis, and delays in vendor payments adversely affected private sector profitability. In FY2005 the same forces continued to exert themselves, and economic activity declined by a further, by 0.9%.

13. In FY2006, under a new administration, the state again went through another period of poor fiscal management, payroll expanded by 20%, and the bi-weekly wage cost rose by 15%. With continued pressure on the utility corporation driven by increasing world energy costs, electricity prices rose significantly, and the state CPI rose by 5.5%. With an unsustainable expansion in public expenditures, fiscal stability came under severe pressure, and arrears mounted. While the public sector performed strongly, growing

by 14% because of the additional payroll, the private sector contracted by 1.2% as the crisis hit. Overall state GDP grew by 3.0%.

14. In FY2007-08, the state was required to phase out the remaining use of non-conforming activities from the capacity-building sector grant. While at the start of FY2007, the state had been slow to respond credibly to the imminent crisis, state leadership convened a conference to adopt a comprehensive adjustment package. An RIF was the main component of the adjustment, and the state targeted a reduction of 375 positions. A compensation package equivalent to one year's salary, funded with a grant from the U.S, was paid to the terminated workers. FY2007 was not a good year for the state economy, and GDP fell by 8.4%, reflecting a 21% reduction in government GDP. The private sector also contracted by 6.5%. By FY2008, the full impact of the RIF had worked its way through the economy, and a final reduction of 317 positions was achieved. While state government GDP fell by 11%, the private sector also fell by 8%, reflecting the impact of the world economic recession on rising prices, as well as reductions in real incomes and demand.

15. In FY2009, matters improved slightly, and the state economy grew by 0.8%, reflecting expansion in the public sector of 4.6%, which increased the number of hours worked. However, the continued world recession and high prices of the previous year continued to erode real incomes, and private sector activity contracted by 10%. FY2010 was a good year for the state with use of the infrastructure grant for the first time and the large FAA Airport Improvement Projects (AIP) project. Private sector GDP grew by 25%, reflecting increased construction activity, and state GDP grew by 4%.

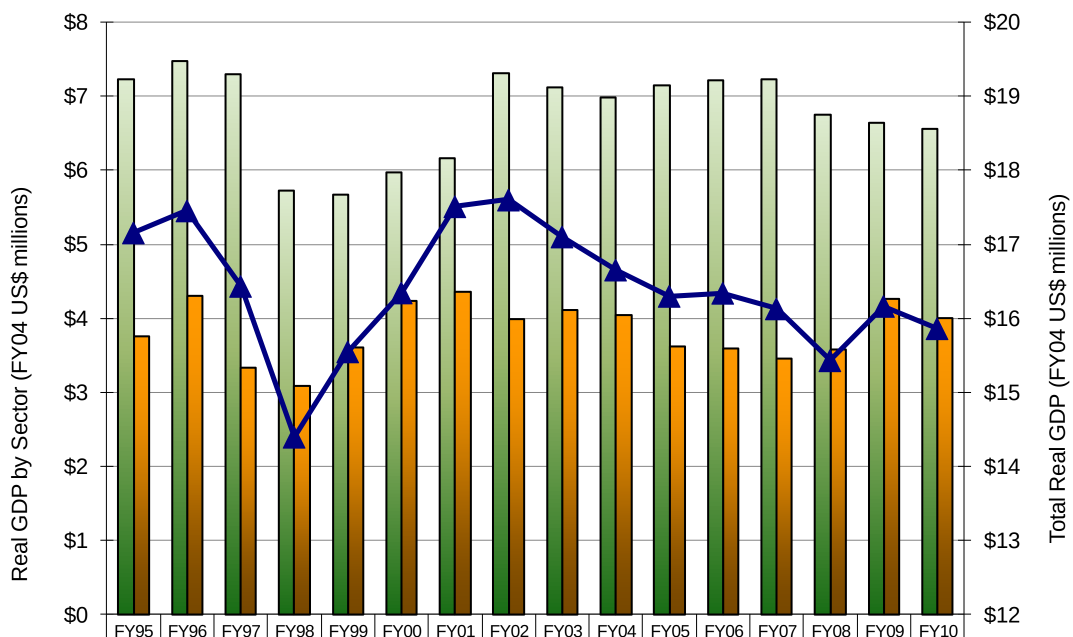
16. At the industry level, nearly all sectors have experienced decline during the amended Compact period. Agriculture, fisheries, manufacturing, electricity and wholesale and retail trade have all experienced trended significantly downward. The only private sector activity bucking the trend has been construction, which in FY2008-10 grew strongly from a very low base, as the FAA-funded airport renovations commenced and the state was able to start drawing on the infrastructure grant. The provision of public administration has also fallen sharply, by an annual average of 12%, reflecting the sector grant approach of the amended Compact and the RIF. With protected funding levels, education has grown moderately, by 0.3% per annum, and health has been buoyant at 4.2%. As Fig. 3 indicates, the first six years of the amended Compact have not been kind to Chuuk state, and overall economic activity has contracted by 2.0% per annum. However, while the state has gone through hard times and has accumulated a significant debt that will be difficult to service or liquidate, its fiscal position is now in balance. If the state can avoid the usual cycle of boom and bust and put the hard times behind it, there is potential for improved economic performance.

ii Kosrae

17. Of all the FSM states, Kosrae is the most dependent on public sector activity; it has only a very small private sector. In the late 1990s, the state underwent a severe con-

traction as it was forced to shed personnel and adjust to the second stepdown in Compact funding; both private and public sectors were adversely affected (Fig. 4). However, while the state achieved the ERP targets set in the PSRP, the gains were eroded through increases in wages. In FY2002, Kosrae opted to draw down its share of the bump-up funds for public expenditures, and the biweekly payroll was increased from 56 to the former level of 64 hours. Both wage rates and the wage bill had risen to levels above those prevailing before the reforms, despite the fact that the number of public servants was 14% below the FY1995 level. While state GDP in FY2002, buoyed by unsustainable fiscal policy, had returned to the FY1996 levels, this rebound was to be short-lived. In FY2003, the state was require to make provision to set aside an amount greater than the one-year level of the bump-up funds to contribute to the amended Compact Trust Fund. As a consequence, the state economy contracted by 2.8%, with a matching decline in the public sector.

18. Economic performance during the first four years of the amended Compact exhibited a declining trend. Output in government remained relatively constant, as the state delayed the adjustment required to phase out non-conforming uses of the capacity-building sector grant. However, the loss of the Compact I energy sector grant, along with rising world fuel prices during the period, had a strong impact on the utility and public enterprise sector. Public enterprise GDP fell by 24% over four years. The impact of higher prices during this period, along with the lower rate of Compact transfers, reduced de-



	FY95	FY96	FY97	FY98	FY99	FY00	FY01	FY02	FY03	FY04	FY05	FY06	FY07	FY08	FY09	FY10
Government	7.2	7.5	7.3	5.7	5.7	6.0	6.2	7.3	7.1	7.0	7.2	7.2	7.2	6.8	6.6	6.6
Private sector	3.8	4.3	3.3	3.1	3.6	4.2	4.4	4.0	4.1	4.0	3.6	3.6	3.5	3.6	4.3	4.0
GDP	17.2	17.5	16.4	14.4	15.6	16.3	17.5	17.6	17.1	16.7	16.3	16.3	16.1	15.4	16.2	15.9

Figure 4 Kosrae State constant price GDP by sector (FY2004 prices, US$ millions)

mand for the small private sector, which contracted by 16%. Overall the Kosrae economy went into a gradual decline during the first four years of the amended Compact and fell by an annual average of 1.5%.

19. By FY2007, postponement of the phase-out of the use of the capacity-building sector grant for non-conforming purposes could no longer be deferred. It was no longer possible to sustain the level of public expenditures of the bump-up years, and in the run-up to the FY2008 budget, the state was confronting imminent collapse. However, in a leadership conference in mid-2007, the state decided to remedy the deteriorating fiscal position by implementing an adjustment program, cutting expenditures, and raising revenues. Supported through a retirement package equivalent to one year's salary and funded through a U.S. grant, the state was able to implement a RIF of 110 positions. While the impact of the salary payout would stimulate demand, it was insufficient to compensate for the reduction in the public sector, and the economy contracted by 1.3%.

20. In FY2008, the state felt the full impact of the RIF, and the public sector contracted by -7%. Despite the impact of the reduced level of public sector demand and the onset of the world recession, the private sector grew by 3.1% reflecting the state's increasing utilization of the infrastructure grant and FAA-funded renovation of the airport. Overall, the economy contracted by 4.4%. In FY2009, with the RIF complete, the public sector managed to avoid any further contraction. With improvement in the use of the infrastructure grant, on-going airport improvements, and a good year in the fisheries sector, the overall economy grew by 4.8%. While there was little change in most activities in FY2010, the construction sector contracted by 24%, as projects came to an and state GDP fell by 1.8%

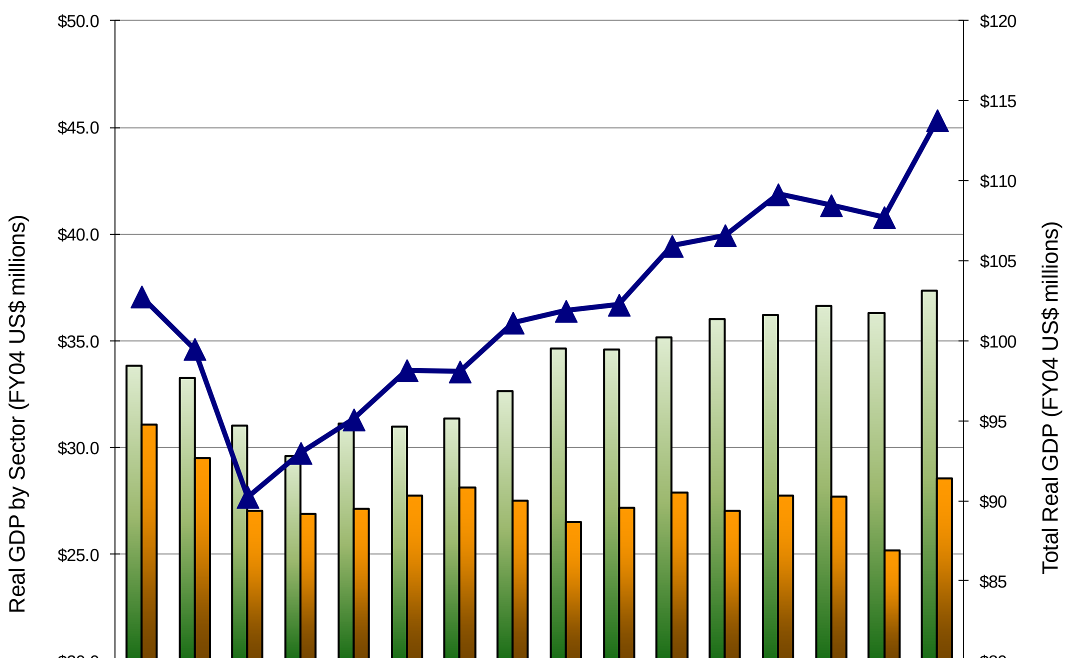
21. At the industry level, Kosrae state experienced many of the same developments as in Chuuk. Agriculture, manufacturing, and electricity have all experienced a downward trend during the amended Compact period. The main sector bucking this trend was fisheries, which expanded by an annual average of 3.3%. In FY2009 fisheries grew by 14%, with the reopening of the old freezing plant. With greater use of the infrastructure grant and airport renovation, the construction sector showed strong growth in FY2008 and FY2009 but eased back in FY2010 with the completion of projects. But the amended Compact period has been disastrous for the very small tourism sector, which contracted by an annual average rate of 2.8%. Public administration contracted by an annual average rate of 5.3%—less than in Chuuk—reflecting the impact of the RIF, but this was offset by increases in output in the protected education and health sectors. As with Chuuk, the first seven years of the amended Compact have not been kind; Kosrae's GDP fell by1.1% over the period.

iii Pohnpei

22. Pohnpei state experienced a substantial reduction in economic activity subsequent to the second stepdown, and state GDP declined by an annual average of 6.3% over the FY1995–97 period (Fig. 5). The state maintained a prudential fiscal policy, and economic

activity rose by an average annual 2.1 % from FY1997-2001, as the economy achieved an acceptable rate of growth. In FY2002, growth was strong, and state GDP grew by 3.1%, as the state fully utilized the available bump-up funds and benefited from an additional increase in resources after the final repayment of the Medium Term Notes (MTNs) in FY2001. In FY2003, the final year of Compact I, economic results were mixed. The state legislature opted to fully fund a return to an 80-hour pay period so as to stimulate economic activity (government GDP grew by 6.1%), but it also committed to fully meeting its contribution to the Compact Trust Fund in only one year, rather than setting aside the additional bump-up funds over two years. This sterilized and offset the impact of the return to 80 hours, and the private sector contracted by 3.6%. Overall the economy recorded an increase of 0.7% in FY2003.

23. Perhaps surprisingly, the Pohnpei economy weathered the implementation of the first year of the amended Compact without any undue adverse impact, and GDP held steady. Unlike Chuuk and Kosrae, Pohnpei had in the mid-1990s phased out the use of the energy grant to subsidize utility prices and thus avoided the associated reduction in public enterprise value-added. Pohnpei state hosts the national government, which was largely unaffected by the decline in Compact resources. The more-developed nature of the state economy and the higher revenue effort meant that the state was able to make the adjustment to the new Compact regime without suffering the negative impact of the transition to a sector-grant approach.



	FY95	FY96	FY97	FY98	FY99	FY00	FY01	FY02	FY03	FY04	FY05	FY06	FY07	FY08	FY09	FY10
Government	33.8	33.3	31.0	29.6	31.1	31.0	31.4	32.6	34.6	34.6	35.1	36.0	36.2	36.7	36.3	37.3
Private sector	31.1	29.5	27.0	26.9	27.1	27.8	28.1	27.5	26.5	27.2	27.9	27.0	27.7	27.7	25.2	28.6
GDP	102.8	99.5	90.2	93.0	95.1	98.2	98.1	101.1	101.9	102.3	105.9	106.6	109.2	108.5	107.7	113.8

Figure 5 Pohnpei State constant price GDP by sector (FY2004 prices, US$ millions)

24. In FY2005-06, the economy continued to grow, at 3.6%, and 0.6%, respectively, reflecting a positive outcome in most sectors. In FY2007, the state economy grew by 2.4%, mainly reflecting strong growth in the fisheries sector. High tuna prices contributed to favorable conditions in the state owned fishing enterprise, and the start-up of operation of the previously state owned fish loining plant, now under private management, boosted output. In FY2008 public investment demand was strong, with the construction of the new state government administrative complex and airport runway improvements. However, with no further stimulus from fisheries and the onset of the world recession, state GDP contracted by 0.5%. The same forces were evident in FY2009; construction activity remained strong, but the fisheries sector experienced a bad year, and with the negative impact of high inflation on demand, state GDP contracted further, by 0.7%. Finally, in FY2010 the state economy experienced strong growth, driven by fisheries, construction and expansion in public services; overall the state economy grew by 5.6%

25. At the industry level, economic developments have been markedly different from either conditions in Chuuk or Kosrae. Agricultural output improved during the amended Compact, registering an annual average growth of 3.1%, which reflects an increase in subsistence production. As noted earlier, this outturn is derived from the results of recent household income and expenditure surveys, which may be inaccurate. The fisheries sector has provided a constant trend level of output but varies from year to year depending on fishing conditions and prices. As noted above, the switch in ownership of the former state-owned fish processing plant boosted output in FY2008. Manufacturing and electricity production have both shown declining trends during the initial years of the amended Compact but in later years have shown improvement.

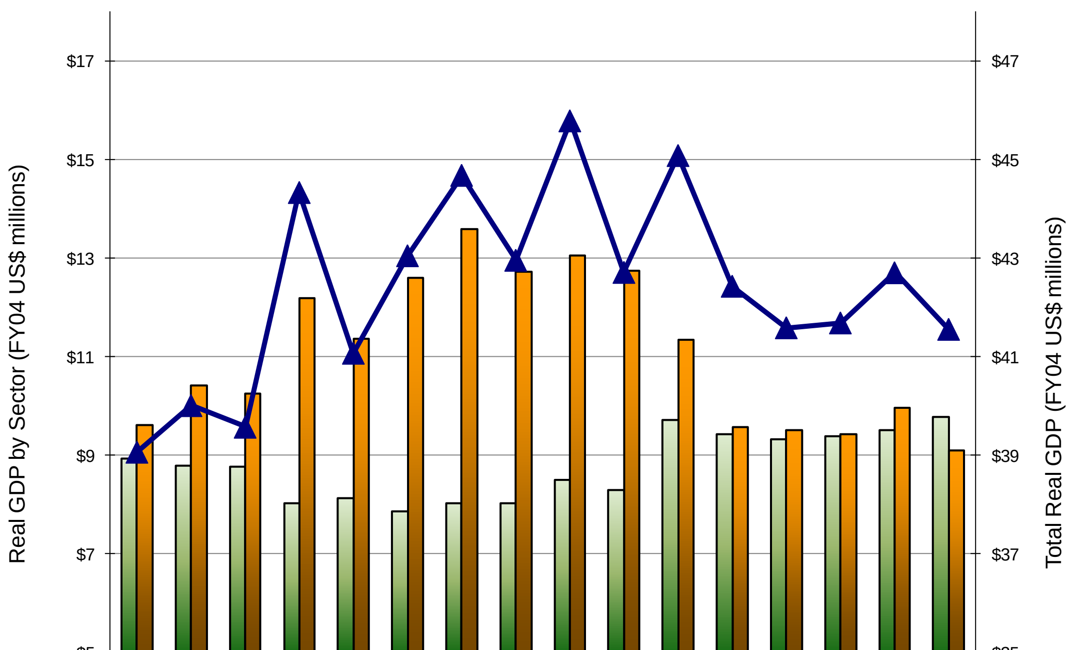
26. Construction demand was weak in the initial years but has been a strong source of growth in FY2008-10, with airport renovation and runway extension together with increased use of the infrastructure grant. The wholesale and retail trade has shown a positive trend, reflecting growth in the economy, but it declined in FY2009-10, reflecting the impact of the world recession. As in all states, including Pohnpei, the tourism sector has shown very poor results. It declined by an annual average of 2.5% during the amended Compact and performed worse than all other major economic sectors. Public administration was unaffected in Pohnpei by the switch to a sector-grant approach but has declined by an annual average of 1.1%, suggesting a general downward adjustment. Conversely, both education and health have been growth sectors, expanding by annual averages of 2.7% and 5.6%, respectively. Unlike Chuuk and Kosrae, Pohnpei's performance during the first seven years of the amended Compact has been positive, despite the setbacks in FY2008-09, and the economy has expanded by an annual average of 1.6% over the period.

iv Yap

27. The Yap state economy has displayed a markedly different development pattern from those of her sister states (Fig. 6). While the state's public sector contraction was similar to that of the other states after the second step-down, the private sector managed

to remain buoyant and assisted the state in maintaining positive GDP growth through the end of Compact I. GDP averaged an annual growth of 2.0% during FY1995-2003. While it is difficult to attribute success to any one particular factor, it is noteworthy that Yap maintained stable fiscal policies and perhaps a more laissez-faire policy environment. The state achieved a good outcome in the PSRP, meeting its ERP targets and achieving the anticipated cost-savings. These policies were maintained through the end of the original Compact period, and the state avoided the temptation to utilize the bump-up funds to temporarily inflate public expenditures.

28. The advent of the amended Compact in FY2004 saw a significant 6.7% reduction in the state economy, although this was largely due to the impact of Typhoon Sudal rather than any negative adjustment to the new regime. During Compact I, Yap pursued a very conservative fiscal policy, largely under-spending the available resources and accumulating the savings in substantial reserves. While these policies served the state well, the rules of the amended Compact did not permit the saving of unspent resources. In FY2004, at the start of the amended Compact, the lack of absorptive capacity resulted in the state's spending only $7.4 million of the available $10.2 million, and government production fell by 2.5%. Reflecting the impact of Typhoon Sural, the private sector also contracted by 2.5%, and subsistence production for own consumption fell significantly because of the destruction of crops. Yap, like Pohnpei, had also phased out the use of the energy grant to



	FY95	FY96	FY97	FY98	FY99	FY00	FY01	FY02	FY03	FY04	FY05	FY06	FY07	FY08	FY09	FY10
Government	8.9	8.8	8.8	8.0	8.1	7.9	8.0	8.0	8.5	8.3	9.7	9.4	9.3	9.4	9.5	9.8
Private sector	9.6	10.4	10.3	12.2	11.4	12.6	13.6	12.7	13.1	12.7	11.4	9.6	9.5	9.4	10.0	9.1
GDP	39.1	40.0	39.6	44.3	41.1	43.1	44.7	43.0	45.8	42.7	45.1	42.4	41.6	41.7	42.7	41.6

Figure 6 Yap State constant price GDP by sector (FY2004 prices, US$ millions)

subsidize utility prices. However, the state continues to maintain a sizeable array of public enterprises, and in FY2004, reduced profitability in the fishing sector contributed significantly to the reduction in GDP.

29. In FY2005, the economy rebounded strongly by 5.0%, fueled by the infusion of FEMA funds to support rehabilitation and reconstruction. Despite significant additional demand for private sector services and the construction of the Southern Road system, the closure of the two garment factories resulted in a 10.9% contraction in private sector activity. Additional funds from FEMA, along with improved capacity utilization of the Compact sector grants, enabled the public sector to grow by 17.3%. A return to normal climatic conditions also enabled subsistence production to resume prior levels of output. In FY2006, economic activity fell by 5.9%, reflecting the reduction in FEMA funding that had artificially boosted output in the previous year. As a result, both the private and government sectors contracted substantially. The state-owned fishing enterprise also suffered a significant reduction in operating surplus, and public enterprise output fell by 30%, although the overall contribution to GDP for this sector is small. Economic developments in FY2007 continued the trends of the previous year, and GDP fell by a further -2.0%. By FY2008, the economy had bottomed out and grew by only 0.2%, despite favorable conditions in the fisheries sector. In FY2009 the economy defied the impact of the world recession and grew by 2.4%, reflecting strong growth in the construction sector and FAA-funded airport renovation. In FY2010 the state economy contracted by 2.7%, reflecting a poor year in fisheries, reduction in construction activity due to completion of projects, and reductions in education expenditures, despite expansion in public administration.

30. At the industry level, Yap state economy shows mixed performance during the amended Compact, resulting in wide variation in state GDP from year to year. Agriculture was stagnant, reflecting household survey and population data on which the agricultural GDP estimates are based . The fisheries sector trended downward during the amended Compact period, but varies from year to year, depending on fishing conditions and prices. Manufacturing all but disappeared in FY2005 with the closure of the two garment factories. While the factories made a significant contribution to GDP, most of the employed labor consisted of foreign workers. State GNI (Gross National Income), which adjusts for compensation of non-residents, would show a more stable pattern. Tourism, as in Yap's sister states, performed abysmally and declined by an average annual rate of 3.6% during the amended Compact period.

31. Reflecting the general forces prevailing in the FSM, electricity production revealed a downward trend during the early part of the amended Compact, the result of weakening demand in the face of rapidly rising prices. More recently, electricity production has stabilized, reflecting the large subsidy now incurred by the state. Construction output has varied in proportion to public investment demand. It rose very strongly in FY2009 with the FAA funded airport renovation but fell back in FY2010 as the improvements came to an end. Wholesaling and retail trade has shown an upward trend but

fell back in FY2009-10. In the absence of any need to compress public expenditures, government administration output has held steady but shot up by 13% in FY2010. Yap managed to avoid having to phase out nonconforming use of the capacity building grant by funding general administration from earnings on its offshore equity investments. Since the start of the amended Compact, education services have benefited from the sector-grant approach and grown modestly in most periods by an annual average of 1.5%, although they increased significantly in FY2006, by 14%. Health outlays have grown strongly in most periods averaging 5.7% a year.

32. In FY2008, the state legislature barred the use of a variable fuel charge enacted in FY2006 by the Yap State Public Service Corporation (YSPSC) to cover increases in fuel costs. From an average level of 17¢ per unit in FY2005, prices had risen to 31¢ in FY2007, but due to enactment of the new law, the Corporation was forced, in 2008, to return average prices to their prior levels. As a result, the YSPSC was forced into a dire financial position: formerly one of the most efficient utilities in Micronesia, it was now running one of the largest deficits in the region. In FY2007, gross revenues were $5 million, with costs of an equal amount. By FY2008, the utility was forced to repay $3.1 million in revenues to customers and recorded an operating loss of $5.7 million. In February 2009, the YSPSC implemented a new tariff that built fuel cost into the base rate, with an average price of 32¢ a unit. While the new tariff goes a long way towards improving the financial position of the utility, it was insufficient to cover costs, and a higher rate was billed out to government departments at 70¢ per unit, effectively subsidizing the utility. Overall, the YSPSC registered an operating loss of $1.0 million in FY2009. In FY2010 this amount was reduced to a break-even position, as the repayments required by the state legislature were completed. With grant assistance from DOI, the utility commissioned a rate study in 2010, with the intention of establishing a new tariff in 2011.

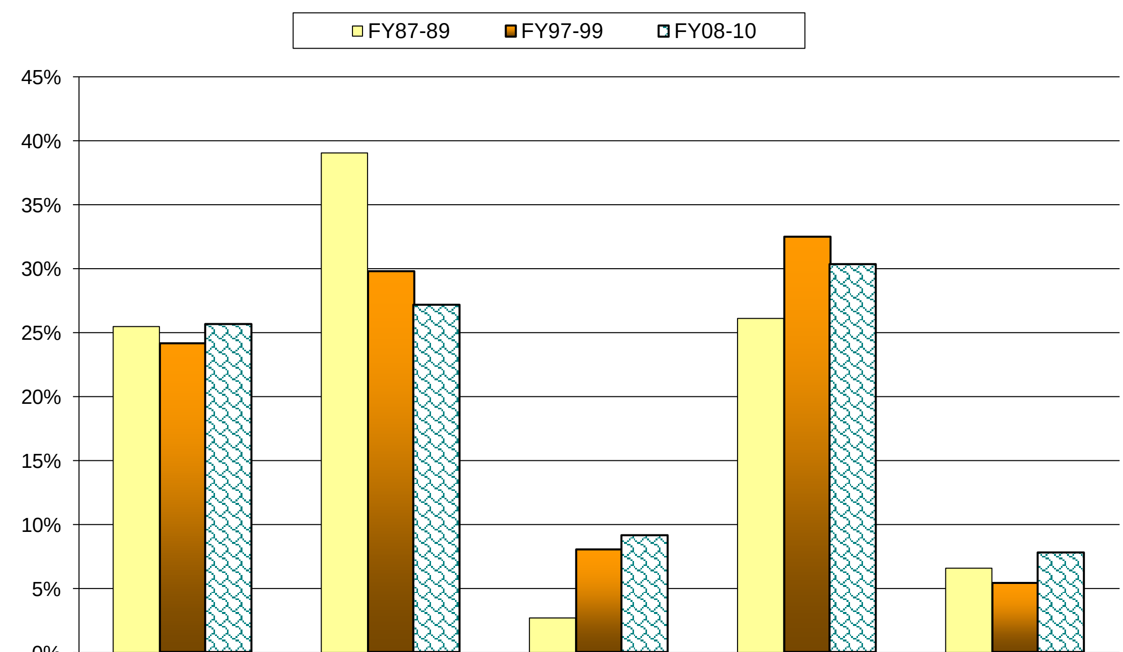
33. Like Chuuk and Kosrae, Yap initially funded a significant proportion of general government from the capacity-building sector grant. However, in FY2006, the state decided to draw on its substantial investments to fund these activities. The recent adverse developments of the YSPSC have compounded the state’s problems. While the use of Yap’s carefully accumulated resources to fund public sector operations and subsidize utility prices avoids the need for immediate adjustment, this solution is not viable in the longer term. Yap was a state with an enviable fiscal record, but recent developments necessitate some hard decisions that require a strong leadership response. The YSPSC must be allowed to re-instate a financially sound pricing policy, and the state needs to consider options for financing government operations without drawing on its reserves.

3 THE STRUCTURE OF THE ECONOMY

34. Analysis of the structure of the FSM economy is presented in two parts: by institutional sector and industry. The 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. 7). The share of government has declined significantly, by 11.8%, since the beginning of Compact I. This decline reflects three major forces: (i) a reduction

in the size of government due to the lower levels of Compact assistance after the second-stepdown; (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 Compact II. The increase in PSEs of 5.3% in the initial period 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 are now mostly defunct or consolidated under private sector management. The result has been a 1.2% increase in the share of the PSEs since the late 90s. Overall, combining government and the PSEs, the contribution of the public sector at large has fallen by 5.3% since the beginning of the Compact.

35. The 25% share of the private sector since 1987, at the start of Compact I, has remained virtually unchanged. Given the reductions in the share of the public sector, including PSEs, this result is surprising. Compensating for the public sector decline, the contributions from the household sector has increased. This sector includes market production of commodities, non-market production (subsistence), and home ownership. The total share of households has risen by 4.3%, entirely offsetting the decline in the public sector. In essence, the failure of the private sector to become the engine of growth has forced households to fall back on their own resources and devote more effort to subsistence production.

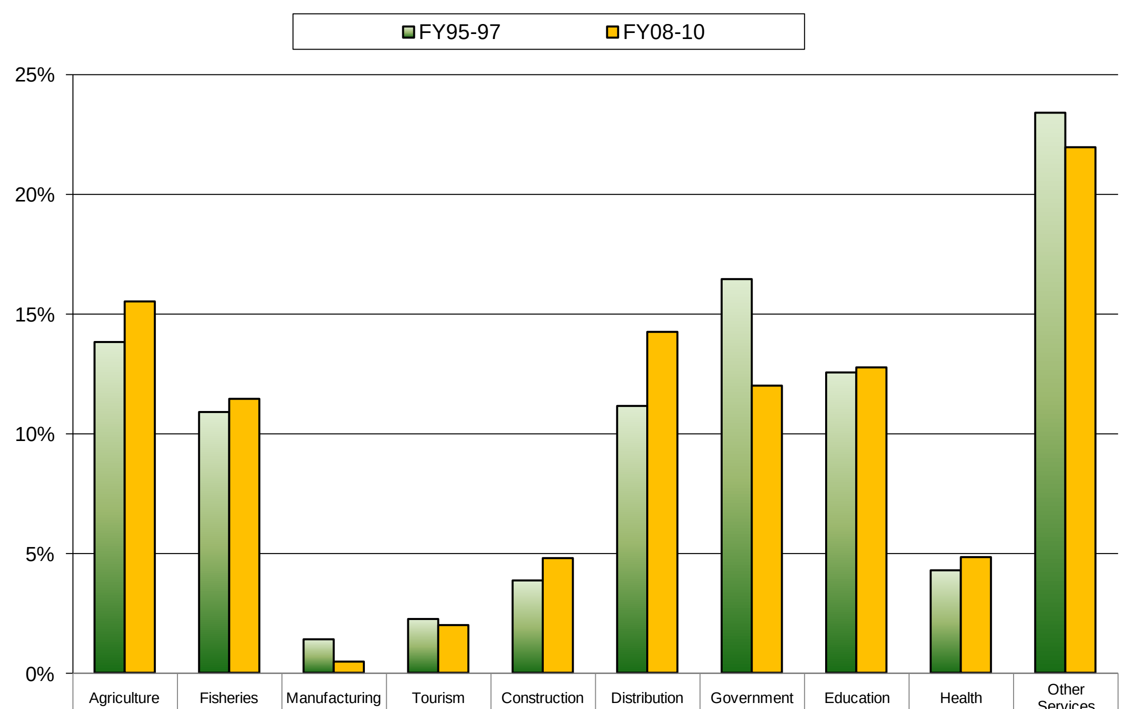


	Private Sector	Government	Public Enterprises	Households	Indirect Taxes
FY87-89	25.5%	39.0%	2.7%	26.1%	6.5%
FY97-99	24.2%	29.8%	8.0%	32.5%	5.4%
FY08-10	25.7%	27.2%	9.2%	30.4%	7.8%

Figure 7 The institutional structure of the FSM Economy (%)

36. In addition to the households and the private and public sectors, indirect taxes form a significant proportion of the economy, increasing slightly, from 6.5% of GDP during the initial phases of the Compact to 7.8% during the last three years (the dip in FY1997-1999 reflects the weak level of demand during a period of fiscal adjustment). This development reflects two trends. First, reform of the national customs tax structure under the PSRP broadened the tax base, by subjecting all sectors in the economy to the same tax rates, and it changed the evaluation of duties from an f.o.b. to a c.i.f. basis. Second, indirect tax rates at the state and national levels rose through the period to offset declining Compact revenues.

37. Fig. 8 shows the changes in the structure of the economy in the more standard way, by industry. the share of agriculture has grown by 2.3% since the mid 1990s, reflecting the increase in household subsistence production discussed above,. Similarly, the fisheries sector has increased its share of GDP, reflecting the mid-90s financial consolidation and the move to private sector management. The share of the manufacturing sector has fallen by 1.1%, reflecting the closure of the Yap garment factories. These activities represented trade diversion of garments behind preferential tariffs accorded to the FSM. The loss of these arrangements resulted in the factories closing rather than any reduction in the competitiveness in the economy. The share of tourism has fallen, albeit marginally. This is a most disappointing development, since tourism is the major sector that could lift the economy from its current stagnation.



	Agriculture	Fisheries	Manufacturing	Tourism	Construction	Distribution	Government	Education	Health	Other Services
FY95-97	13.8%	10.9%	1.4%	2.2%	3.9%	11.1%	16.4%	12.5%	4.3%	23.4%
FY08-10	15.5%	11.5%	0.5%	2.0%	4.8%	14.2%	12.0%	12.7%	4.8%	22.0%

Figure 8 The industrial structure of the FSM Economy (%)

38. Taking together the four sectors that represent the traded goods sectors of the economy—agriculture, fisheries, manufacturing, and tourism—one might be tempted to say that the overall increase in share, by 1.0%, represents a reduction in "Dutch disease." Dutch disease analysis is based on the impact of a leading sector that diverts resources away from traded goods into non-traded goods production. The increase in agricultural production does indeed represent a switch to non-marketed production due to the weakening public–sector–led economy, but this development reflects an economy turning in on itself rather than increasingly integrating itself into the world economy. The FSM has always been heavily influenced by the dominance of the public sector and Dutch disease effects, but these conditions have changed little since the commencement of Compact I.

39. The non-traded goods sectors—construction, distribution (wholesaling and retailing) and other services (includes electricity)—have collectively increased their share by 2.6%, but the large increase in the share of distribution services, 3.1%, is surprising. However, it is not surprising (*cf.* the discussion above) that the share of public administration (i.e., government) has fallen significantly, while that of education and health has risen. In the design of the amended Compact, the U.S. explicitly intended that the focus of the new arrangements should protect education and health. The Compact was also perhaps implicitly designed to encourage a reduction in the size of the government. In this regard, the amended Compact has been successful. While it is clear that the reduction in government has been achieved without any noticeable reduction in services, it is not clear that the shift in resources to education and health has resulted in better education or health care.

4 Sectoral Developments

40. Data on the primary economic sectors of the FSM are weak: there are no indicators of agricultural production, there is limited information on agricultural exports, and information on fisheries is poor. In agriculture, subsistence activities make a substantial contribution to GDP, while production for either the domestic or export market is surprisingly small. The perception persists among local growers that returns from agriculture are low and slow to materialize compared to other activities such as non-traded services and government employment. Compact assistance has exerted upward pressure on wages, turning the terms of trade against agriculture and making agricultural production unattractive. Copra production, as in many other Pacific Island nations, has all but disappeared because of inefficiencies and low prices, but profitable export opportunities exist in other niche agricultural products.

41. With the vast marine resource under FSM jurisdiction, it might be anticipated that fisheries would be a well-developed sector making a significant contribution to GDP. However, the sector has failed to achieve the anticipated growth. In the early 1990s, in an attempt to develop the economy, the FSM embarked on a strategy of substantial public sector investment in fisheries facilities and enterprises. Joint ventures with foreign partners in purse seine fishing operations were initiated in Chuuk, while similar but direct public sector investment in Pohnpei and Yap was undertaken. Investment in freezing,

storage, and transshipment plants was undertaken in all four states, along with air shipment of sashimi-grade tuna to Japan by the national government. A long-line fishing company, the Micronesian Long-line Fishing Corporation, was set up with ADB loan finance for eventual sale to the private sector but subsequently filed for bankruptcy and liquidation and no longer exists.

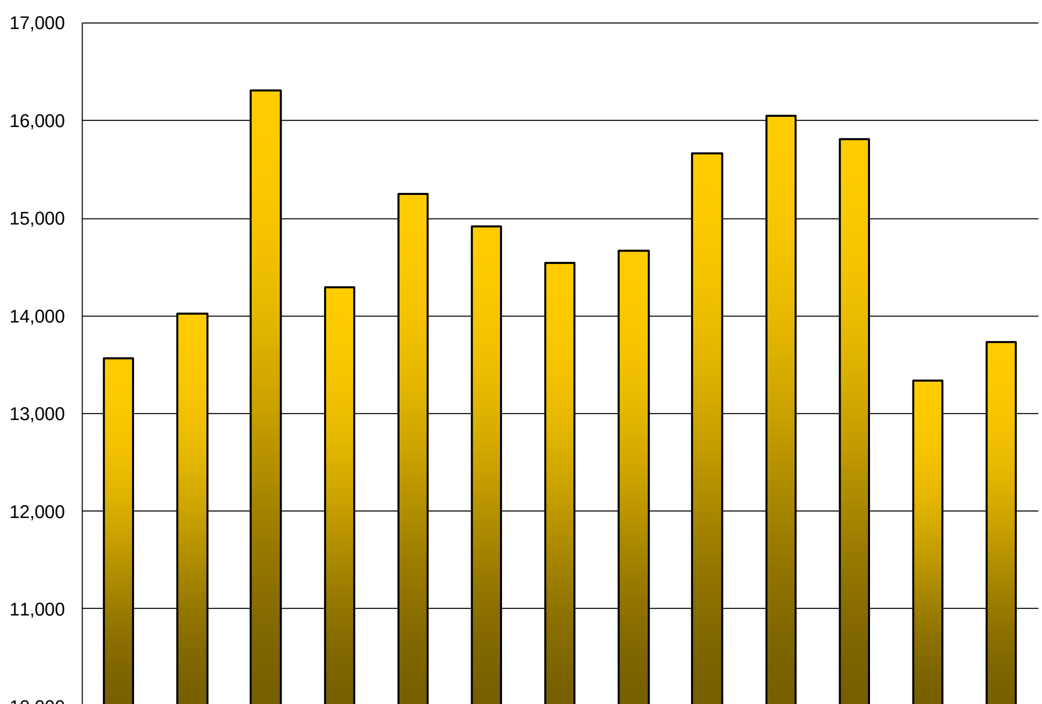
42. However, none of the original fisheries under public sector management are still operating. While there was awareness that the public sector should not be involved in the productive sectors of the economy, it has taken a long time for this policy to be implemented. Only recently have four public sector enterprises in the fisheries sector been transformed. The national government divested its ownership shares in the Caroline Fisheries Corporation, and 60% of the enterprise is now owned by a private foreign investor, with the remainder held by Pohnpei state. The Pohnpei Fisheries Corporation has also been leased to a private foreign investor, although the assets remain under public ownership. Similarly, Yap Diving Seagull is under private management, although the asset (purse seiner) is owned by the state government. The large Kosrae freezing plant has also been leased to a foreign operator. The main benefit of the fisheries resource has been the annual rents earned from fishing access fees; these make a substantial contribution to national government revenues. After a prosperous period in the mid 1990s, when annual fishing royalties averaged $21 million, receipts fell by about 50% during the initial years of the 2000s. During recent years, this trend has reversed, and in FY2009 fishing fees exceeded $20 million, although they dropped back to $17.7 million in FY2010.

43. As this review is being prepared, there is a large potential fisheries project under consideration. It would cover the four states of the FSM, with private sector participation. A borrowing in excess of $20 million from Eximbank would fund renovation of the state fish processing facilities and other shore-based assets. The plant would be leased to the private party, which will operate a fleet of long-liners and purse seiners. Fish would be processed either for transshipment or loining. The enterprise is attractive to the private interests because it grants them access to FSM waters, while it benefits the FSM by creating jobs . Various pieces of legislation are under consideration by the national government; the intent is to close the deal by year-end. However, there remains uncertainty over the project, as the FSM will take liability for the Eximbank loan, while the private party is committed only to lease the renovated facilities for as long as the activity remains profitable.

44. Fig. 9 indicates recent trends in the FSM tourism industry and includes data on tourist and visitor arrivals. Since the start of the data series, in FY1998, there has been a gradual upward trend, and visitor arrivals grew by an annual average of 1.5% through FY2008. This rate is above the estimated annual average decrease in the hotel and restaurant GDP figures, which had been declining by 2.1% per annum since FY1995. Which series is more reflective of actual developments is open to question, but plant capacity has not increased over the period. The peaking of arrivals in FY2000 and apparent collapse in FY2009 are observations of dubious validity; there is some question about the

accuracy of the statistics. Overall, however, it is clear that the performance of the sector has been lackluster and well below the potential for an industry designated as a—if not the—major growth sector of the FSM economy.

45. Many factors currently hinder development of a vibrant tourism industry. The Private Sector Development Program (PSD) initiated with ADB loan finance was intended to rectify many of the weaknesses. The climate for foreign direct investment was streamlined during the Public Sector Reform Program (PSRP), and additional improvements were carried out during the PSD. However, further reform must be completed before an attractive climate for private sector investment is established. Difficulties in obtaining secure long-term land leases are an impediment. Hotels currently operate at low capacity levels, but most if not all of the facilities offer a standard of accommodation that is unattractive to international travelers. Growth in demand has been hampered by reliance on a single carrier operating high-priced flights to and from a remote geographical location. While these factors have all impeded tourist development, the FSM has much potential, particularly as a niche market in the eco-tourism and dive areas. The recent extension of the Pohnpei runway, which will enable direct flights from Japan, could help increase visitor arrivals. However, the current generally low quality of tourism facilities and infrastructure is unlikely to attract any but the most hardened of travelers.



	FY1998	FY1999	FY2000	FY2001	FY2002	FY2003	FY2004	FY2005	FY2006	FY2007	FY2008	FY2009	FY2010
Visitor Arrivals	13,567	14,020	16,310	14,297	15,247	14,917	14,538	14,672	15,662	16,048	15,813	13,334	13,727

Figure 9 Visitor arrivals to the FSM, FY1998–FY2010, ‘000s

5 INCOMES, POPULATION, AND MIGRATION

46. At the beginning of the Compact, population growth as recorded between the 1986 and 1989 censuses, was rapid, at 3.0% per annum (Table 2). Between 1989 and the next count in 1994, the rate fell to 1.9%, reflecting lower fertility rates and modest rates of emigration. However, between the 1994 and 2000 censuses, the population growth rate fell to 0.2%, and according to 2010 count, the downward trend continued, and population growth turned negative. Population declined in both Chuuk and Kosrae, while Pohnpei and Yap recorded small but positive increases. While fertility rates fell, the majority of the decline reflected outward migration to neighboring U.S. territories, Hawaii, and the U.S mainland, under the migration provisions of the Compact. Clearly, the negative economic growth rates in the FSM after the second step-down and recent RIFs in Chuuk and Kosrae resulted in large-scale migration to seek employment opportunities and better rates of remuneration in the U.S. In the long-run, migration plays an equilibrating role: as incomes decline, outward migration compensates, improving average income levels for those remaining. Outward migration will have a distorting impact on the local economy, however, if it is achieved through a loss of the economically active and skilled individuals. This loss of human capital will reduce the long-run productive potential of the economy.

47. The relationship among real incomes, employment, and migration is further illustrated, by state, in Fig. 10. In all states, real incomes and employment have either fallen or remained largely stagnant, reflecting poor economic performance during the last 14 years. As a result of the decline in incomes and reduction in jobs, especially in Chuuk and Kosrae, outmigration, as measured by net movements of air passengers leaving the FSM during 2004-10, has also been significant. Clearly, there is a strong association between economic performance and outmigration.

Table 2 Population by state and annual average growth rates

	Population					Annual average growth			
	1980	1989	1994	2000	2010	1980-89	1989-94	1994-00	2000-10
Chuuk	37,488	47,871	53,319	53,595	48,500	2.7%	2.2%	0.1%	-1.0%
Kosrae	5,491	6,835	7,317	7,686	6,750	2.4%	1.4%	0.8%	-1.3%
Pohnpei	22,080	30,669	33,692	34,486	34,749	3.7%	1.9%	0.4%	0.1%
Yap	8,100	10,365	11,178	11,241	11,810	2.7%	1.5%	0.1%	0.5%
FSM	73,159	95,740	105,506	107,008	101,809	3.0%	1.9%	0.2%	-0.5%

Source National Census Report May 2002
2010 preliminary estimate

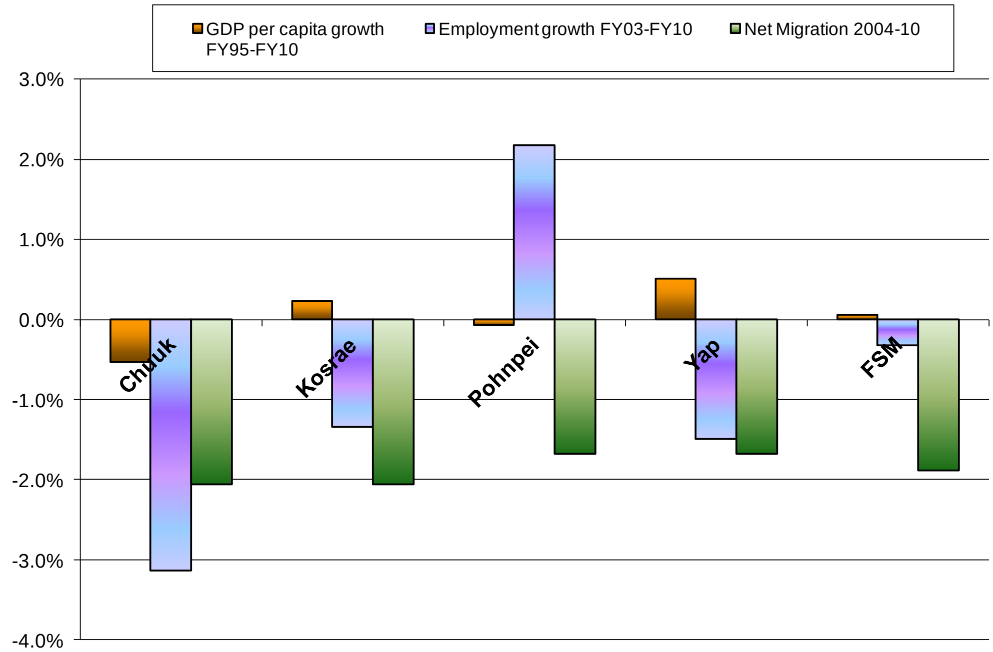


Figure 10 GDP per capita, migration, and population growth (annual averages)

48. Fig. 11 indicates the changes in constant price GDP and real GNDI per capita in 2004 prices. The constant price GDP estimates are derived from chaining the earlier GDP series with the current national accounts series, and real GNDI includes the primary and secondary incomes received and paid to the rest of the world. The major differences between the two estimates are the inclusion of (i) fishing fees, (ii) earnings on foreign investments, (iii) transfers from overseas households, and (iv) the receipt of grants from the U.S. and other donors (see balance of payments for a list of primary and secondary income flows). The data for the GNDI estimates begin in FY1995 and indicate a far higher level of disposable incomes when the additional flows are taken into account. In FY2010, GNDI per capita was over $1,188—41% higher than current price GDP.

49. The data in Fig. 11 provide a clear message about the developments in average real incomes (discussion is based on the GDP series). The advent of the Compact saw a large improvement in income levels in the run-up to the Compact; this improvement was sustained through the mid-90s, until the second stepdown. The stepdown triggered a significant shock, but there was a gradual improvement over the remainder of Compact I, and by FY2001, per-capita incomes had surpassed the last highest recorded level (FY1993). The implementation of the amended Compact caused a reduction in incomes as the economy adjusted to the new regime. Incomes recuperated in the following two years but then fell off as inflation peaked and the international recession took hold. In the last two years, FY2009-10, incomes regained the lost ground and attained the highest level ever recorded. However, this result was achieved by out-migration, which sustained average living standards of those remaining behind.

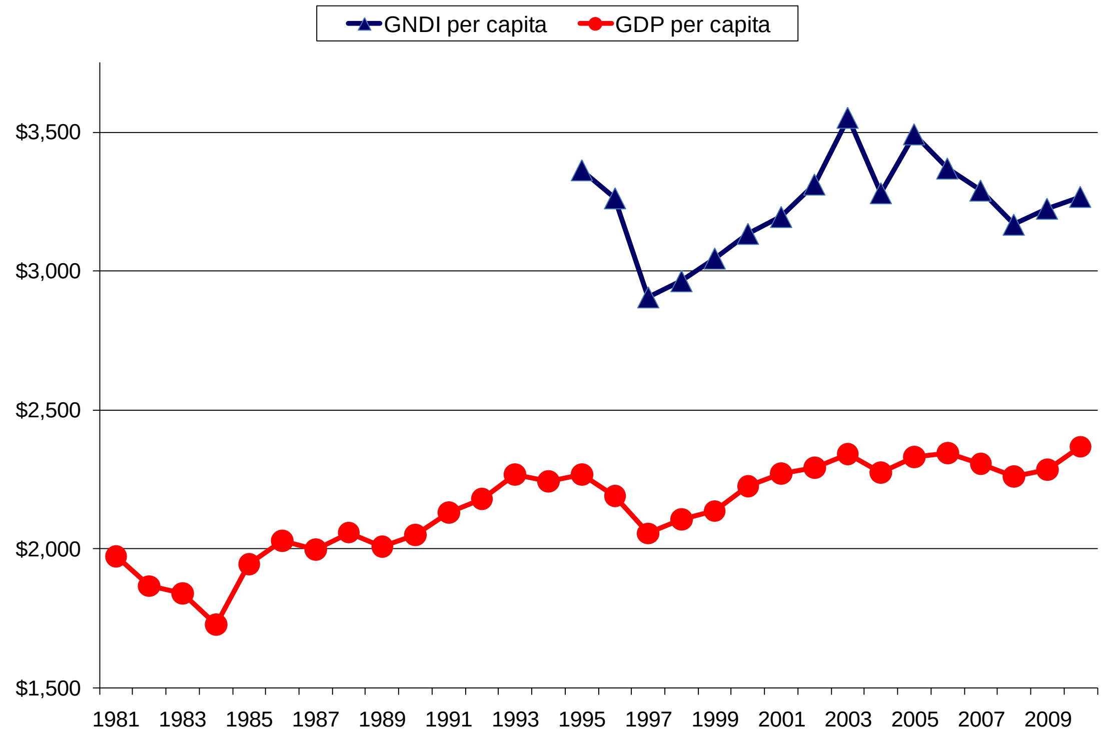


Figure 11 GDP and GNDI per capita, constant prices 2000, $'s 1981–2010

50. The GNDI data, including primary and secondary incomes received from the rest of the world, tell a similar story, although changes have been more pronounced. Analysis at the state level tells an interesting story (see statistical appendix), with per-capita incomes remaining largely stagnant in Chuuk and Kosrae and a sustained improvement in Pohnpei. In Yap, after a significant improvement in the early 90s, living standards have also stagnated but remain higher than those in Pohnpei and more than twice as high as in Chuuk.

6 Employment

51. Table 3 indicates that from FY1995–2010, formal sector employment contracted by an annual average rate of 0.5% (a 7% decline over the period) and was unable to provide enough jobs for new job seekers (source: Social Security Administration). Over the period, some 1,883 jobs were lost in Chuuk (31% of those employed in FY1995), Kosrae suffered a loss of 54 (4% of those employed in FY1995), while Yap just managed to break even. Pohnpei generated an additional 735 new jobs, representing some 10% of those employed in FY1995. Public sector employment contracted overall and in all states except Pohnpei, reflecting the downsizing of the public sector after the second step-down and the completion of the RIFs in Chuuk and Kosrae in FY2007. Private sector employment generation was positive in Kosrae, Pohnpei and Yap but contracted in Chuuk. The general results are very disappointing, and the lack of job creation clearly reinforces the

Table 3 Employment Growth Rates by Sector and State (annual averages)

	FY1995-FY2010			2nd Step-Down FY1995-FY1999			Final Phase Compact I FY1999-FY2003			Compact II FY2003-FY2010		
	Total	Gov	Private	Total	Gov	Private	Total	Gov	Private	Total	Gov	Private
Chuuk	-2.4%	-3.9%	-0.6%	-4.4%	-5.9%	-3.8%	0.9%	0.5%	2.3%	-3.1%	-5.1%	-0.4%
Kosrae	-0.3%	-1.9%	2.7%	-0.2%	-3.9%	5.0%	1.6%	0.9%	5.2%	-1.3%	-2.4%	0.0%
Pohnpei	0.6%	0.6%	1.5%	-1.4%	-0.2%	-1.8%	0.1%	1.6%	-0.7%	2.2%	0.5%	4.8%
Yap	0.0%	-0.3%	0.2%	1.5%	-4.0%	5.6%	1.3%	0.1%	2.6%	-1.5%	1.7%	-4.1%
FSM	-0.5%	-1.5%	0.8%	-1.9%	-3.5%	-0.4%	0.7%	0.9%	1.4%	-0.3%	-1.6%	1.2%

Source FSM Social Security Administration Data

already strong incentive to emigrate and seek employment opportunities in the United States.

52. Fig. 12 indicates recent trends in private and public sector employment since FY1995. Employment in the public sector contracted severely after the second step-down in Compact funding, reflecting a major fiscal adjustment. The ADB-financed PSRP enabled implementation of an ERP that facilitated the needed compression to restore fiscal

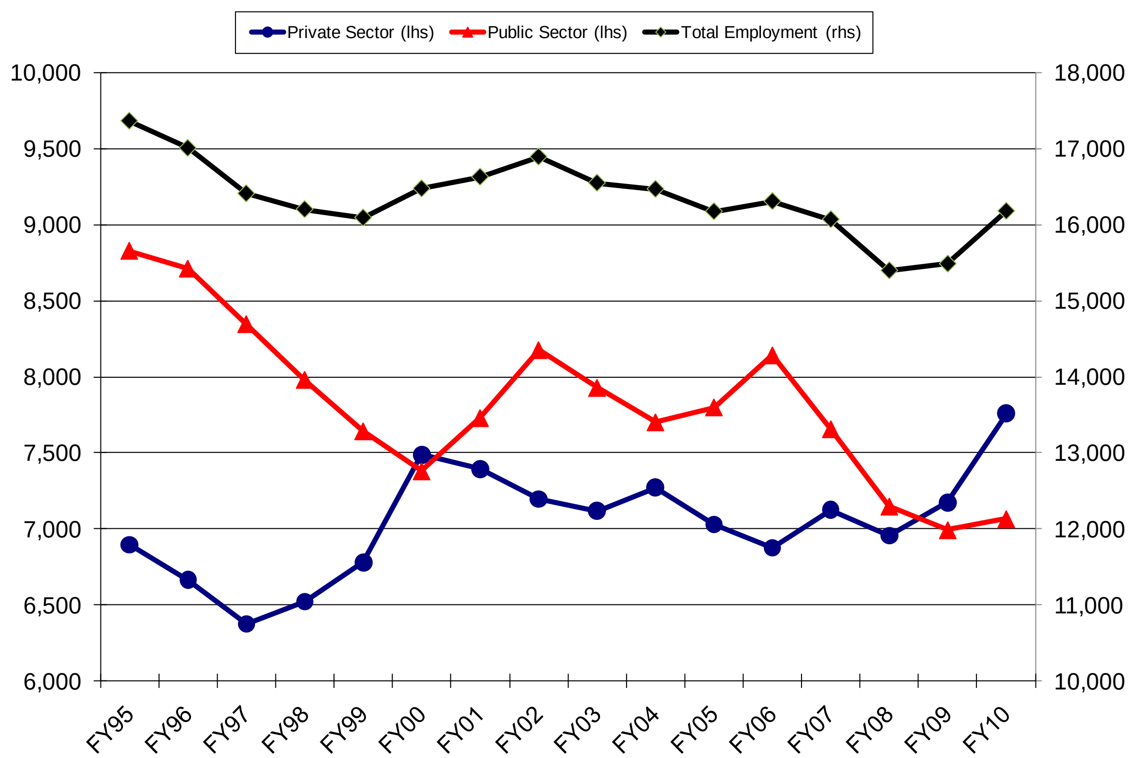


Figure 12 Employment by sector, FY1995–FY2010

balance. By FY2000, employment in the public sector had fallen from 8,826 in FY1995 to 7,381, a 16% reduction. However, in the following period, FY2000-FY2010, public sector employment has shown an oscillating trend, corresponding to the fiscal position in different states. A lack of discipline in Chuuk in FY2002 and FY2006 is reflected in sharp increases in total FSM public sector employment levels. However, with the need to compress expenditures -- a result of the phase-out of the use of the capacity-building grant to fund government operations in both Chuuk and Kosrae -- public employment fell in FY2008 to a level just 3% below what it was at the height of public sector reforms in FY2000. While public sector employment has been held steady in Yap (with the exception of FY2005, when there was a large step increase), public sector employment in Pohnpei has risen significantly during the amended Compact.

53. Private sector employment contracted between FY1995 and FY1997, reflecting the contraction in the public sector, but rose strongly between FY1997 and FY2000. During these years, the FSM economy improved after completion of the adjustment to the second step-down and the resolution of the earlier financial crisis in Chuuk. Since that time, however, during FY2000-06, private sector employment declined as Compact I came to an end and during the initial three years of adjustment during Compact II. More recently, during 2009-10, private sector employment has grown (by 8% in FY2010).

7 Wages

54. The labor market in the FSM is relatively free from regulatory distortions and institutional rigidities. Pohnpei is the only state to impose a minimum hourly wage ($1.35) for the private sector. While the minimum wage may not affect the demand for skilled workers, it may be an active constraint in labor-intensive activities, although private sector operators do not suggest that this is the case. All the FSM governments have set minimum hourly wages for government employment ($2.00 for Pohnpei, $1.25 for Chuuk, $1.42 for Kosrae, $1.60 for Yap, and $2.34 for the National Government), but these levels coincide with the lowest step on the public servant pay scale and are thus redundant. There are currently no unions in the FSM, and there is no indexation of wage rates.

55. However, while the labor market is relatively free from market rigidities, it is distorted by high public-sector wage rates, the ease of migration, the availability of higher wages in Guam and other U.S. labor markets, and the opportunity cost of labor in the subsistence sector. Table 4 indicates the level of real wages by state and compares the private and government sectors. In FY2008-10, government wages for the FSM as a whole were 225% higher than those of the private sector. While the skill mix of the two activities affects the differential, the public sector clearly asserts an upward pressure on wages and influences the allocation of labor among the sectors.

56. Unfortunately, policymakers are constrained in their ability to influence distortions in the labor market. The effect of unrestricted external migration is part of the basic rights of FSM citizens under Title III of the Compact. However, during the Second Economic Summit, the FSM adopted a policy to reduce the differences between the private

Table 4 Real wages and differentials by sector and state

	Real Public Sector Wages (2004 US$)		Real Private Sector Wages (2004 US$)		Differentials	
	Average FY95-FY97	Average FY08-FY10	Average FY95-FY97	Average FY08-FY10	Average FY95-FY97	Average FY08-FY10
Chuuk	6,374	6,162	3,254	2,823	196%	218%
Kosrae	8,195	6,728	3,217	2,729	255%	247%
Pohnpei*	12,140	9,423	4,653	3,703	261%	254%
Yap	7,959	6,213	3,801	3,543	209%	175%
FSM	8,694	7,645	4,009	3,393	217%	225%

Source FSM Social Security Administration Data
Notes * includes national government

and public sectors. Data in Table 4 indicate that this objective has been achieved in Yap and to a lesser extent in Kosrae and Pohnpei, but in Chuuk there has been a significant increase in the disparity. Table 4 also shows that real wages fell significantly in the FSM from FY1995–2010, by a total of 12% in the public sector and 15% in the private sector.

B Monetary Developments and Prices

1 PRICES

57. Fig. 13 provides information on the rate of annual change (each quarter is compared to the same quarter of the previous year) in the FSM CPI, including food and energy prices (see statistical appendix for greater detail). From the first quarter of FY2004, inflation started to rise from its historically low levels, averaging less than 1% during the first four years of the 2000s, to averages of 4% during 2005-07. The CPI rose to 6.6% in 2008 and 8.2% in 2009 but fell back in FY2010 to 4.3%. The main reasons for the increase in prices were: (i) increases in imported food prices in 2008; (ii) increases in utility prices at the start of Compact II, because of the loss of the Compact I energy grant; and (iii) increases in world petroleum prices in 2008 and 2010. While there were some general increases in prices of imported food in FY2004, the main increase did not occur until 2008, when food prices rose sharply, reflecting the disequilibrium in world markets. Given the significance of food in the FSM CPI (37%), the 25% price increase had a large impact on the overall CPI.

58. The Compact I energy grant was used in Chuuk and Kosrae to subsidize utility prices, and its loss compelled both states to raise electricity tariffs. In Pohnpei and Yap, the state governments had adopted a cost recovery price basis of production and had, in the mid-90s, ceased to use the energy grant to subsidize prices. However, the impact of

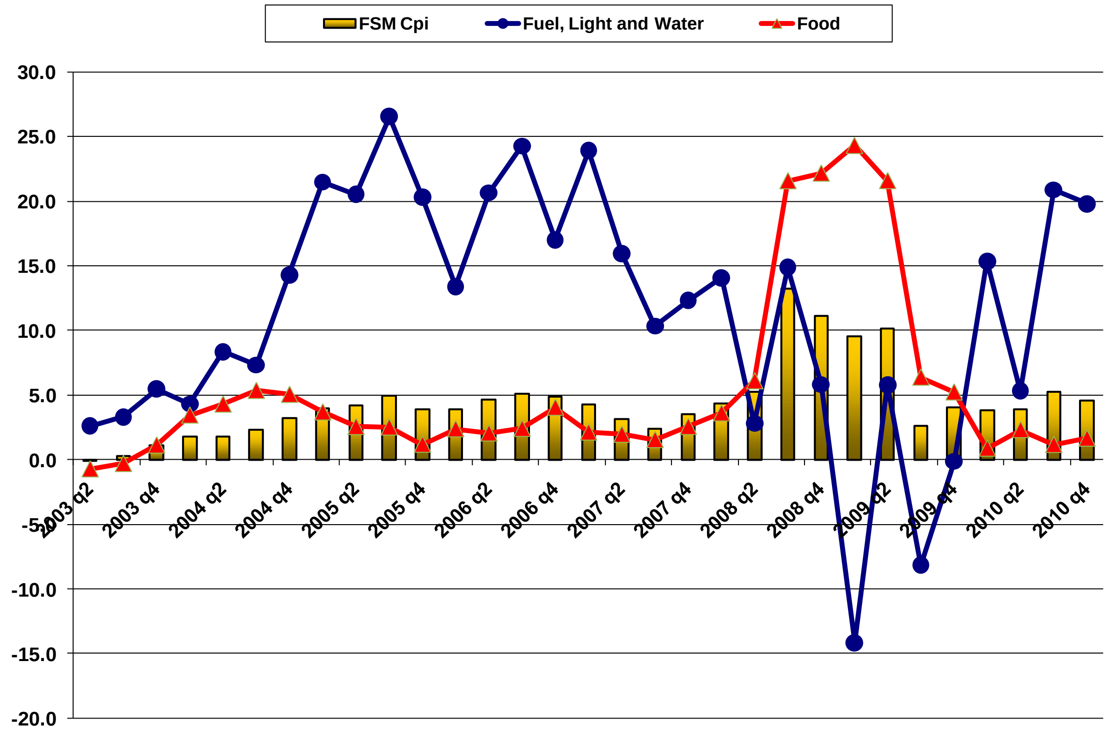


Figure 13 Change in Consumer Price Index – food and energy sections (year on year % change)

the loss of the energy grant was compounded throughout the period by rising world petroleum prices, which not only pushed up prices of gasoline at the pump but also required further increases in utility tariffs in all states. At the end of 2008, world energy prices began to moderate, and the energy section of the CPI recorded a negative change in the first quarter of 2009. Despite a strange spike in the 2nd quarter due to erratic price changes at the state level, energy prices continued to moderate during the remainder of the year. The reduction in energy prices was aided by the start-up of operations of the FSM Petroleum Corporation, which took over the supply and distribution of petroleum in the FSM after the departure of Mobil. In 2010 energy prices again rose, and the rate of inflation averaged 4.3% during the year, as other prices, including food, moderated.

2 Money and Banking

59. With the adoption of U.S. currency in the FSM, macroeconomic policy and adjustment has been limited to the use of fiscal policy. Many other small island economies of the Pacific use foreign currency, and this practice has served the FSM well. The range of macroeconomic policy options is limited; thus, there is no potential to use inflationary monetary policy to adjust to changes and reductions in Compact funding. Of course, this has left the FSM with no way to adjust to reduced levels of resource transfers other than the more politically painful cutting of government expenditures, reducing public sector employment and wages, and increasing domestic revenues. The use of a foreign currency

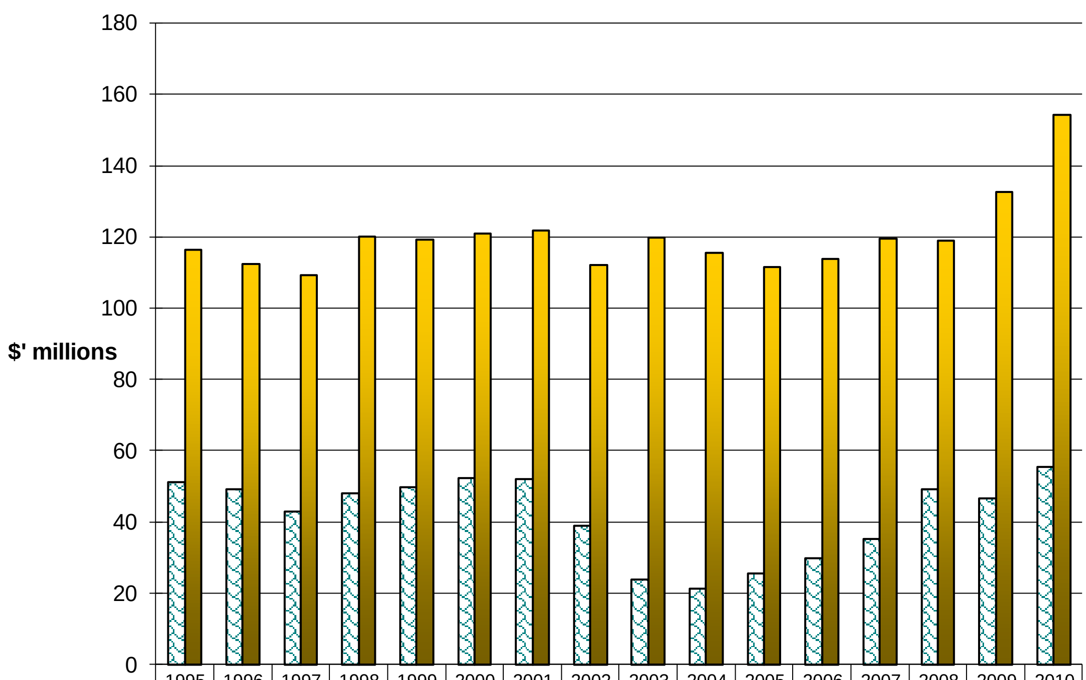
has removed exchange rate realignment and devaluation as ways to encourage the export and traded-goods sectors of the economy. At this stage of the FSM economic development, with many underlying structural impediments, exchange rate adjustment without accompanying supporting policies would be unlikely to encourage a favorable supply response in traded goods production.

60. The result of a lack of an independent monetary policy is that domestic interest rates are closely aligned with those of the U.S. Deposit interest rates observed in the market are broadly similar to those throughout the United States, while lending rates are generally higher, reflecting the additional risk and costs of doing business in the FSM. Initially, the higher rates charged on loans resulted in regulation, and limits were placed on both consumer and commercial loan interest rates. As part of the Public Sector Reform Program, removal of regulation was recommended and was a loan condition. The interest rate limits were effectively removed (leaving only a non-binding usury limit of 24%) in 1998, and there was no adverse change in the local interest rate structure as the financial system was allowed to adjust to market forces. CD rates have fallen from the end of the 1990s, when they averaged 1% ,to 4% in 2005; they now stand at 0.9%, reflecting the low level of interest rates in the U.S. Lending rates on consumer loans have always been high and have averaged 15% over the last 10 years, with only minor variation. Commercial lending rates appear more subject to market forces and currently stand at 6.6%.

61. The FSM banking system benefits from the Federal Deposit Insurance Corporation (FDIC), as provided in the Compact. The FDIC has played a critical role in supervising the banking system and ensuring a sound and stable financial system. Under the amended Compact, FDIC support remains effective and will help maintain financial stability in the economy and avoid the adverse consequences of banking system failure, which has occurred in many other Pacific Island economies. The banking system is also regulated by the FSM Banking Board, which is developing a capacity for banking supervision. The role of the Board includes licensing of domestic and foreign banks, on-site and off-site supervision of all banks, consumer protection, and consultation with the FDIC. Since December 2002, when the Bank of Hawaii withdrew from the FSM market, there has been one U.S. bank operating in the FSM. There is also one locally owned bank, Bank of the Federated States of Micronesia. The remaining U.S. bank, Bank of Guam, is a branch of its parent, and thus also comes under U.S. federal supervisory requirements. The present system is thus well supervised and provides a secure basis for financial intermediation.

62. Statistics on the FSM banking sector were first created in 1990, but analysis begins in 1995 (Fig. 14). With regard to deposits, the data indicate a lack of growth from FY(?)1995 to the start of Compact II through FY(?) 2008. There is a dip in the data in 1996 and 1997, reflecting the Chuuk financial crisis, a run-off in 2002 (coinciding with the departure of the Bank of Hawaii), and a reduction in deposits during the first two years of the amended Compact period, as economic activity faltered. Since 2008, the deposit base has grown more rapidly, by 11% and 16% in FY2009 and FY2010, respectively. The lack of financial deepening during most of the period until FY2009 is consistent with the lackluster performance of the economy.

63. Regarding lending, developments reveal a similar pattern through the end of 2001. In 2002, the Bank of Hawaii began to withdraw from the market. Outstanding bank credit fell precipitously, declining by $21 million (or 59%) by the end of 2004. While the departure of Bank of Hawaii was implemented quietly and without adverse publicity, the bank failed to sell its assets to the two remaining banks. Neither Bank of Guam nor Bank of the FSM tried to capture the available business, preferring to leave the problem to the departing bank. While the Bank of the FSM was restructuring its portfolio at the time, the bank has since taken a more proactive stance, opening operations in Saipan, and the level of outstanding credit in the system has grown by $34 million since 2004 and stood at $55.7 million at the end of 2010.

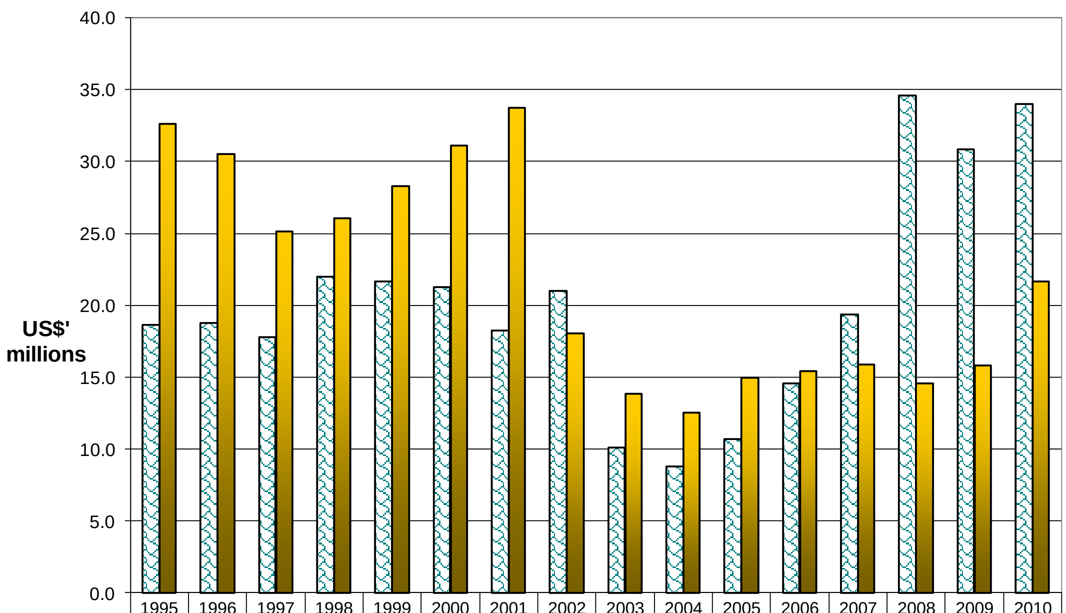


	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Total Loans	51.3	49.3	42.9	48.1	50.0	52.4	52.0	39.1	24.0	21.3	25.7	30.0	35.3	49.2	46.7	55.7
Total Deposits	116.3	112.3	109.3	120.0	119.1	120.8	121.7	112.0	119.8	115.4	111.4	113.7	119.5	118.9	132.5	154.1

Figure 14 Commercial bank loans and deposits (end of period)

64. The difference between loans and deposits indicates the large level of liquidity in the FSM banking system and reinforces a widely observed phenomenon in the Pacific Islands region: as a factor of production, capital is not in short supply. Reflecting the trends described above, the loans-to-deposit ratio remained relatively constant, hovering around 39%-44% until the departure of Bank of Hawaii. By the time of the bank's complete withdrawal from the market, at the end of September 2004, the loans-to-deposits ratio had fallen to 18%. Since that time, there has been some improvement in the situation, and the ratio had risen to 36% by the end of 2010.

65. Because of a lack of bankable projects, the commercial banks have generally preferred to extend credit to consumers with secure public sector jobs and an identified repayment stream. Consumer credit dropped off rapidly in the mid-90s, as the Chuuk crisis set in and the second step-down in funding went into effect (Fig. 15). With a return of more prudent fiscal policies in the state, consumer credit once again expanded. The impact of the departure of Bank of Hawaii was initially more severe in the consumer market than the business sector, although runoff of commercial loans followed suit shortly thereafter. The figures indicate that there has been some growth in consumer credit in recent years, especially in 2010—but that it has been very modest and has failed to return to the levels of the 1990s. On the other hand, commercial credit has grown rapidly since the departure of Bank of Hawaii, with the levels of outstanding loans surpassing those of the 1990s. This development reflects the more proactive lending of the Bank of the FSM, which began operations in Saipan, and extension of a large credit facility [line of credit?]



	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010
Commercial Loans	18.7	18.8	17.8	22.0	21.7	21.3	18.3	21.0	10.1	8.8	10.7	14.6	19.4	34.6	30.9	34.0
Consumer Loans	32.6	30.5	25.1	26.0	28.3	31.1	33.8	18.1	13.9	12.5	14.9	15.4	15.9	14.6	15.8	21.7

Figure 15 Commercial bank credit by sector

by the Bank of Guam to the newly created FSM Petroleum Corporation (FSMPC). The drop-off in loans to the private sector in 2009 reflects the early repayment of the FSMPC line of credit, although commercial credit grew by over 10% in 2010 and regained some of the lost ground.

C Balance of Payments (BoP), External Debt, GNI, GNDI and International Investment Position (IIP)

1 Balance of Payments

66. In this section the balance of payments is discussed and presented in abbreviated form in Tables 5 and 6; more detail can be found in the statistical appendix. Discussion of GNI and GNDI are reviewed at this point (rather than along with GDP earlier in the review) as they reflect changes in the primary and secondary income accounts of the BoP. The International Investment Position (IIP) is presented in the section following, and the discussion concludes with an analysis of external debt.

67. The trade account of the balance of payments is composed of imports and exports and runs a significant deficit, reflecting the excess of imports over exports. Exports currently include fish, re-exports of fuel, and a small quantity of agricultural produce. While small volumes of inshore reef fish are exported to neighboring islands, fish exports are mostly tuna caught by local purse seine and longline vessels operated by enterprises with joint private-public ownership but under private management. Most of the fish caught in FSM waters are, however, caught by foreign vessels under license, and the associated fishing access fees are treated as a primary income in the balance of payments. Imports dominate the trade account, and growth reflects the level of activity in the economy. Imports have grown by an annual average of 4.0% since FY2004, largely in line with nominal GDP growth of 3.7%, and GNI or GNDI growth of 3.9% or 3.3%, respectively.

68. The service account is dominated by two main items: tourism receipts and transport of goods and people to and from the FSM. The demand for tourism/travel was stagnant in the first part of the 2000s but has since grown steadily but slowly. Service imports are dominated by the cost of transporting goods to the FSM, but travel (including medical referrals) is significant. Construction services provided by non-resident producers are also important and have grown strongly, reflecting recent FAA grants for airport improvement. Other minor service imports are large in total but comprise a host of smaller items.

69. The primary income account comprises fishing access fees, earnings of dividends and interest on overseas investments, payments of dividends, and payment of interest on debt. Fishing fee earnings have shown a positive uptrend since FY2001 and in FY2010 reached $17.7 million, nearly achieving the record $21.5 million of 1995. The FSM governments have maintained a sizeable level of foreign investments, which have provided a significant source of interest and dividend earnings in the past. However, the level of FSM investments has fallen significantly in recent years (with the exception of Yap) and,

Table 5 Balance of payments: current account (FY2004–FY2010, US$ millions)

	FY2004	FY2005	FY2006	FY2007	FY2008	FY2009	FY2010
Current account balance	***-38.8***	***-17.0***	***-29.5***	***-18.9***	***-41.2***	***-53.0***	***-46.2***
Goods and services balance	*-146.5*	*-145.5*	*-148.0*	*-137.5*	*-159.0*	*-180.2*	*-172.2*
Goods balance	*-109.3*	*-107.0*	*-110.8*	*-104.4*	*-119.4*	*-127.7*	*-127.6*
Exports of goods	15.3	18.7	18.7	26.0	27.4	25.2	30.1
Fish	7.8	10.4	10.5	14.4	18.2	15.3	19.3
Other	7.5	8.2	8.2	11.6	9.2	9.9	10.8
Imports of goods	124.6	125.7	129.5	130.4	146.7	152.9	157.6
Services balance	*-37.2*	*-38.4*	*-37.2*	*-33.2*	*-39.6*	*-52.5*	*-44.6*
Exports of services	21.9	23.0	26.8	30.1	32.0	33.3	36.2
Travel	15.0	15.9	17.9	19.7	21.7	21.8	24.0
Other	6.9	7.1	8.9	10.4	10.3	11.5	12.2
Imports of services	59.1	61.4	64.0	63.3	71.6	85.8	80.8
Transport	35.3	36.0	36.8	36.9	38.6	41.2	41.7
of which: Passenger services	14.3	15.6	15.9	15.0	15.4	15.7	15.6
of which: Freight and postal services	20.9	20.4	20.8	21.8	23.2	25.4	26.0
Construction services	3.6	3.5	6.9	4.5	10.4	18.4	10.2
Other	20.2	21.9	20.3	22.0	22.6	26.2	28.9
Primary income balance	*7.4*	*12.2*	*15.3*	*17.5*	*12.3*	*18.8*	*14.2*
Receipts	19.5	23.7	27.2	29.8	27.7	28.9	27.0
Fishing licence fees	12.6	13.7	13.3	14.8	17.0	20.4	17.7
Other (mainly dividends and interest)	6.9	10.0	13.9	14.9	10.7	8.5	9.2
Payments	12.0	11.5	11.9	12.2	15.4	10.1	12.7
Secondary income balance	*100.3*	*116.3*	*103.1*	*101.2*	*105.5*	*108.4*	*111.8*
Receipts	110.4	126.8	113.9	111.8	116.2	122.8	127.1
Budget grants	73.9	82.5	79.6	79.2	79.0	84.4	85.6
Compact current grants	52.1	56.0	59.3	60.6	57.9	65.8	65.9
Other budget grants	21.8	26.5	20.3	18.6	21.1	18.7	19.7
Off-budget grants	13.9	19.9	10.7	6.9	8.7	6.4	5.8
College of Micronesia	10.8	11.5	9.4	10.2	10.8	13.3	16.3
Other (mainly households)	11.9	12.9	14.3	15.4	17.8	18.7	19.4
Payments (mainly households)	10.1	10.5	10.8	10.6	10.7	14.4	15.3

coupled with poor market performance, has caused yields to fall substantially. Earnings on the Compact Trust Fund are now the major component of primary income receipts, although commercial bank earnings on foreign assets and earnings on Social Security funds are also important. On the payment side, dividend payments of foreign investment are the major item, while the low-level and concessional nature of the FSM's external debt has held debt service obligations in check.

70. The most notable component of the balance of payments is the secondary income account, which includes Compact transfers and other aid flows. Compact flows comprise the sector grants while other budget grants include federal and special programs. Off-budget grants reflect other receipts from the U.S. and from other donors, while receipts by the college of Micronesia include Pell grants. In total, current grants represent about

half of current account receipts. Private remittances are relatively small in the FSM compared with other Pacific Islands, which have large migrant communities living in neighboring metropolitan nations. However, the BoP estimates have projected this item to rise strongly, especially in the amended Compact era, as a result of the large out-migration in previous years and the subsequent associated flows back home. Payments from households reflect transfers from foreign workers living in the FSM and are substantial.

71. Table 6 provides details of the capital and financial accounts of the balance of payments. The major items in the capital account include Compact capital transfers (infrastructure sector grant), other capital transfers, and contributions to the Compact Trust Fund (CTF). The failure of the FSM to meet the drawdown conditions of the infrastructure sector grant of the amended Compact resulted in the loss of this grant in FY2004 and extremely low drawdowns thereafter (compared with the available funding). The large accumulation of unspent funds (over $115 million) remains available to the FSM, once projects have met the FPA conditions. The first U.S. contribution to the Compact Trust Fund (CTF) was not made until FY2005, and the figure for that year represents the sum of the FY2004 and FY2005 amounts. Other capital transfers have grown significantly in recent years, reflecting the large FAA contributions to airport improvement, which will have had a significant impact on the economy. However, these transfers are likely to drop to lower levels once the airport improvements have been completed.

72. The main items in the financial account are direct foreign investment, portfolio investment, and other investments. While direct foreign investment has been small, reflecting low levels of FDI in the FSM, portfolio investment has been a significant com-

Table 6 Balance of payments: capital and financial account (FY2004–FY2010, US$ millions)

	FY2004	FY2005	FY2006	FY2007	FY2008	FY2009	FY2010
Capital account balance	***8.6***	***43.1***	***35.0***	***37.3***	***48.9***	***75.8***	***85.7***
US contribution to Compact Trust	~	32.2	16.4	17.7	19.0	20.9	21.5
Compact capital grants	~	0.0	3.0	7.0	4.9	7.5	16.3
Other	8.6	10.9	15.5	12.6	25.1	47.4	47.9
Net lending/Borrowing (Curr + Cap)	***-30.2***	***26.1***	***5.4***	***18.5***	***7.8***	***22.9***	***39.5***
Financial account balance	***-16.6***	***16.2***	***-4.8***	***-16.1***	***-9.3***	***-21.6***	***-29.4***
Direct investment	*0.2*	*0.2*	*0.1*	*0.1*	*-5.3*	*0.6*	*0.8*
Portfolio investment (increase in assets: -	39.4	-52.3	-8.2	-17.3	-20.0	-17.9	-17.9
Assets	40.9	-53.2	-8.7	-17.2	-22.2	-17.3	-16.3
Compact Trust Fund Contributions	~	-62.4	-16.4	-17.7	-19.0	-20.9	-21.5
Other public sector investments	40.9	9.2	7.7	0.4	-3.2	3.6	5.2
Liabilities	-1.5	1.0	0.6	-0.0	2.1	-0.6	-1.6
Other investment (increase in assets: -)	-56.1	68.4	3.2	1.0	16.0	-4.2	-12.3
Assets (mainly bank deposits)	-56.4	67.4	1.6	-1.5	11.9	-17.7	-12.5
Liabilities (public sector loans)	0.3	0.9	1.6	2.5	4.1	13.5	0.1
Reserve assets	~	~	~	~	~	~	~
Errors and omissions	-46.7	42.3	0.6	2.4	-1.6	1.3	10.1

ponent of the BoP. Portfolio investment comprises two major items: investments in the CTF and public sector investments. The large transaction in FY2005 to the CTF reflects the FSM contribution of $30 million plus the two years' worth of U.S. contributions. Other public sector movements represent contributions and withdrawals to the FSM investments, including the original savings from the bump-up funds to meet the FSM contribution to the CTF. Other investments include changes in the levels of foreign assets of the commercial banks and external debt drawdowns and repayments. External debt drawdowns and repayments have generally been small, but were large in FY2009 reflecting the drawdown of the fiber optic loan by FSM Telecom.

73. The balance of payments account has undergone a significant overhaul, and the errors and omissions in the account have been within respectable limits during the period presented in Table 6. In FY2004 and 2005, the errors were large but of different offsetting signs reflecting the switch in treatment of the FSM contribution to the Compact Trust Fund from other investments to CTF contributions. The analysis and structure of the BoP clearly indicates the dependent nature of the FSM economy. Attainment of the Compact goal of economic self-sufficiency and replacement of official transfers with other foreign-exchange earning sources will be a long-term process and presents perhaps the major and most difficult challenge facing the FSM economy.

2 GNI and GNDI

74. In most economies, analysis focuses on GDP, since this indicator most accurately reflects the economic circumstances of the country under investigation. However, in the FSM the large inflows of primary and secondary incomes from the rest of the world have a significant impact on aggregate demand and indicate that analysis should also feature changes in GNI and GNDI. In the FSM, GNI and GNDI were 5% and 44% higher than GDP (nominal values) in FY2010, respectively. Fig. 16 shows the trends in GDP and primary and secondary incomes from FY1995-2009. Since GDP plus primary incomes equates to GNI, and GNI plus secondary incomes is equal to GNDI, Fig. 16 provides the information necessary to analyze recent trends in the series. Both the primary and secondary incomes of the BoP have been deflated by a composite index of the CPI and GDP deflator.

75. The primary income series (and hence GNI) is relatively unimportant compared with secondary incomes. While several factors influence primary income, the most dominant has been changes in fishing fee royalties. In the mid 1990s, fishing fees receipts averaged about $20 million per annum, but subsequently dropped to a lower level in the early 2000s and then rose again through FY2010. The dip in FY2008 reflects the impact of the world recession on interest and dividend incomes, as s and erosion in real values due to high inflation. In FY2009 the same forces exerted themselves, although a reduction in dividend outflows improved the net position. In FY2010, fishing fees were lower, and dividend payments rose due to the growth in GDP; overall net primary incomes fell during the year.

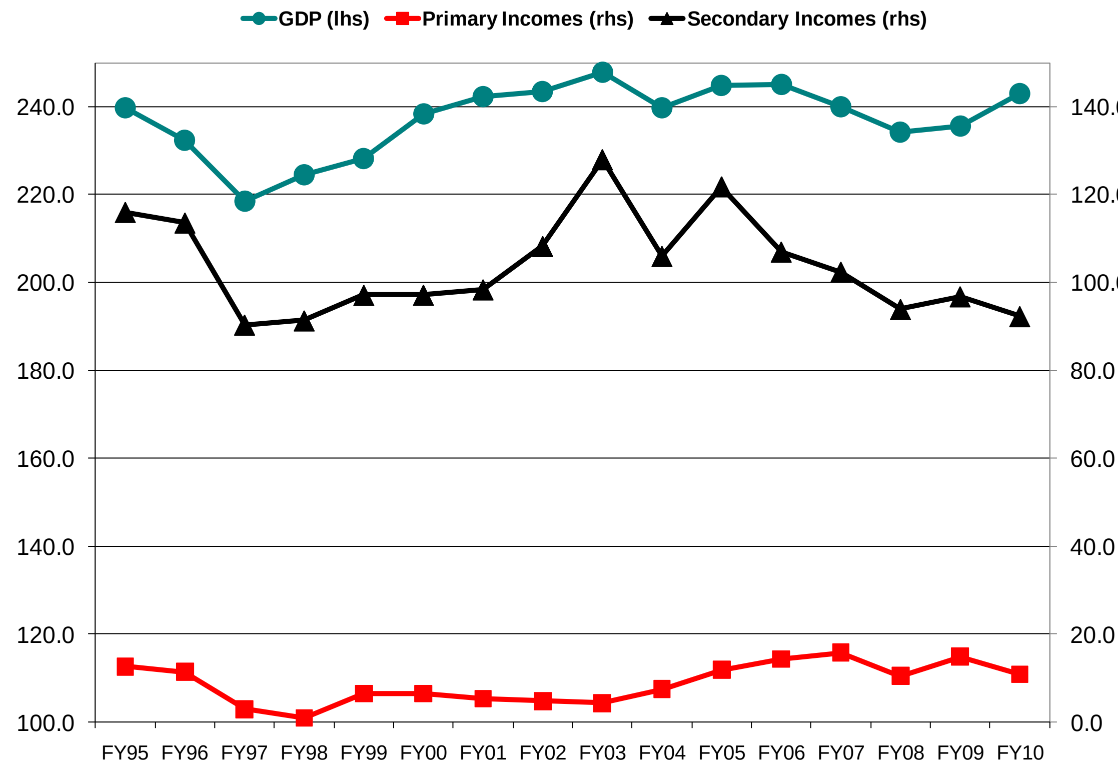


Figure 16 GDP, primary and secondary incomes, $'s million, constant prices 2004

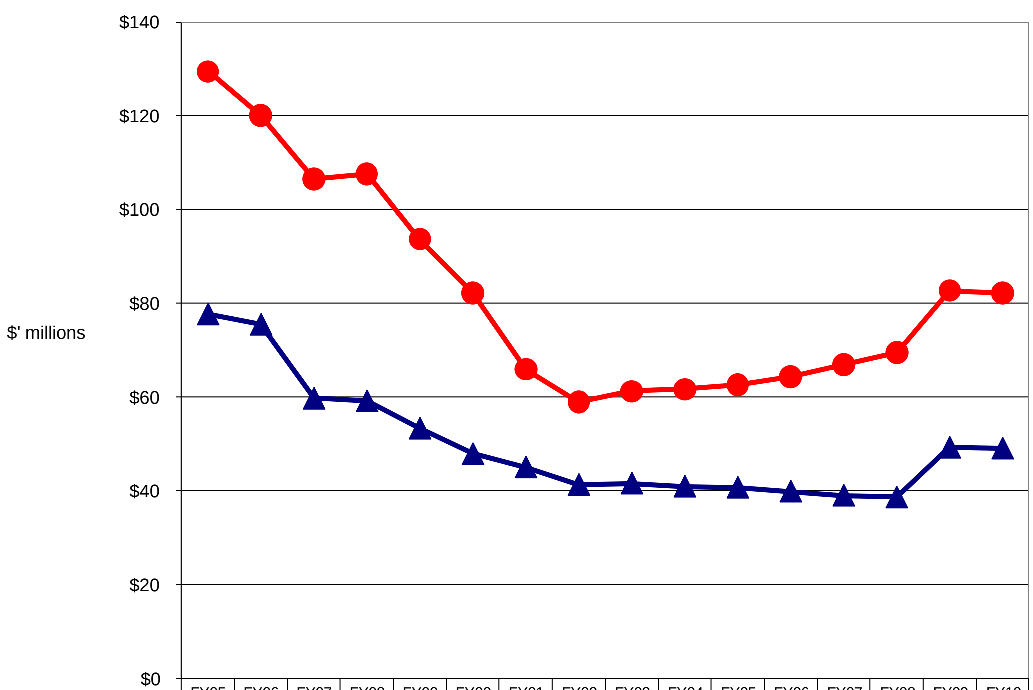
76. In the case of secondary incomes, Compact and other US grant receipts have exerted a large impact on the series. The dip in FY1997 reflects the reduction in Compact grants due to the second step-down. The increase in real secondary incomes in FY2002 represents the increase in funding from the bump-up grants. In FY2003 the receipt of FEMA funds for cyclone rehabilitation, together with the bump-up funds produced the spike in the series. However, in FY2004, without the receipt of FEMA funds and with the lower level of grants at the start of the amended Compact, secondary incomes drop back. In FY2005 cyclone rehabilitation and receipt of FEMA funds again exert a large upward movement. In the remainder of the data series, there is a gradual decline in the real level of secondary incomes, reflecting the impact of higher rates of inflation and a variety of forces.

77. The strong association between secondary incomes and GDP can be easily identified from Fig 16. While Compact flows have dominated and set the trend, the influence of federal and other U.S. grants has been an important determination in yearly developments. The influence of primary incomes on GDP is less visible. In the early period the reduction in fishing fees coincided with decreases in secondary incomes and GDP. During the amended Compact period, the increase in fishing fees has helped offset the decline in secondary incomes and maintain the level of real GDP.

3 External Debt

78. Prior to FY1990, the FSM had no official public sector debts to offshore lenders. During FY1990-93, the nation rapidly increased its external public borrowing, including (i) MTN bonds issued for $71 million to finance portfolio investments by Yap State and (ii) $42.9 million for fisheries-related investments in Pohnpei, Chuuk, Kosrae and the National Fisheries Corporation. Public guaranteed borrowing also included $41 million from the U.S. Rural Electrification Administration to the FSM Telecommunications Corporation and $9 million to the Yap Fishing Corporation. Fig. 17 shows that the heavy borrowing by FSM governments brought the nation's total official external debt to a level of $120 million at the end of FY1995, representing 55% of GDP in that year.

79. Since the issue of the MTNs in the early 90s, the FSM has adopted a prudent external debt management strategy, and external borrowing has been modest. In FY1997 and FY1998, drawdown of the ADB Public Sector Reform Program (PSRP) loan provided a major source of funds to finance the Early Retirement Program (ERP). The FSM continued to draw on ADB loans in FY1999 and FY2000, but the withdrawals were small. There were no further commitments until loan effectivity of the Private Sector Development Program (PSDP) in FY2003 and the Basic Social Services Program in FY2004. Drawdowns under both programs were not extensive, as several of the FSM

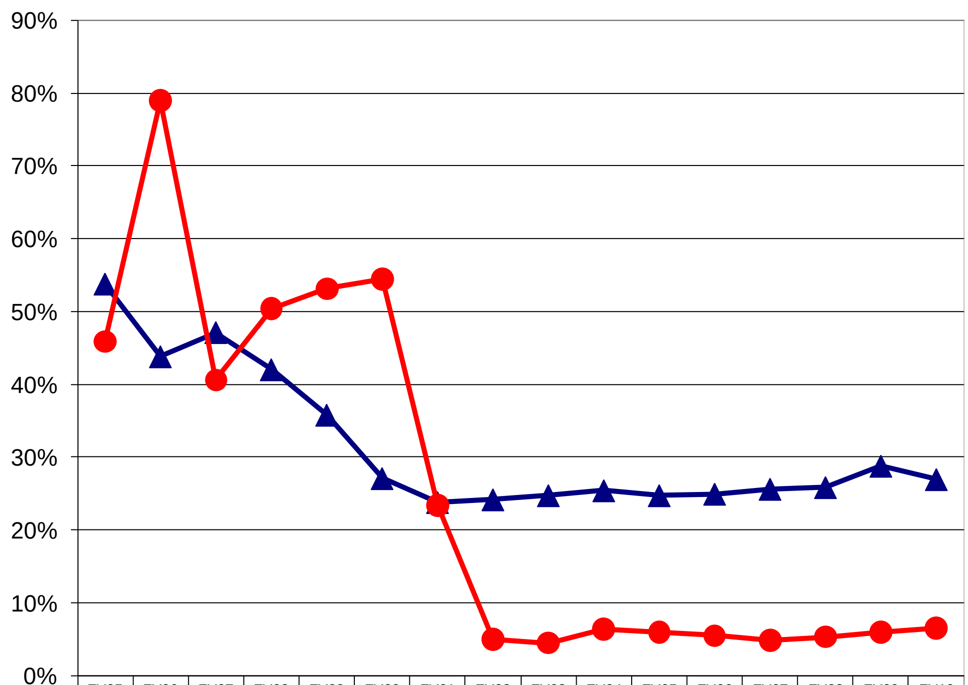


	FY95	FY96	FY97	FY98	FY99	FY00	FY01	FY02	FY03	FY04	FY05	FY06	FY07	FY08	FY09	FY10
External Debt	129.5	120.1	106.5	107.6	93.7	82.3	65.9	59.0	61.2	61.7	62.6	64.3	67.0	69.5	82.7	82.2
Net of offsetting Assets	77.8	75.6	59.7	59.2	53.3	47.9	45.0	41.3	41.6	40.9	40.7	39.9	39.0	38.6	49.3	49.1

Figure 17 FSM External Debt (US$ millions)

states did not qualify for the loans or meet the conditions for second tranche drawdown. In FY2008, the FSM made the first drawdown under the Omnibus Infrastructure loan to finance specific infrastructure projects in the FSM states. In FY2009, external debt rose significantly with the drawdown of $11.2 million (by the FSM Telecom) of a loan from the U.S. Rural Electrification Administration to finance the installation of a fiber optic connection to the U.S. backbone.

80. The FSM external debt level has shifted from a position that was, in the early 1990s, quite adverse to one that is now favorable. This favorable outcome is the result of the completion of the Medium-Term Note program, with final repayments taken from Compact revenues in FY2001. With a debt-to-GDP ratio of just 27% in FY2010, the FSM's debt level is low by Pacific Island standards (Fig. 18). Furthermore, with the remaining debt on concessional terms, the debt service ratio in FY2010 is projected at the low level of 6% of exports of goods and services. Each of these ratios is somewhat overstated, in light of the fact that the FSM holds a sinking fund equal in value to the amount outstanding for the PSRP, PSD and BSS loans. Adjusting for this asset held against external debt, the debt-to-GDP ratio in FY2010 would be 16%, and the corresponding debt service ratio would be 5% of exports of goods and services.



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

Figure 18 FSM external debt ratios

4 INTERNATIONAL INVESTMENT POSITION

81. The FSM international investment position is presented in Table 7. The data provide stock positions at the end of each year corresponding to the financial account of the balance of payments. While there is no available record of foreign direct investment, the table provides an important indication of the FSM's portfolio investments. At the end of FY2010,the value of the Compact Trust Fund stood at $177 million, which is analyzed in further detail in the policy section of this report. While the volumes are large, they stand below the levels projected at the start of Compact II, because of late investment of the annual contributions and low market returns. The state governments of the FSM pool their investments, which are maintained by the national government. In FY2010 Yap state decided to withdraw $30 million of its resources from the FSM investments and set aside the funds in a separate Trust for future generations of Yapese. The remaining FSM investments stood at $71 million at the end of FY2010, reflecting a further $21 million of Yap's investments, resources for ADB loan repayment (the PSRP, PSD, and BSS loans), and the small FSM national government trust fund, which stood at $8.3 million at the end of FY2010. The Social Security Administration, Development Bank, and FSM Telecom all also hold significant levels of foreign assets. The major other foreign asset is the commercial bank holdings, which are included in "other investment" and represent that portion of bank deposits that are not loaned out in the FSM. These stood at $112 million at the end of FY2010. Lastly, the external debt of the governments of the FSM and public corporations represent the major external liabilities of the nation.

Table 7 FSM International Investment Position, (FY2004–FY2010, US$ millions)

	FY2004	FY2005	FY2006	FY2007	FY2008	FY2009	FY2010
TOTAL STOCKS, NET	***230.3***	***256.1***	***277.6***	***317.9***	***269.3***	***302.2***	***363.6***
Direct investment, net	***n.a.***	***n.a.***	***n.a.***	***n.a.***	***n.a.***	***n.a.***	***n.a.***
Portfolio investment, net	***158.6***	***222.4***	***247.1***	***288.2***	***255.6***	***282.8***	***331.0***
Assets	162.1	227.0	252.1	293.3	262.8	289.4	336.0
Compact Trust Fund, Government	~	64.2	86.5	122.6	117.5	138.1	177.2
Investment portfolio, Government	97.0	97.0	95.9	105.8	91.7	94.4	70.6
Yap investment trust fund	~	~	~	~	~	~	31.7
Social Security	35.9	37.8	41.8	39.6	31.6	36.4	36.9
Development Bank	15.8	11.2	10.5	11.2	10.6	9.3	9.5
Telecommunications Corporation	9.7	12.9	13.8	10.2	7.6	7.3	5.5
Other	3.8	4.0	3.7	3.9	3.7	3.9	4.6
Liabilities	3.6	4.5	5.1	5.1	7.2	6.6	5.0
Equity: Capital and retained earnings of	3.6	4.5	5.1	5.1	7.2	6.6	5.0
Debt: Medium-term notes	~	~	~	~	~	~	~
Other investment, net	***69.9***	***31.8***	***28.6***	***27.6***	***11.6***	***17.3***	***30.4***
Assets	130.7	93.6	92.0	93.5	81.6	99.4	111.8
Deposits	100.5	93.6	92.0	93.5	81.6	99.4	111.8
Other assets, accounts receivable	30.3	~	~	~	~	~	~
Liabilities: Loans	60.8	61.8	63.4	65.9	70.0	82.1	81.4
Government	34.9	36.0	38.3	41.6	44.6	46.9	46.4
Public corporations	26.0	25.8	25.0	24.2	25.4	35.2	35.0
Reserve assets	**1.8**	**1.9**	**2.0**	**2.1**	**2.1**	**2.1**	**2.1**
SDR	1.8	1.9	2.0	2.1	2.1	2.1	2.1

D Fiscal Developments

1 Fiscal Policy Framework

82. The agreement and adoption of the amended Compact by the FSM and U.S. governments became effective in FY2004 and initiated a wholly new fiscal framework for the FSM. The structure entailed a series of sector grants earmarked for education, health, environment, private sector development, capacity building, and infrastructure. The innovation in the amended Compact was a trust fund designed to provide a yield sufficient to replace the annual grants after 20 years. Table 8 indicates the aggregate structure of the annual Compact grants and the contribution to the Compact Trust Fund. Each year, over a 20-year period, the United States will contribute to the FSM $92 million, partially adjusted for inflation. The inflation adjustment factor remains as in the original Compact. The annual sector grants start at a level of $76 million in FY2004 but are to be annually reduced by $0.8 million from FY2007 onward. The difference between the total contribution and the annual sector grant levels will be deposited in a trust fund to accumulate over the 20-year Compact period.

83. In comparison with the original Compact, the new regime avoids the need for large fiscal adjustments every five years. However, in order to establish the viability of the trust fund, the United States instigated the annual decrement. While avoiding large shocks to the system, the decrement requires an annual compression of expenditures from FY2007 onward. This compression, coupled with the lack of full inflation adjustment,

Table 8 U.S. annual Compact grants and contributions to the Trust Fund

	Annual Grants	Trust Fund Contribution	Total Contribution
FY04	76.0	16.0	92.0
FY05	76.0	16.0	92.0
FY06	76.0	16.0	92.0
FY07	75.2	16.8	92.0
FY08	74.4	17.6	92.0
FY09	73.6	18.4	92.0
FY10	72.8	19.2	92.0
FY11	72.0	20.0	92.0
FY12	71.2	20.8	92.0
FY13	70.4	21.6	92.0
FY14	69.6	22.4	92.0
FY15	68.8	23.2	92.0
FY16	68.0	24.0	92.0
FY17	67.2	24.8	92.0
FY18	66.4	25.6	92.0
FY19	65.6	26.4	92.0
FY20	64.8	27.2	92.0
FY21	64.0	28.0	92.0
FY22	63.2	28.8	92.0
FY23	62.4	29.6	92.0

means an annual reduction in real resources of about 2%; thus, the FSM will need to make significant fiscal policy adjustments unless it can develop a policy regime sufficiently attractive to encourage private sector investment and to generate enough economic growth to offset the decline.

84. The sectoral structure of the amended Compact presented a special problem. In the FY2004 budgets, the altered fiscal framework resulted in funding shortages for the operations of government not covered under the sector grants. In order to address the shortfall, the United States permitted the FSM to utilize the capacity-building sector grant for this purpose—provided that the FSM agreed that it would,, over a five-year period, phase out the use of the grant for "non-conforming" purposes. Under duress, the FSM had no alternative but to concede. While the operation of the FY2004 budgets was not affected, the transition requirements became binding in FY2007 and required a painful adjustment of expenditure cuts as well as increased revenue effort.

85. At the FY2005 Joint Economic Management Committee (JEMCO) meeting in August 2004, it was resolved that the FSM must allocate at least 30% of Compact sector grants to the infrastructure grant, effective from FY2006. The FY2005 infrastructure requests were considered substantially below desired levels, and JEMCO felt that a floor should be established to ensure that public investment was maintained at levels sufficient to support the development of the economy as aggregate Compact resources declined. Access to federal programs is to continue during the amended Compact, with the exception of certain education programs, which were "cashed out" and have been replaced through the Supplemental Education Grant (SEG). Finally, implementation of the amended Compact entails a whole new accountability regime that is specified in the Fiscal Procedures Agreement (FPA). Taken as a whole, the new fiscal arrangements of the amended Compact have had a wide-ranging impact on the conduct of fiscal policy and management in the FSM.

86. Fiscal policy has been formulated for the national and state governments, with separate expenditure and revenue policies, in the absence of significant coordination. With respect to revenue policy, the national government has the power under the constitution to collect import and income taxes, and all remaining taxes are reserved for the states. Through its taxing powers, the national government collects about three-fourths of all domestic taxes. In FY2010, national taxes amounted to $26.5 million, while the four states collected an additional $8.0 million. The states, with widely varying levels of tax effort, collect the remaining one-fourth of domestic taxes, primarily through general sales taxes and excise taxes on alcohol, tobacco, and other goods. In 2006, the FSM Congress enacted legislation (modified in 2009) to attract captive insurance businesses to the FSM. In essence, the law provides preferential tax treatment to Japanese firms registering under the program. In FY2009, the FSM collected its first receipts under the system; receipts rose to $0.8 million in FY2010.

87. By constitutional mandate, at least 50% of the nationally imposed taxes (and 80% of the fuel import tax) must be shared with the state in which the taxes were collected. Since the revenues collected under the captive insurance legislation are not collected in the FSM, the tax revenue is not subject to revenue share. While overall tax effort remains low relative to other Pacific Islands, there has been some gradual increase over time. In FY2010, tax revenues equated to 11.9% of GDP. The small increase is primarily the result of a policy change to the import tax that shifted the base from f.o.b. to c.i.f. and of tax increases on beer and tobacco (effective FY2005) but was offset in FY2007 by deductions allowable against the Gross Receipts Tax for payroll costs. It is likely that collection performance has improved modestly; however, tax administration and, in particular, compliance and audit functions remain in need of reform.

88. Non-tax revenues continue to be dominated by fishing access fees, which represent nearly one-third of all domestic revenues. The national government manages the tuna resources and keeps all revenues from the licensing fees. Revenue from penalties and fines is shared with specific states and, in some cases, local governments. The fishing access fee as a source of revenue grew rapidly, from less than $4 million in FY1987 to a peak of over $21 million in FY1995. After an extended period of decline, fishing access fees have returned to their former levels, and $18 million was collected in FY2010. The declining trend in this revenue source in the late 1990s and early 2000s was the leading cause of the deterioration in the national government's fiscal position, but the recent strengthening in fishing fees has been matched by a gradual increase in recurrent operational expenses.

89. The national government has acted as an agent in distributing to each government, according to mutually agreed-upon formulas, the grant funding received from the United States under the Compact. The FSM government receives 10% of grants, and the remainder is distributed to the states, based on a formula that splits roughly 30% of funding evenly among the four states and the remaining 70% according to population.

90. On the expenditure side of fiscal policy, the five governments all operate within balanced budget requirements based on either constitutional or statutory provisions. However, the definition of a "balanced budget" is not restricted to the operations of a single budget year. Funds unexpended in one year are reported as revenues in the following year. The use of this so-called "carry-over" component in revenue projections tends to cloud fiscal management and can mask the onset of significant structural imbalances. The vulnerability to fiscal imbalance is compounded by delays in financial reporting and expenditure controls; consequently, legislative bodies must take appropriation actions without an accurate appraisal of each government's true fiscal position.

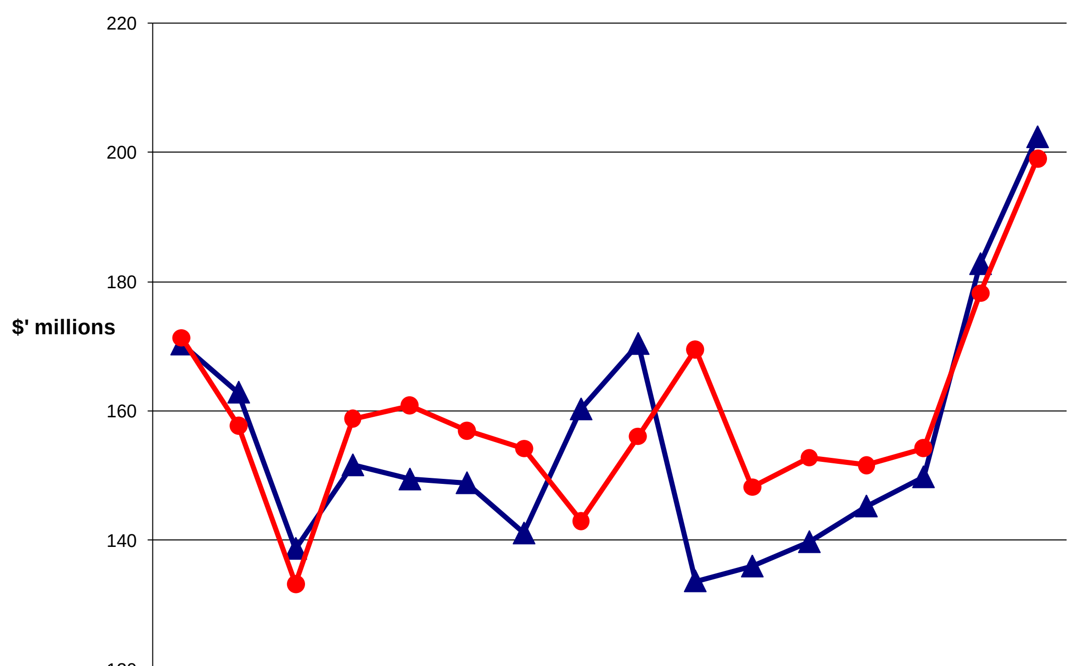
91. The national and state governments conduct budgetary operations through a series of separate funds, the most important being the general fund. Expenditures from the general fund are largely unrestricted in nature, but there is limited flexibility or authority to use resources from the other funds. Under Compact I, a major part of the external assis-

tance provided revenue to the general fund. Under the amended Compact, all such receipts are recorded as special funds and are restricted in nature.

92. Tables 11a-f in the Statistical Appendix show the fiscal performance on a consolidated basis for each of the five governments. The presentation follows a standard format based on IMF Government Financial Statistics (GFS) classifications. Tables 11g-k show the fiscal performance of each of the five governments in the audit format. This latter format groups the different funds into three broad categories—general, special, and capital—and does not report financing items below the line.

2 Recent Fiscal Performance

93. Fig. 19 indicates the major trends in fiscal performance for the FSM (consolidating the five government accounts) since FY1995. At the start of the period, revenues and expenditures were largely in balance, and the economy achieved fiscal balance. However, from FY1998-FY2001, after the second step-down in Compact I funding, the fiscal account came under severe pressure, as the nation was forced to adjust to a significant loss in revenues; the overall fiscal balance recorded an average deficit of 5% of GDP. The fiscal deterioration was compounded by a loss in fishing fee revenues, which fell from an average of $21 million per annum in FY1995–96 to $14 million from FY1997–2001. The



	FY95	FY96	FY97	FY98	FY99	FY00	FY01	FY02	FY03	FY04	FY05	FY06	FY07	FY08	FY09	FY10
Revenues	170.3	162.9	138.7	151.6	149.4	148.8	141.1	160.3	170.4	133.6	135.9	139.7	145.2	149.8	182.8	202.5
Expenditures	171.3	157.7	133.2	158.8	160.8	156.9	154.2	143.0	156.1	169.5	148.2	152.8	151.6	154.2	178.2	199.1

Figure 19 FSM consolidated revenues and expenditures

large recorded deficits were financed through drawdown of savings accumulated during the early phase of the Compact.

94. The FSM fiscal accounts recorded overall surpluses during the two bump-up years, FY2002 and FY2003, as the nation was required to save the excess funds to contribute to the amended Compact Trust Fund. However, in FY2004, at the start of the amended Compact period, the nation once again shifted back into deficit, as funding returned to levels below those prevailing before the pre-bump-up period. The large reduction in funding from FY2004 onwards represents not only the lower aggregate level of Compact funds, but also capacity constraints that hindered implementation; these constraints were related to both the recurrent sector grants and to the failure to establish compliance procedures for the drawdown of the infrastructure grant.

95. Absorptive capacity constraints have been a major problem in the amended Compact and have prevented the FSM from making full use of available funding. For the five operational grants, the FSM was unable to spend $6.2 million of a total budget of $58.9 million in FY2004. The same problem has continued in subsequent years with an average of 10% under-utilization of the grants awarded in the first five years of the amended Compact. In the case of the infrastructure grant, implementation problems and inability to fulfill the requirements of the awards have been extreme. Of the $155.1 million awarded during FY2004-10, the FSM has been able to utilize only $36.7 million, or 24% of available funding. Implementation issues are being slowly resolved and in FY2010 capacity utilization improved with 64% of available resources drawn down. The economic impact of the failure to fully utilize the amended Compact resources has not been as pronounced as the figures would suggest and reflects the historically low level of absorptive capacity, even before the amended Compact. On the positive side, the inability of the FSM to fully use the infrastructure grant, amounting to $118 million through the FY2004-FY2010 period, represents the potential for economic expansion in the future, once implementation issues have been resolved.

96. In FY2004, all governments were required to make payments (equivalent to $28.3 million) to the amended Compact Trust Fund. After deduction of the Trust Fund contributions from the overall deficit of $36 million, an underlying deficit of $7 million reflects more accurately the fiscal position in that year. In FY2005 and FY2006, the FSM recorded deficits of $12 and $13 million, representing 5% of GDP in each of the two years; these deficits indicate the difficulties in adjustment. By FY2007 and FY2008, efforts to adjust to the amended Compact regime started to take effect, the fiscal position improved, and the deficit fell to $6 and $5 million in the two years—or 3% and 2% of GDP, respectively. In FY2009 and FY2010, the nation benefited from large grants from the FAA for airport renovation, amounting to $32 million and $34 million, respectively, and both revenues and expenditures jump dramatically in the two periods. However, the restoration of fiscal balance was finally attained, and the nation recorded an overall surplus of $5 and $3 million, representing 2% and 1% of GDP in FY2009 and FY2010, respectively.

97. If we take a broad overview of the structure of the fiscal accounts at the FSM level, we note that the government sector has played a dominant role in the economy, but its significance has fallen significantly (Table 9). Government expenditures have declined as a share of GDP, from 77% in FY1995 to an estimated 64% in FY2001, and a projected 67% in FY2010 (or 55% ignoring the impact of the FAA grants for airport renewal). Although in future years the figures will revert to higher levels as the nation overcomes capacity bottlenecks and utilizes a greater proportion of the infrastructure grant, the dominance of government in the economy will be reduced. On the revenue side, the dependence on external grants as a percentage of GDP has fallen significantly. Grants represented 50% of GDP in FY1995 and 40% in FY2001 (near the end of Compact I); they are estimated at 46% in FY2010 (but 34% if we ignore the impact of the FAA grants). Grants as a percentage of total revenues, on the other hand, have remained little changed over the period. In FY2010, grants as a percentage of total revenues stood at 67% (or 61%, ignoring the FAA projects), which change little in either FY2001 or FY1995. Tax effort as a share of GDP is low in the FSM but has grown from 9% in FY1995 to 12% in FY2010.

i National Government

98. In the closing years of Compact I, FY1997-2001, the national government was running large deficits in the range of 4-5% of GDP, or an average annual $10 million. These deficits were incurred largely to fund discretionary public projects which averaged $14 million during the period and were funded from surplus balances accumulated in pri-

Table 9 Comparative analysis of fiscal structure FY1995, FY2001, and FY2010

FY95	Chuuk	Kosrae	Pohnpei	Yap	National	FSM
Grants as % of GDP	45%	82%	30%	48%	9%	50%
Grants as % of Total Revenue	84%	84%	79%	68%	38%	66%
Tax Revenue as % of GDP	7%	11%	11%	10%	8%	9%
Total Expenditure as % of GDP	53%	87%	43%	71%	23%	77%
Overall Balance as % of GDP	1%	10%	-6%	0%	1%	0%
FY01						
Grants as % of GDP	37%	71%	24%	40%	8%	40%
Grants as % of Total Revenue	79%	90%	70%	74%	48%	68%
Tax Revenue as % of GDP	10%	15%	12%	12%	8%	11%
Total Expenditure as % of GDP	55%	84%	31%	46%	21%	64%
Overall Balance as % of GDP	-8%	-5%	3%	9%	-5%	-5%
FY10						
Grants as % of GDP	30%	41%	14%	10%	23%	46%
Grants as % of Total Revenue	77%	75%	64%	43%	65%	67%
Tax Revenue as % of GDP	9%	12%	9%	38%	14%	12%
Total Expenditure as % of GDP	40%	54%	23%	5%	34%	67%
Overall Balance as % of GDP	-2%	1%	0%	3%	1%	1%

Notes
1 State GDP is used as the divisor for each of the four states, and FSM GDP is used as the divisor for the national government and consolidated account
2 Taxes include all taxes collected in each state irrespective of the revenue sharing arrangements.
3 In FY2009 and FY2010 unusually high FAA grants for airport renewal distort the trend figures.

or years—in effect, by drawing down portfolio assets from abroad. During FY2002 and FY2003, it became increasingly apparent that such deficits were no longer sustainable, and expenditures on public projects had to be severely curtailed. Although these expenditures were cut to an annual average of $4 million, the adjustment was insufficient, and the national government continued to run deficits averaging 1% of GDP. As a result of the reduced revenues negotiated for Compact II, the states pressed for a greater share of Compact revenues, and at a leadership meeting in FY2003, the share of the national government was reduced from 13.3% to 8.65%, effective FY2004. To maintain fiscal balance, the Congress of the FSM legislated the restoration of the lost 20% revenue share given to the states in FY1999, and the national government recorded an underlying surplus of 0.6% of GDP in FY2004, the first year of the amended Compact (adjusting for the $8 million contribution to the Compact Trust Fund).

99. At the beginning of FY2005, the national government further legislated to set the minimum share of Compact resources at 10%, effective FY2007. In early 2005, legislation was passed to implement additional tax measures to increase revenues on beer and tobacco. However, despite these measures, the fiscal position remained in deficit, and the national government recorded deficits of $1.6 and $6.1 million in FY2005 and FY2006, respectively. In FY2007, the government implemented tax measures to provide relief to the private sector by allowing firms to offset payroll costs in the calculation of the Gross Revenue Tax. While the loss of revenues turned out to be small, fishing fee revenues improved, but the potential impact on the fiscal balance was offset by growth in public servant wage costs. With the increase in tax revenue share, the overall fiscal position improved, and the national government recorded a smaller deficit of $1.6 million (1% of GDP).

100. In FY2008, fishing fee revenue continued its upward trend and grew by $2 million, but this improvement was offset by a $1.5 million increase in wage costs. Overall, the national government recorded its first surplus ($1.5 million) in 12 years. In FY2009, revenues were buoyant, with growth in taxes and strong performance in fishing fees. Expenditures also expanded, and while the number of public servants remained largely static, wage rates increased by 5%, and the public sector wage bill grew by $0.6 million. FY2009 again produced a favorable result, with a surplus of $5 million, representing 1.9% of GDP. Finally, in FY2010, tax revenues were buoyant, reflecting the first significant receipts from the captive insurance market as well as improvement in regular tax collections. Most categories of expenditures also rose, and the year saw a reduction of the surplus to $3 million.

101. During Compact II, certain trends in the national government budget have emerged. Fishing fee royalties have grown strongly, expanding by $5.7 million, but these have been offset by growth in public servant wages of $4.5 million. At the same time, the FSM Congress has restrained public project expenditures, which have averaged an annual $3.2 million over the same period. While wage costs have grown by a total of 27% during

Compact II and raise concerns about sustainability, the overall fiscal outturn has been positive, and the national government has returned to fiscal surplus.

ii Chuuk State

102. Chuuk has been the least well-managed of the five FSM governments, and fiscal performance has oscillated from one extreme to the other. While the state has the capacity for significant periods of fiscal mismanagement, it has also displayed the ability to rein in expenditures when needed to restore fiscal balance. The impact of the reduction in Compact grants in FY1997 required a particularly difficult adjustment, and expenditures were cut from $42.4 million to just $25.8 million. The return to fiscal discipline in Chuuk from FY1997–99 was a significant achievement and was sufficient to repay arrears and to support a substantial economic recovery. However, immediately upon achieving recovery, the state returned to many of the same poor fiscal practices that led to the original financial crisis.

103. In the run-up period to the amended Compact during FY2002-03, the state recorded two years of fiscal surplus, resulting from the receipt of bump-up funds and the need to set aside the increase for the amended Compact Trust Fund. In FY2004-06, because of difficulties adjusting to the new regime of the amended Compact, along with lack of financial discipline, the state once again moved back into the red and registered overall deficits of $12.8, $5.8 and $5.5 million, respectively or 16%, 7%, and 7% of state GDP in each period.

104. In FY2007, Chuuk was required to make the first of three annual reductions in non-conforming uses of the Compact capacity-building sector grant; each reduction amounted to $0.9 million. After a slow start, the leadership confronted the pending financial crisis and implemented a reduction-in-force of 300 state employees, funded through a U.S. grant and implemented over a two-year period. In response to the fiscal crisis and implementation of the RIF, state expenditures were cut from $37.7 to $29.4 million and further reduced to $26.5 million in FY2008. The state went from a deficit of 7% of GDP in FY2005 to a surplus of 1% in FY2008. In FY2009, the overall balance improved further, and the state recorded a surplus of $2.5 million (3% of GDP). However, despite holding the line with the number of state employees since the RIF, payroll costs grew by $1.5 million through a return to an 80-hour bi-weekly pay period. In FY2010 payroll costs continued to climb, expanding by $1.4 million the result of a 15% increase in average wages, "Other" costs also grew rapidly, by $3.5 million. These adverse movements were offset by improved state tax collections of $1.4 million but were insufficient to keep the overall fiscal position from returning to a deficit of $1.3 million (1.5% of GDP).

105. While Chuuk had by the end of fiscal FY2008 effectively restored fiscal balance, the state had accumulated appropriated debts of $21.6 million and unappropriated liabilities of $7.3 million. In prior financial crises, Compact funds could be set aside to repay creditors. But the current structure prohibits the use of the new sector grants for purposes other than those specified. The state can restore solvency only through savings of local

revenues, which are under considerable stress already, to fund activities that are no longer eligible for Compact sector grants. The capacity to pay down the debt out of local revenues—now $7 million in FY2010—is thus extremely limited. With total liabilities of $28.9 million, the state is in effect insolvent.

iii Kosrae State

106. In the final years of Compact I, FY2002 and FY2003, Kosrae had benefited from the large increase in revenues from the bump-up funds, which enabled a substantial increase in payroll expenditures. These developments left the state in an unenviable position at the start of the amended Compact. In effect, the modest current surplus achieved in FY2002–03 was less than the bump-up and provided a clear signal that the state had a structural deficit and would have to undergo a period of painful adjustment. The structure of Kosrae's fiscal accounts had been transformed the least of all five FSM governments, tax effort was weak, and the local economy was the most dependent on Compact revenues. These conditions indicated a lack of flexibility in adjusting to the provisions of the amended Compact. In FY2004, the state experienced cash flow management problems, revealing an underlying stressed fiscal position, and after adjusting for the contribution to the Compact Trust Fund, a structural deficit of $3.8 million (23% of state GDP) was recorded. Matters failed to improve in FY2005 and FY2006, and the state continued to experience overall deficits of $1.2 and $1.5 million, or 7% and 9% of GDP, respectively.

107. In FY2007, the state began to put its house in order. In mid-2007, the state convened a leadership conference and adopted a program of reform to increase state revenues and phase out, in an orderly manner, non-conforming uses of the Compact capacity-building sector grant. The main instrument of adjustment was a RIF, which had a small initial impact on payroll (reducing costs from $6.0 million in FY2007 to $5.7 million in FY2008). Tax effort was also increased, and local revenues rose from $0.1 million in FY2006 to $0.6 and $1.1 million in FY2007 and FY2008, respectively. By FY2009, the full impact of the RIF was felt, and payroll costs fell by a further $0.8 million, to $4.9 million. The small (3% of GDP) surplus in FY2007 had turned negative in FY2008, indicating that further adjustment may be required. In FY2009, the state budgeted for only nine months of the fiscal period against revenues for the full year. However, by year-end, the state achieved an overall surplus of $0.4 million, a development which implies that the dire nature of the state's finances may have been overstated. The situation remained virtually unchanged in FY2010, and the overall fiscal outturn recorded a small surplus of $0.1 million.

108. Since the reforms introduced in FY2007, the fiscal situation remains difficult, but the state has held a tight rein on payroll costs, and wage rates have recently risen less than in any other FSM government. Although the independent viability of a small state such as Kosrae has been called into question, the fiscal situation has eased, at least for the time being.. In the future, reductions in real Compact flows will continue to place pressure on the government to provide services in an economy that has limited options.

iv Pohnpei State

109. Pohnpei has operated a finely balanced fiscal policy. At the start of the amended Compact in FY2004, a deficit of $5.5 million (5% of GDP) was recorded. However, this outturn hides the state's contribution of $7.5 million to the Compact Trust Fund (CTF) and an unusual increase—of about $5 million—in non-tax revenues. Adjusting for these non-recurring features, the state ran an underlying deficit of $3.0 million (3.0% of GDP). Unlike her sister states, Pohnpei did not require any phase-out of the use of the capacity-building sector grant for non-conforming purposes. The structure of the economy and state budget prevented a shortfall in funds for public administration, and Pohnpei was able to enter the amended Compact period with a fiscal structure in alignment with the sector grant approach.

110. In FY2005, the state operated at a small deficit of $0.1 million, and a surplus of $0.3 million was recorded in FY2006. However, state finances were finely balanced, and in FY2007 reductions in non-tax revenues and increases in goods and services resulted in an overall deficit of $0.4 million. In FY2008, these trends were exacerbated by reductions in earnings on investments and increases in payroll because of a COLA (Cost of Living Adjustment) awarded in FY2008 to state government employees. As a result, an overall deficit of $3.7 million (3% of GDP) was recorded. In FY2009, matters improved, and tax revenues grew by $0.9 million (or 11%) and with payroll held in check, the deficit was reduced to $1.3 million (1% of GDP). In FY2010 trends were broadly similar, and with the state economy growing by 6%, tax revenues expanded by over 7%. Payroll costs were held in check, and the overall deficit fell to $0.4 million (0.4% of GDP). Pohnpei has managed to maintain a delicate balance in its state finances, with a general low level of deficit. However, as with the other FSM governments, the continuing reduction in real Compact flows requires prioritization in service delivery, as well as adjustment in the medium and longer term.

v Yap State

111. During Compact I and the FY1995–FY2003 period, Yap showed the most consistent fiscal performance in the FSM and recorded an average surplus of 8% of GDP throughout FY1997-03. A key component of the state's fiscal situation has been the success of its monetization scheme. In FY1991, the state borrowed $71 million through the issuance of MTN bonds secured by future Compact assistance flows under full faith and credit provisions provided for in the Compact Treaty by the U.S. government. Having borrowed at a weighted average interest rate of 8.5%, the state has received investment earnings in excess of the cost of borrowing, which is reflected in investment balances in FY2010 of $53 million.

112. During the amended Compact, fiscal performance in Yap state deteriorated significantly in the initial years, and after adjusting for the contribution to the Compact Trust Fund in FY2004, the state recorded overall persistent deficits during FY2004–09, averaging $2.7 million (6.0% of GDP). After many years of fiscal discipline, pressure to in-

crease wages resulted in a significant increase in payroll costs in FY2005 and FY2006. While some of this increase was due to the infusion of FEMA funds after Typhoon Surdal in FY2006, increases in operating expenditures were a significant component. In FY2009, payroll costs reached a level of $8.0 million, 27% above the level of $6.3 million recorded in FY2003 before the start of the amended Compact. Not only have payroll costs grown, but outlays on goods and services have also expanded strongly, by 25%, from $8.4 million in FY2003 to $10.4 million in FY2010. However, in FY2010, the situation improved, with a significant $2.8 million increase in non-tax revenues. Expenditures fell by $1.6 million, despite increases in payroll, and the state recorded the first surplus of 3.2% during the amended Compact.

113. While Yap was presented with the same problem as Chuuk and Kosrae—the need to phase out the use of non-conforming uses of the capacity-building sector grant—the state decided to make the transition through drawdown of funds from its substantial investments rather than make any fiscal adjustment via reductions in payroll or additional revenue effort. In FY2008, the state legislature barred the use of a variable fuel charge that had been enacted in FY2006 by the Yap State Public Service Corporation (YSPSC) to cover increases in fuel costs (see section on Yap state GDP for further details). Further, the law directed the corporation to refund to customers the variable fuel charge imposed two years earlier. The dire situation resulted in the state government funding the corporation through a series of subsidies and loans. With the payments of refunds complete, the YSPSC broke even in FY2010 and avoided the need for direct subsidy from the state government.

114. The YSPSC debacle and the failure of the state to adjust to the new provisions of the amended Compact have contributed to the state's poor fiscal performance. Formerly Yap was one of the best-run states, but it now faces a series of challenges in order to return to the fiscal prudence that it practiced before the amended Compact. While the state has been able to rely on its large investments to fund a persistent level of deficit in the amended Compact, a sound policy is needed if it is to avoid, over the long term, an undisciplined drawdown of resources which have been arduously built up to provide for the well-being of future generations.

III POLICY ISSUES

A Public Financial Management

1 PUBLIC SECTOR REFORM

115. A major objective of the Compact has been the attainment of economic self-reliance. However, at the beginning of the Compact I period, the policy environment was hostile to the private sector, inward-oriented, and supportive of large and growing governments—a truly unfortunate policy mix for the support of economic development and attainment of the goals enshrined in the Compact. With the coming of the second step-down of Compact I, an awareness emerged in 1995 that matters needed to change. The First FSM Economic Summit resulted in a consensus on policy reforms, and with the assistance of the ADB through the Public Sector Reform Program (PSRP), a series of reforms was implemented by the FSM states and national government.

116. While the PSRP is now part of history, the program attempted to reform many of the major policy areas that are prerequisites for economic development. It thus presents a suitable benchmark from which to initiate discussion and assess performance. The goal of the PSRP was the transformation and development of a more efficient FSM economy. It had two purposes: (i) reforming and reducing the size of the public sector to adjust to declining external resource transfers; and (ii) shifting the balance of economic activity from the public to the private sector. Five outputs were specified: (i) reduced size and operating cost of the civil service; (ii) increased domestic revenue generation; (iii) restructured government operations and public enterprises, with the divestiture of some of the latter; (iv) successful mitigation of negative social and economic impacts of the adjustment in public expenditure; and (v) improved conditions for private sector development.

i Public sector payroll

117. Table 10 presents a comparison of the situation in FY1996, with the PSRP targets and current position (note that the current position is not directly comparable to the PSRP because the restricted fund categories have been excluded from the original PSRP targets). In terms of numbers of civil servants, the PSRP targeted a reduction of 27%. By FY1999, a 16% reduction had been achieved. This reduction has been maintained right up to the present, and it remains a considerable achievement. However, the story in payroll cost is significantly different. With an initial target savings of 35% of payroll costs, the five governments of the FSM had attained 20% by the time of the PSRP closeout in FY1999. By FY2011, more than ten years later, the benefits of the PSRP had almost been completely eroded, and payroll costs stood just 1% below the original level, with a cost saving of $0.3 million.

Table 10 Payroll reduction performance: PSRP targets, actual performance as at loan close out in FY1999 and FY2011

	Workforce Reduction Target	Workforce Reduction FY99	Workforce Reduction FY11	Wage Bill Reduction Target	Wage Bill Reduction FY99	Wage Bill Reduction FY11	Annual Payroll Savings (US$)
Chuuk	-29%	-15% (2,676 ==> 2,268)	-27% (2,676 ==> 1,959)	-44%	-29%	-14%	2.6 million
Kosrae	-14%	-19% (783 ==> 634	-27% (783 ==> 568	-26%	-19%	-13%	0.7 million
Pohnpei	-28%	-20% (1,554 ==> 1,251)	-9% (1,554 ==> 1,417)	-37%	-24%	-6%	1.0 million
Yap	-30%	-21% (1,109 ==> 874)	-4% (1,109 ==> 1,067)	-29%	-19%	15%	-1.1 million
National	-21%	8% (631 ==> 679)	6% (631 ==> 666)	-21%	7%	35%	-3.0 million
FSM	**-27%**	**-16% (6,753 ==> 5,706)**	**-16% (6,753 ==> 5,676)**	**-35%**	**-20%**	**-1%**	**0.3 million**

118. Further detail of emerging payroll trends for the national government and the five state governments (see Fig. 20). It is important to note the basis on which the analysis is presented. First, the data report average wage cost, which measures the total wage bill divided by the number of employees in each government. This is different from measures of wage rates, which would be based on hourly wage rates, annual salaries, etc. Average wage cost can rise for many reasons, despite the fact that wage rates have remained unchanged. In the following discussion, it will be noted that average wage costs have risen significantly during the amended Compact, although wage rates have also risen to a lesser degree. Secondly, the data on employment in the statistical appendix have been modified in the present analysis to allocate all federal program employment administered by the national government to the states in which the employment takes place. Federal program employees at the state level have been administered at different times by both the state and national governments; to provide a clearer picture of the trends, it is desirable to treat these employees on a consistent basis. Third, employees under Yap Cap and Head Start in Pohnpei were transferred to the Special Education Grant (SEG) during the amended Compact. These employees have been allocated to the two state government payrolls prior to the implementation of the SEG to ensure consistency in the present analysis, despite their allocation to the "government agency" category in the statistical tables.

119. Chuuk was highly successful, through the end of the PSRP program, in reducing both numbers and the total wage bill. However, the fiscal crisis of the early 2000s undermined commitment and led to an increase in average wage costs and to the hiring of contract workers. The implementation of the amended Compact required phase-out of the use of the capacity building grant for non-conforming purposes, which in turn necessitated the Chuuk RIF in FY2007; over 300 public servants were retrenched. As a result of

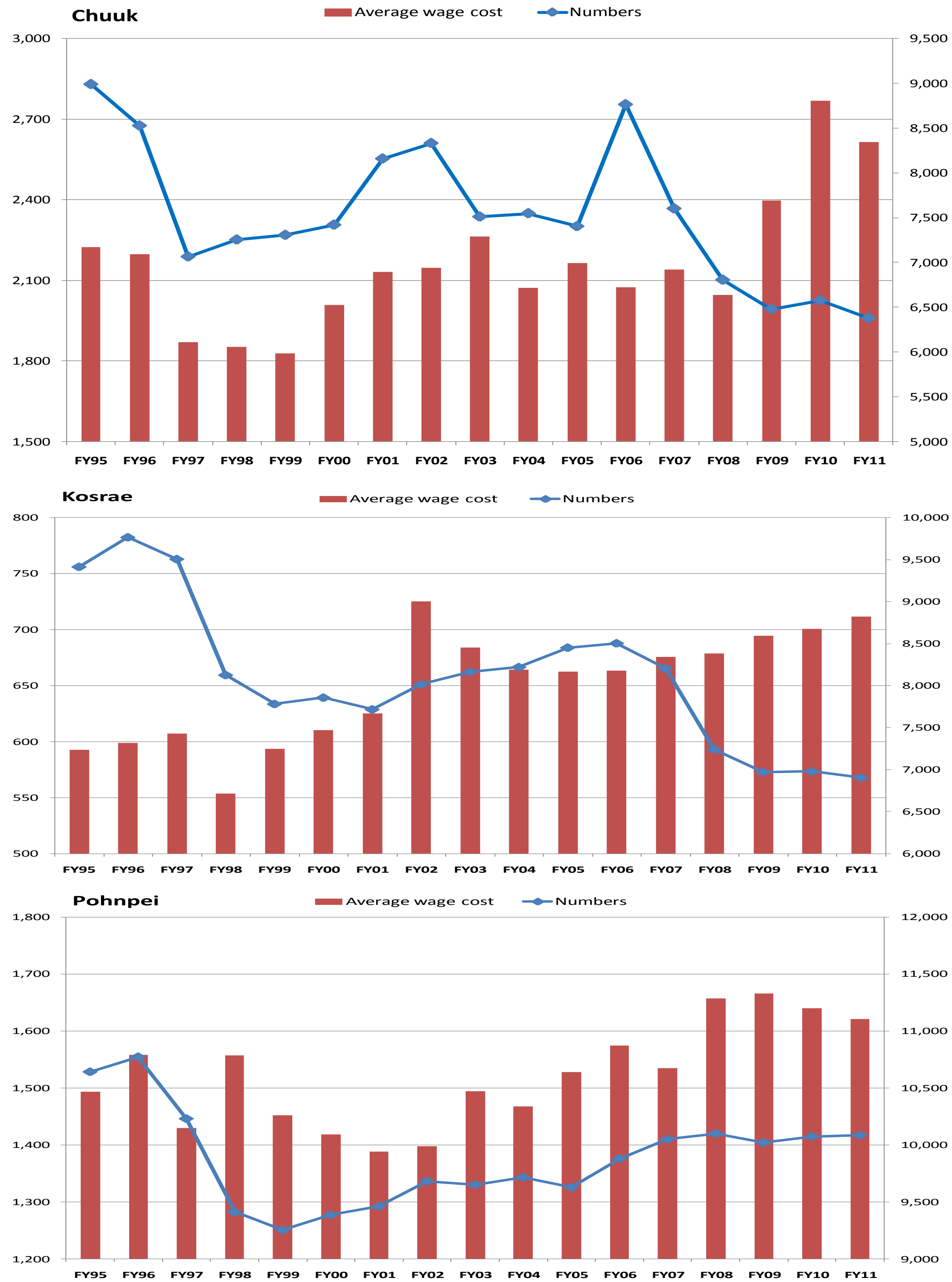


Figure 20 State and National Government Payroll and Wage Rates, FY95–FY11

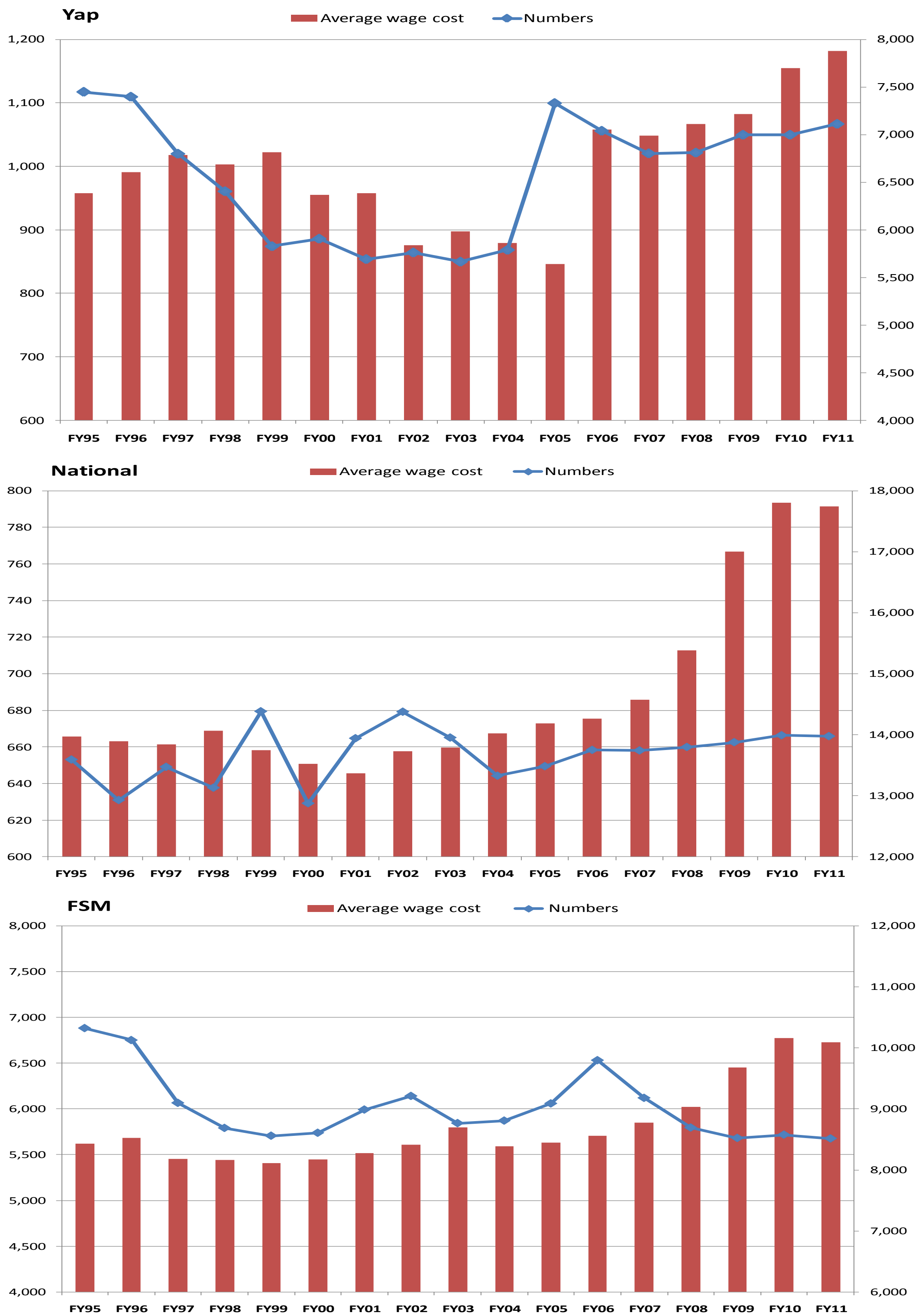


Figure 20 State and National Government Payroll and Wage Rates, FY95–FY11

these developments,the number of civil servants now stands below what it was before the start of PSRP. However, average wage costs have risen very significantly in the last three years, by 26% (ignoring the peak in FY2010). This result originates from two main factors. First, the impact of the RIF fell disproportionately on lower-skilled workers, thus pushing average wage costs upward. Second, the state returned many of the workers to an 80-hour pay period. While the number of employees hired under the education and health sector grants has remained unaltered since the start of the amended Compact, average wage costs for the two sectors have risen by 42%, compared with 25% for general fund employees. It is not possible to determine from the data whether wage rates have risen during the amended Compact. However, it is clear that both the return to an 80-hour pay period and the composition effect of the RIF have significantly increased average wage costs and offset some of the gains of the RIF.

120. Kosrae has been the most successful state in the FSM, with significant reductions in both the number of civil servants and the total wage bill. The number of civil servants fell by 19% as part of the PSRP and, after some slippage in the early 2000s, decreased by another 8% as part of the RIF necessitated to phase out the use of the capacity-building sector grant for non-conforming purposes. Average wage costs have, however, displayed a continual upward trend since the end of the 1990s. This reflects the composition effect of the RIF and the annual 5% step increase (wage rate increase) effective in Kosrae. It is also worthy of note that employment in the protected education and health sector grant areas has remained unaltered since the start of the amended Compact.

121. Pohnpei state also implemented the early retirement program of the PSRP and achieved significant success. The number of civil servants fell by 20%, and the wage bill was reduced by 24%. However, over the following years, increases in payroll numbers, unconstrained by the need to adjust to the amended Compact, neutralized much of the earlier achievements. The number of civil servants has risen and now stands only 9% below the pre-PSRP levels, while the total wage bill is 6% below former levels. In FY2008, a Cost of Living Allowance (COLA/wage rate increase) of $30 per employee per pay-period was awarded. Increases in employment in the education and health sector have grown by 22% during the amended Compact, while those in the general fund have grown by 12%.

122. Recent performance in Yap has been a disappointment. The state was one of the best achievers of the PSRP, but recent weak management has eroded its fiscal position. At the end of the PSRP the number of civil servants had fallen by 21%, and the total wage bill had been reduced by 19%. Current employment numbers are 4% below PSRP levels, but the wage bill is 15% above. While the state was faced with the same adjustment problem to the amended Compact as Chuuk and Kosrae, it chose to avoid adjustment through drawdowns from its large investment pool. In FY2005, civil servant numbers rose sharply by 27%, the result of Typhoon Surdal, but, after a slight decline in the following two years, have remained steady. Yap has the lowest wage rates in the FSM, but in FY2006, a wage rate adjustment was awarded, and average wage costs rose 25%.

As a result of these developments, the total wage bill has risen by 65% since the beginning of the amended Compact. The data for Yap suggest that both the number of civil servants and wage rates have grown faster in the education and health sectors. (The payroll data for Yap displays some anomalies which require resolution; thus, the results for the state must be viewed with caution.)

123. While the national government also participated in the PSRP and early retirement program, it did not need to adjust to either the second stepdown or the amended Compact. Both employee numbers and wage rates remained relatively constant through the end of Compact I. Since the commencement of the amended Compact, employee numbers have grown modestly, while average wage costs increased by a strong 27%, in part due to a COLA awarded in FY2008. As a result, the total wage bill is 31% above the pre-PRSP levels.

124. For the FSM as a whole, public employment fell dramatically after the PSRP was implemented, and the FSM must be complimented on the achievement. The significant growth in numbers in the early 2000s was reversed through the RIFs in Chuuk and Kosrae. Average wage costs, on the other hand, have risen sharply during the amended Compact—by 20% overall, or nearly 2.7% per annum, since FY2003, and the total wage bill is now only 1% below the pre-PSRP levels.

125. It has not been possible to assess the influence of the individual factors influencing the average wage increase, but these include: (i) changes in workforce composition (RIF effect); (ii) hours worked (return to 80-hour pay period in Chuuk); (iii) annual step increases (wage rate increase); (iv) COLA (wage rate increase); and (v) other factors (overtime, etc.). It is worthy of note that the average increase in wages costs that has occurred annually since the start of the amended Compact was held in check in FY2011.

126. The FSM does not have an explicit wage rate policy, and in the past policy has implicitly been determined by resource availability. Going forward, the nation must develop an explicit policy, particularly as the annual decrement and lack of full indexation erode the real value of the annual grants. However, holding nominal wage rates constant may not be a desirable policy, if the FSM wants to retain better qualified staff and limit emigration. 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.

ii Other public sector reforms

127. The major focus of the PSRP was the downsizing of the government sector through the ERP, but the program also emphasized other areas of public sector reform and restructuring, as well as private sector development. While there was an intentional emphasis on expenditure compression, the second output of the PSRP included important revenue reforms. The collection of import taxes was shifted from an f.o.b. to a c.i.f. basis, and the system was broadened to levy import duties on all sectors of the economy, both

private and public. Revenue targets were met or exceeded by the end of the program period, and consolidated tax revenue was 27% higher on average in FY1998–2001 than in the previous four years. Exports were exempt from gross revenue taxes, consistent with adoption of an "outward-looking" development strategy. However, the revenue reforms were intentionally undertaken within the existing regime rather than through adoption of a modern administration and tax system, such as would be required with a VAT. Tax reform is currently an active area of policy reform and is discussed below in the section on fiscal issues.

128. The PSRP also addressed the need for restructuring of government operations and public enterprises through the third output, but progress has been slow. An attempt at Public Sector Enterprise (PSE) reform was initiated through ADB Technical Assistance, and agreed-upon target transformations were specified in the Private Sector Development Program (PSDP). Although no significant transformations were achieved as a result of the program, money-losing public enterprises have either been effectively liquidated or placed under private-sector management. The PSE sector does not pose a threat to fiscal stability, although recent developments in the utilities sector in Pohnpei, Chuuk and Yap are a cause for concern. The remaining PSRP output, related to improving the conditions and regulatory environment for private-sector development, was taken up in the FY2008 review, and as there have been no significant changes, this issue is not discussed in this year's report.

2 Financial Management Information Systems (FMIS) and Performance Management

129. At the start of the amended Compact, the FSM inherited a disparate set of FMIS, with three different systems. 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. Furthermore, a uniform system and approach were required to ensure commonality in reporting across the five governments. A selection process was initiated and RFP issued to replace the old systems. In FY2004, a committee of officials from the five governments selected a new system. The selection and implementation of the new FMIS were supported through an OIA grant and took place over a period of several years, with the last government converted in FY2008.

130. A new chart of accounts was drawn up and implemented throughout the five governments. However, while the new chart was drawn up to suit the financial characteristics of the FSM, it was not well designed for performance management or economic reporting. Systems built for small nations such as the FSM frequently implement the Government Finance Statistics (GFS) standard developed by the International Monetary Fund. In the FSM, the GFS format presented in this report is based on the annual audits and is only an approximation to GFS (1984). To upgrade the GFS to current standards (2001), the ideal solution would be to redesign the chart to dovetail with GFS classifications so that consistent reports would automatically be generated. In the absence of rebuilding the chart, a new GSF spreadsheet system must be developed, but this would require substan-

tial additional drill-down to identify important transactions that are not included in the audits.

131. While not part of the PSRP, the FSM initiated a process of performance budgeting and management, with assistance from the ADB, through a series of four TAs in 1996-2003, OIA in 2007, and the ADB again in 2010. The process of implementation has been long and drawn out and has yet to produce tangible improvements in service delivery. In the initial phases, the process was concerned with adoption of a performance or output orientation in budgeting. Over a period of time, each of the FSM budgets was converted from a line-item basis to a performance basis. However, the process more frequently than not largely involved a change in budget format rather than the introduction of any new processes. A software program referred to as the BPS (Budget Preparatory Software) was developed and has been used by all governments. While it has the benefit of storing budgets in a central database (enabling the BPS to produce consistent reports), development of the performance orientation has not progressed much beyond allocating existing inputs to outputs. Also, existing processes have been made to "fit" the selected performance criteria, rather than costing the inputs needed to produce each output. Along with the BPS, the FSM has developed a Progress Reporting System (PRS) to monitor results for reporting purposes under the Compact. However, like the BPS, its sister program, the PRS is used only for reporting to the U.S. and is not an active tool of budget management and implementation.

132. With the implementation of the new Fiscal Procedures Agreement (FPA), the amended Compact required by law that the FSM adopt a performance basis in the preparation and execution of its budgets. However, there has been misalignment between the two nations' understanding of the meaning of "performance." In preparing the performance budgets, the FSM specified departmental expenditures at the "output" or delivery level, together with the associated inputs. The U.S., on the other hand, was interested in the attainment of results (or "outcomes"), plus, at the budget preparation stages, the intended use of U.S. funds by input or cost. The BPS software had failed to include any measurement of "outcomes," and thus the FSM system fails to measure the attainment of results. On the U.S. side, the strict focus on "outcomes" sent a message to the FSM: that improved budgeting and specification of deliverables were either not required or not a priority. However, measurement of both outcomes and outputs is clearly essential if the performance system is to function properly.

133. The performance budgeting and management system in the FSM thus requires significant reform in order to improve the delivery of services and the management of public expenditures. First, there is no performance audit corresponding to the financial audits. If managers are not accountable for the outputs specified in the budget, there is no incentive to ensure service delivery. Second, the U.S. needs to support the performance process in its entirety and not just at its "outcome" stage. While it is understandable that the lack of meaningful budget preparation results in managers focusing on inputs, there is nevertheless no excuse for not encouraging the FSM departments to prepare well speci-

fied and meaningful budgets. In the longer term, if the amended Compact is to see better results in the Compact sectors, especially as real resources decline, the FSM must build capacity in budget preparation, and the use of the capacity-building sector grant would seem a very appropriate use of these funds.

134. Implementation of the new FMIS has focused on the financial side of the equation. This was an understandable decision, given the weak financial management capacity and FSM's delays in fulfilling reporting requirements. However, the FMIS was not designed to integrate and replace the BPS and PRS systems. The operation of standalone budget prep and reporting modules that are unable to upload or download information from the FMIS is not efficient. Budgets are prepared "budget on budget" without information on prior years, and after the budget is appropriated into law, there is no capacity to upload the information into the FMIS.

135. There are moves afoot in the FSM to develop a third standalone piece of budget software, the Integrated Planning and Budgeting (IPB) system. This would replace the BPS and PRS and would enable both download and upload of information from and to the FMIS. However, the current chart of accounts contains no segment of code of the performance categories: activities and outputs. The intent is to apportion/map the current FMIS cost categories (or "object classes"), by department, division, etc., onto the performance categories in the IPB. While the new IPB would improve line-item budgeting—since the cost categories in the IPB and FMIS would be identical—this is not the case with the performance codes, since they do not exist in the FMIS. The intent to map organization codes (FMIS) to performance categories (IPB), while it appears to reflect the cost of output delivery, will at best be an approximation -- and at worst highly distortionary.

136. A recent ADB TA (completed in 2010) to support the performance budgeting process (the 5th such ADB initiative) has so far provided training in the new IPB. Unfortunately, the IPB software has yet to be developed, and the training has had to remain at the conceptual level (the same result as with ADB TA No. 3). The TA also appears to have been under the impression that the existing chart of accounts includes a segment relating to performance. While this is the case in Kosrae, none of the other four governments has adopted this approach. There is thus a compelling need to reform the chart of accounts; to include a code segment for the performance categories; and to revise the cost codes (object classes) to align with GFS (2001). Such an effort would not be without cost but would be necessary if the FSM wants to improve and adopt modern principles of performance and fiscal management.

B Fiscal Issues

1 TAX REFORM

137. The need to reform the FSM tax regime has long been recognized. While the existing system served reasonably well during the early days of nationhood, it does not pro-

vide a strong foundation for an elastic source of revenue without distorting economic incentives. While the design of the PSRP took into account the long-term need for tax-reform, it was felt that the short- to medium-term efforts should be directed at improving administration and reform of known weaknesses of the existing system. It was understood that radical reform of the tax system should be deferred until after the PSRP was complete.

138. As the Compact renegotiations neared completion, it became clear that the new structure of the amended Compact would entail significant adjustments, both in the short term and out to the 20-year horizon. The new sector-grant approach resulted in a system that provided funding to maintain the operations of education, health, and other selected sectors but failed to support the ongoing needs of many government functions. In the near term, the United States permitted the FSM to utilize the capacity-building sector grant for non-conforming purposes, provided it was agreed that these 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 only partial indexation of the transfers. Thus, both the short- and long-term reduction in funding required that the FSM consider measures to increase revenue effort, so that adjustment would not depend entirely on expenditure compression.

139. In 2002, a nationwide tax and revenue symposium was held to raise the awareness of the problems and encourage steps that would result in revenue and tax reform. The symposium passed two important resolutions. First, it recommended the introduction of a comprehensive tax reform program, including the introduction of a broad based consumption tax (value-added tax plus excises) and, subsequently, a simple net profits tax. The consumption tax would be enacted at the state level, replacing the existing national gross revenue tax and state sales taxes. Second, the symposium recommended the establishment of a unified tax administration to implement the new regime and collect taxes on behalf of both layers of government.

140. In March 2004, the FSM convened the Third FSM Economic Summit. Participants were presented with varying scenarios that ranged from a ”dismal” one—under which the FSM fails to generate economic growth and many Micronesians are forced to emigrate due to lack of opportunities—to a Sustained Growth Strategy (SGS). It was recognized that the SGS would require additional domestic resource mobilization, not only for adjustment to the conditions of the amended Compact, but also to support public investment in needed infrastructure. The nation also required a modern tax regime that supported the adopted outward-oriented growth strategy and encouraged private sector investment.

141. During the remainder of 2004, with support from the ADB and Pacific Finance Technical Assistance Center (PFTAC), the design and structure of a modern tax regime appropriate to the FSM was fleshed out. In Chuuk, in September 2004, a preliminary working group with delegates from both national and state governments met and orga-

nized a task force with representation from the various stakeholders, especially the private sector, to provide a comprehensive approach to the issue of tax reform. In January 2005, the Tax Reform Task Force (TRTF) was formally organized and created by the FSM President. The TRTF would be chaired by the Vice-President, with the FSM Customs and Tax Administration forming the Secretariat. Membership on the task force included the FSM Secretary of Finance, representatives from the private sector, one representative from each state, and two members from the FSM Congress. The objectives of the TRTF were:

- to examine different options for reform of the FSM tax system in order to meet expected reductions in revenues and to support the long-term sustained economic development of the nation;
- to prepare a tax reform proposal to present to the leadership of the FSM and the FSM Congress for consideration and enactment at the earliest possible time;
- to assist in education, seminars and working groups to increase public awareness of the fiscal implications of the amended Compact and the need to generate more local revenue, reform the tax system, and strengthen tax administration.

142. In June 2005, the TRTF submitted to the President its final recommendations, which the President approved in December. The key recommendations include:

- establishment of a new, modern independent tax collection authority with operations nationwide;
- introduction of a new Net Profits Tax (NPT) that allows for deductions of business expenses (the NPT will replace the existing Gross Revenue Tax (GRT);
- introduction of a new Value-Added Tax to replace import duties and state sales taxes.

143. In September 2005, the reform proposal was put before the Economic Policy Implementation Council (EPIC) and was adopted by resolution. Congress adopted the reform proposal in September and requested the President to establish an Executive Steering Committee (ESC) to replace the TRTF. The ESC is responsible for implementing tax reform in the FSM. It is chaired by the Vice-President and has representatives from each State and the private sector. Laws were drafted, with the support of the IMF, for the creation of a Unified Revenue Authority (URA), a new Revenue Administration Act, and new VAT and NPT laws. At its inaugural meeting in June 2006, the ESC adopted the creation of a Technical Working Group (TWG) responsible for determining the core tax and administrative policy for the ESC to approve. The Group is chaired by the Secretary of Finance and Administration and has representatives from the FSM Customs and Tax Administration office (CTA), the FSM Department of Justice, the Pohnpei State Department of Finance, and the private sector.

144. In April 2007, the ESC convened again and reaffirmed its commitment to the tax reform initiative. During the same meeting, the ESC also endorsed the high-level implementation plan for the tax reform and requested the states to create state implementation teams (SITs) to help accelerate implementation of the reforms at the state level. The Technical Working Group was tasked with preparing a detailed implementation plan and a tax reform package for submission to each of the FSM states. The Tax Reform Unit was created in late 2007 to manage the reform process. The TRU is staffed by a project manager and a Tax Adviser. Based on the high-level implementation plan endorsed by ESC in April 2007, a detailed operational plan for implementing the proposed tax reforms was developed with the assistance of PFTAC in December 2007.

145. Finalization and transmission of the legislation to the FSM Congress was originally planned for July 2008, but these steps were not taken because of several legal issues concerning the constitutionality of the URA legislation at the state level. These issues were resolved by the end of 2009 through amendments acceptable to the states, and the TWG and ESC approved the legislation. In March 2010, the President transmitted the set of tax reform bills to the Congress, and after resolution of several minor issues and a further election, the URA law was finally passed by Congress in April 2011. With the states and national government now agreeing on the sharing of the costs of the URA by MOU, the stage is set for the state legislatures and FSM Congress to enact the remaining pieces of legislation. The current schedule calls for completion of the legislative process by the end of 2011, along with the establishment of the URA within one year of passage into law. Implementation of the NPT is scheduled for end of FY2012. Implementation of the VAT will take place one year later, at the end of FY2013.

146. Clearly, progress in tax reform has been painfully slow, but there is strong state-level support, and the issue is now in the do-or-die stage. The initial plan had been for the reformed regime to support the phase-out of the use of the capacity-building grant from non-conforming purposes. However, implementation has been too slow, and the fiscal adjustment was unavoidably achieved entirely on the expenditure side, through painful reductions in payroll. However, the need for tax reform remains strong over the long term. Tax reform will assist with adjustment to the annual decrement over the remainder of the amended Compact, and it will support the private sector through the adoption of a broad based, modern, and non-distortionary system.

2 ADJUSTMENT TO THE AMENDED COMPACT

147. After completion of the amended Compact renegotiations with the United States, the FSM was left with a set of fiscal adjustments. First, the amended Compact entailed an 8% decline in funding, from $83 million to $76 million. Second, the switch from general budgetary support to a sector-grant approach meant that there was a shortage of domestic revenues to fund non-Compact sector operations such as administration, law and order, public works, and transportation. In the interim, the United States agreed that the FSM could use the capacity-building sector grant to fund operational activities listed under the grant, provided that the FSM agreed to phase out these activities over a five-year period.

Third, those activities that were not listed under the capacity-building grant required immediate adjustment. Fourth, the U.S. required that 30% of Compact resources be devoted to infrastructure. Fifth, the annual decrement and partial inflation adjustment require long-term fiscal adjustment to the decline in the real level of Compact assistance, amounting to approximately 2% per annum. And finally, the loss of the Compact I energy grant meant that in certain states, utility corporations were forced to raise prices to cover costs that had previously been subsidized. The second and fifth of the above adjustment issues are discussed below.

148. The need to phase out the use of the capacity building grant from non-conforming purposes required painful adjustments: expenditure cuts entailing a substantial loss of jobs, as well as additional revenue efforts. The governments of Chuuk and Kosrae were required to make substantial expenditure cuts. In the most extreme case, Kosrae was required to compress non-Compact expenditures by 32%, by eliminating 110 positions, enacting an across-the-board pay cut, reducing non-payroll costs and increasing taxes. In Chuuk. the compression was 28%. and 317 public service positions were eliminated. In Yap. the financing gap was 19%, but the state has been able to avoid adjustment through the use of the its extensive reserves. Only Pohnpei and the national government have been spared the need to phase out the non-conforming uses of Compact funds.

149. With medium-term adjustment to the amended Compact now complete, the government's (?) attention has switched to the impact of the lack of full indexation and annual decrement on fiscal management during the remaining years of the amended Compact. Over the next 12 years, the accumulated reduction in real funding equates to 20% of the current value of the Compact sector grants (or an annual average real decline of 2%). This represents a real resource loss of 5% of the projected value of GDP in FY2012. The amended Compact was specifically designed to avoid the large impact of the five yearly step-downs of Compact I and thus ease the process of adjustment. However, the relatively small adjustment of 2% per annum cannot be easily achieved year-to-year on a long-term basis without distorting the delivery of public services or the cost structure of government. In September 2009, in recognition of the impact of the annual real decline of Compact resources, JEMCO adopted a resolution (JEMCO 2009-2) that subsequently became known as the "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.*
>
> *JEMCO further resolves that the FSM shall submit its findings and plans to the JEMCO through the Office of Insular Affairs not later than August 1, 2010 and*

shall demonstrate that it has used the findings and plans as part of its internal budget development process for Fiscal Year 2012.

150. The FSM did not comply with this request, and during the following annual JEMCO meeting in 2010, an extended version of the original resolution was adopted (JEMCO Resolution 2010-2; Long-Term Fiscal Planning):

JEMCO resolves that the FSM National and State Governments shall develop a report that addresses the broad range of fiscal challenges facing the FSM, which was in part the subject of JEMCO Resolution 2009-2. Since efforts to date have not led to the timely submission of such a report prior to the August 1, 2010 deadline, JEMCO hereby specifies the scope of the issues that need to be addressed in such a report for the review of JEMCO at its mid-year meeting to be held in 2011.

In no order of importance, these fiscal challenges include, but are not limited to:

- *Unsustainable growth trends in health and education expenditures, including rapid growth of wages in these two sectors;*
- *Evidence of unmet needs in critical service areas of government, especially in health and education;*
- *Unsustainable growth in government wage bills, including both Compact-funded areas and all or most other areas;*
- *Limited progress on broad-based tax reforms and limited increases in other revenue categories (although it is noted that there are some limited exceptions for individual governments);*
- *Apparent political obstacles to achieving sustained, broad-based tax reform (as opposed to narrow, and potentially inefficient, tax increase measures);*
- *The decline of Compact funding in real terms, by design, due to the partial inflation adjustment;*
- *The further decline of Compact funding in real terms, again by design, due to the annual decrement;*
- *Stagnant or declining economic activity (again, varied by location);*
- *The inability, to-date, of at least some governments to meet their obligations under the Compact to match contributions to the Infrastructure Maintenance Fund, and the evident need of still greater allocations towards infrastructure maintenance;*
- *The need to constrain expenditures, increase revenues, and/or find subsequent contributors to increase Compact Trust Fund contributions, in order to be able credibly to adjust to projected levels of support after FY2023.*

The report shall also address other factors of importance, which may either worsen or lessen the evident fiscal challenges. These shall include, but are not limited to:

- *Population trends;*
- *Demographic and service delivery requirement trends;*
- *Remittance levels and trends, to the extent such data is available;*
- *The current and reliable future levels of assistance from other donors; to the extent such data is available.*

Finally, the FSM shall demonstrate that the process of developing this report shall be inclusive of policy makers at all levels of government, across sectors. The outcomes of the report relating to fiscal challenges should link to a specific course of action, including plans and necessary policy reform commitments specific to each government and across governments.

151. As a result of the JEMCO resolution, the FSM began preparation of a Long Term Fiscal Framework (LTFF), and convened a National Economic Symposium (NES). The LTFF was prepared by SBOC, the 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 strong participation among FSM leadership. Four resolutions were endorsed by the NES:

- To endorse state and national action plans prepared during the Symposium by five working groups to review and identify impediments to economic growth in (i) trade and industry, (ii) infrastructure, (iii) business, regulatory and logistics, (iv) transportation, and (v) human resource and development.
- To endorse the national long term fiscal and economic framework. After the symposium, the LTFF was to be returned to the States for their endorsement, then submitted to JEMCO before the annual 2011 meeting.
- To reform the FSM tax code.
- To prioritize infrastructure lists (also required by JEMCO).

152. While the FSM approach to the JEMCO decrement management adopted a participatory approach, the LTFF fell well short of providing the intended long-term macroeconomic framework that had been envisioned. Importantly, the LTFF failed to provide a comprehensive and integrated framework that included projections of GDP, linkages to the fiscal accounts, integration with the balance of payments, and banking sector. Instead, the LTFF presented a set of domestic revenue projections based on six-year trends since the start of the amended Compact—a period that is too short for econometric analysis and is unrelated to the tax base. Also, there was no clear fiscal account showing revenues, expenditures and fiscal balance. Moreover, the Compact Trust Fund was not integrated into the framework; indications of the likely fiscal shortfall in FY2023 were thus not addressed. Finally, there was no discussion of the contribution that economic growth might play under a reform scenario to lessen the burden of the annual decrement.

153. While the LTFF was endorsed by the NES, it is far from clear that it has any buy-in at the state level, where it would be used as an operational framework in the preparation of the annual budgets. The LTFF has thus failed to provide not only an integrated macroeconomic framework suitable to address the issues raised by JEMCO, but also a working document that would guide public expenditure allocation during the remainder of the amended Compact. The issue of decrement management thus remains outstanding. After a lengthy process, it is still not clear that requiring the FSM to resubmit a compliant LTFF is appropriate. The FSM has neither the technical capacity to prepare the required macroeconomic and fiscal projections nor the ability to prepare sector plans that prioritize health and education service delivery in a declining fiscal environment. Preparation and implementation of a comprehensive LTFF thus requires technical assistance, capacity building, and commitment in order for the process to be successfully implemented.

3 TRUST FUND VIABILITY—MONITORING THE SUFFICIENCY OF THE TRUST FUND

154. The establishment of the Trust Fund for the Peoples of the FSM 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 onward 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 during the amended Compact period, stated that "the amended Compacts and their subsidiary agreements contain no commitments, either express or implied, regarding the level of the 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."

155. Despite the lack of a secure and sustained funding level, the Trust Fund Agreement specifies a withdrawal rule that is precisely based upon the FY2023 annual grant assistance level plus full inflation, and each year thereafter, the specified withdrawal rate is increased by full inflation. In fact, the specified withdrawals would occur under current rules at this fully inflation-adjusted annual rate, even if it were known by all parties that the Trust Fund was not large enough to reliably support such withdrawals over the long term. This is a serious technical flaw, given that the shared goals are to protect the real value of the Trust Fund and ensure the stability of annual flows. As currently structured, only the nominal value of the Trust Fund is likely to be protected, while the stability of annual distributions will be at severe risk.

156. With the risk of a shortfall in the Trust Fund not being underwritten by the U.S. Government, it is imperative that the FSM Government make every effort to monitor the progress of the Trust Fund and to assess performance against a reasonable goal. The authors of this report suggest that this goal should be the sufficiency 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. By definition, and under the currently specified rules, that means the target value of the Trust Fund at the end of FY2023 must be sufficient to support annual withdrawals equal to the inflation-adjusted value of the grants received in FY2023, while preserving the real value of the Trust Fund in perpetuity. A monitoring procedure is presented below that identifies the terminal condition for sufficiency of the Trust Fund at the outset of FY2024, the first year in which it must provide income to the FSM government.

157. There is no clear documentation of the assumed rate of growth of the initial FSM Trust Fund deposits augmented by the assumed annual contributions; however, there is only one variable that affects the projected direct grant level in FY2023: the rate of inflation – or, more precisely, 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 FY2012 are included, and thereafter an assumed inflation rate of 3.0% is assumed (implying a 2.0% annual adjustment).

158. 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% less 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% higher than what it would have otherwise been.

159. 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 changes—faces a much higher probability of a shortfall in the size of its Trust Fund relative to the size needed to support a smooth and sustainable transition. As described below, the required annual rate of return from FY2004-23 based on actual inflation data through FY09 and projected inflation thereafter would be 10.88%. The same calculations show that the rate of return required for the RMI is 7.99% -- much more likely to be achieved. Had the late-stage modifications not

been made to the FSM amended Compact—or had they been fully offset—the nominal annual rate of return required would have been 8.1%.

160. Using actual inflation adjustment data through FY2012 and projecting forward (assuming inflation at 3%), a direct grant level of $90.3 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).

161. 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% of assets in equities with an assumed real rate of annual return of 6.5% and 35% in fixed income with an assumed real rate of annual return of 2.5%. The blended real rate of return for the distribution period is thus estimated at 5.1%. If inflation were to average 3%, a nominal rate of return of 8.1% would thus be required. All rates are assumed to be net of investment and Trust Fund management costs.

162. Taking the above projections and assumptions into account, the terminal condition for sufficiency of the Trust Fund is projected to be $1.82 billion. If the Trust Fund had been funded precisely and in a timely manner, as called for in the amended Compact (ignoring contributions from third parties), the meeting of this terminal condition value would require an annually compounded rate of return of 10.88%. With annual inflation projected at 3% over the entire period, the implied real rate of return is 7.88%. The projected growth path from FY2004–23 is presented as the baseline growth, and actual progress is compared to this baseline (see Fig. 21, which shows the smooth line projection, from a deposit of $46 million in FY2004 to the target level of $1.82 billion at the end of FY2023).

163. 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, 2011, the value would have grown to $299.9 million; however, the actual value of the FSM Trust Fund at that date was $224.5 million. This shortfall of $75.4 million leaves the Trust Fund fully 25% short after 7.75 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 10.88% annually, the final value of the fund at the outset of FY2024 would be just 85% of the target level, falling short by $265.1 million. And if the returns over the remaining period simply average a more achievable 8.1% over the remaining accumulation period, the shortfall would be $600.7 million, and the fund would achieve just 67% of the target level.

164. Several factors have combined to keep the value of the FSM Compact Trust, as of the end of June 2011, below the projected path necessary to support a smooth and sus-

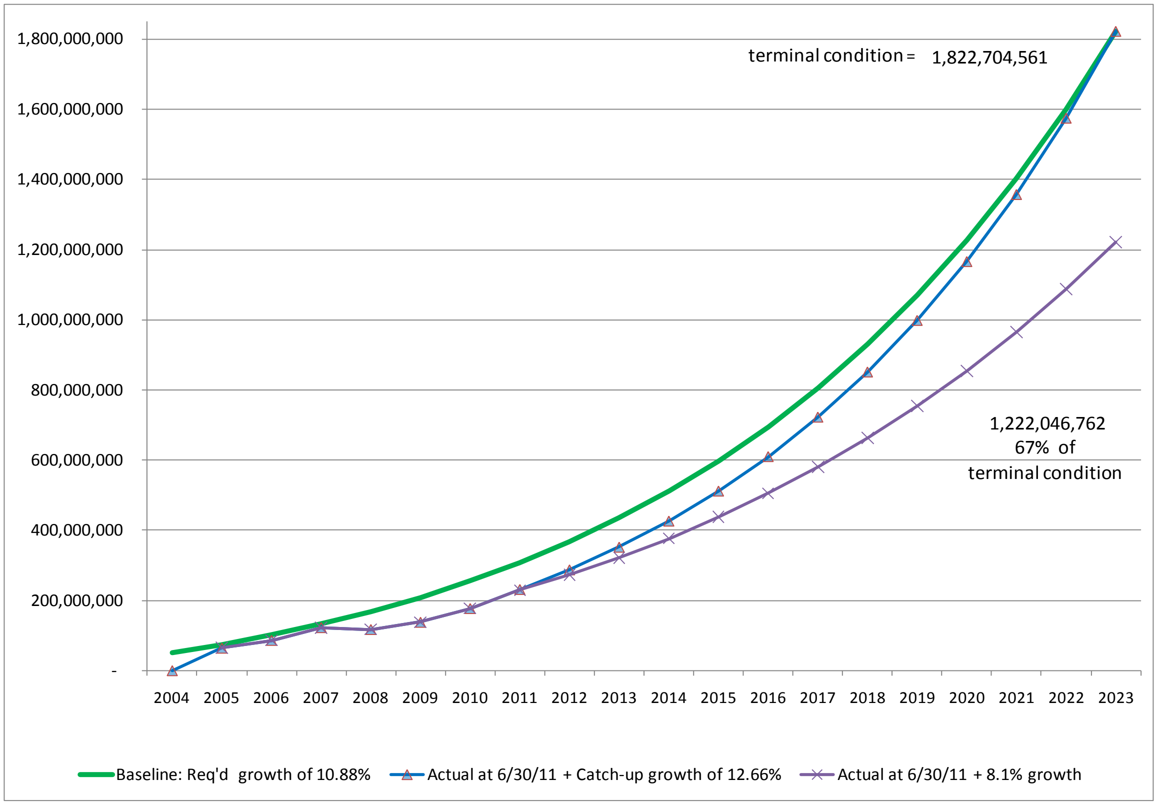


Figure 21 Compact Trust Fund Sufficiency, FY2004 – FY2024, $'millions.

tained transition; however, from the data through June 30, 2011, it cannot be said that the investment climate that prevailed for the entire period (from the beginning of FY2004 through June 30, 2011), is the sole cause of the shortfall to date. The benchmark return from assets invested according to the prevailing FSM Trust Fund policies would have delivered a 6.1% rate of return—well below the 10.88% annual compound rate of growth required to achieve the terminal condition. However, as described above, that required rate of return is extraordinarily high -- 36% larger than the 7.99% annualized return required for the RMI Trust Fund to reach its terminal condition.

165. It is clear 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 which the Trust Fund assets were fully invested. Finally, there has been substantial recovery from March 2009 through June 30, 2011. It is, of course, unfortunate that the Fund has experienced such a historically volatile and negative period so early in the planned 20-year accumulation period. This type of risk is called "sequence of returns" risk, and it will persist throughout the accumulation period but will again be

prominent (stronger? strongest?) in the early years of the planned distribution period (from FY2024 forward).

166. Several other factors that were not market-driven:

- 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 on October 1, 2004, exactly one year late. The U.S. chose to delay its deposit, awaiting the FSM contribution, and made its initial deposit of $16 million on 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. No changes to contribution commitments or anticipated withdrawal dates appear to have been discussed, although it should be noted that a 20-year accumulation period has been truncated to less than nineteen years as a result of legal requirements (i.e., the Compact going into effect nearly nine months after the beginning of the projected accumulation period) or of 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. Again, no discussions appear to have taken place to consider the impact of this and other delays relative to the originally projected 20-year accumulation period.
- Finally, one factor that has not affected the FSM Trust Fund (and that has significantly aided the RMI Trust Fund) is third-party contributions. The allowance for third-party contributions to the Trust Fund, with mutual consent, was an enlightened feature of the amended Compact; however, the parties to the FSM Trust Fund have yet to mobilize any official third-party contributions, and none are apparent in the near term.

167. A decomposition of the negative and positive factors is provided in Table 11. As noted above, the bulk of the shortfall over the initial 7.75-year period is the result of investment returns that fell short of the required 10.88% annual return. The market analysis utilized index comparisons against an initial investment strategy adopted by the Trust Fund Committee, along with a subsequent modification: specifically, U.S. equity at 24% (all-cap core), 26.5% international equity, 26% fixed income (17.5% percent aggregate bond, 8.5% emerging market debt), and 23.5% alternative (16% private equity and 7.5% real estate). While the strategy was implemented in phases and the aforementioned allocation is equivalent to the Phase II portion, the authors had no clear documentation of any

investment strategy changes, and thus the benchmark remained unchanged over the initial period through September 30, 2009.

168. From the outset of FY2010, the FSM government (?) used a revised benchmark based on information provided to the authors: U.S. equity at 28% (of which 21% was large-cap and 7% small-mid-cap); international equity at 29% (EAFE at 20.5% and emerging markets at 8.5%); fixed income at 23.5% (10% aggregate bond, 8.5% emerging market debt, and 5% convertible bonds); and alternative assets at 19.5% (7.5% real estate, 7% global private equity, and 5% hedge).

169. After estimating the investment policy through the two above-mentioned time periods, this report creates a benchmark performance index that reflects the two differing asset allocation targets over each relevant portion of the 7.75 year period. The analysis utilized actual index-based measures consistent with the target benchmarks identified by the investment advisor for the FSM Trust Fund. The analysis also took into account actual date of deposit data to estimate various effects (Table 11).

170. The basic return performance of the FSM Trust Fund as of June 30, 2011 is as follows: So far, contributions received have been $180.4 million, while the market value of the Trust Fund was $224.5 million, reflecting a total gain of $44.1 million. This computes to a compound annual growth rate of 5.1% (notably higher than the 4.4% return achieved by the RMI Trust Fund). While it is difficult to benchmark the asset class identified as "Alternative Assets" in the FSM Investment Policy, the authors estimate that the FSM Trust Fund actually outperformed its benchmark by a substantial margin of $5.7 million. The benchmark would have delivered a compound annual rate of return of 4.6%.

171. As shown in Fig. 21, the catch-up rate required for the FSM Trust Fund to achieve the terminal condition by the end of FY2023 is projected as a 12.66% compounded annual return for the remaining 12.25 years of the originally projected 20-year accumulation period. Even given the historically poor initial period—and the likelihood of a sustained

Table 11 Trust Fund Performance analyzed by Source of Variation as at end June 2011

FSM Trust Fund	Value at 6/30/11	Difference from actual	Decomposition estimates	
If smooth trendline growth:	**299,879,806**	(75,383,036)	100%	The Fund is 35% below target at this stage
If invested from original date:	237,220,472	(62,659,334)	-83%	This is the attribution to actual market
If invested from deposit dates:	230,313,345	(6,907,127)	-9%	This is result of delayed deposit
As entered into Inv. Policy:	218,803,078	(11,510,267)	-15%	This is result of delayed investment
Actual Market Value:	**224,496,770**	5,693,692	8%	This is result of fees, performance, and changes from benchmark inv. policy

period of above-average performance following the downturn—it is highly unlikely that the FSM Trust Fund will achieve the target level. The FSM Trust Fund Committee should revisit its investment strategy—as it should on a periodic basis—to consider the appropriate balance of risk versus reward and the appropriate mix of asset classes and allocations to the various asset classes. However, it is not recommended that the FSM over-allocate to risky assets in an overly aggressive attempt to catch up. Rather, a more advisable policy response would be to mobilize additional contributions—from both domestic and external sources—to the Trust Fund to support the FSM's long-term fiscal stability and sustainability.

C Conclusion

172. The 3rd FSM Economic Summit was held in Palikir, Pohnpei, from March 29-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;
- long-term sustainability.

173. The FSM Strategic Development Plan (SDP) examines the three growth scenarios in detail and makes projections of the likely economic growth and development patterns (Fig. 22). 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 growth 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 achieve only 0.1% over the period. Fig. 23 compares the projected dismal scenario with the actual performance since FY2003. In most years the dismal scenario has outperformed the actual performance, and it was only in FY2010 that the economy finally rose above the dismal scenario and the level of GDP prevailing in FY2003.

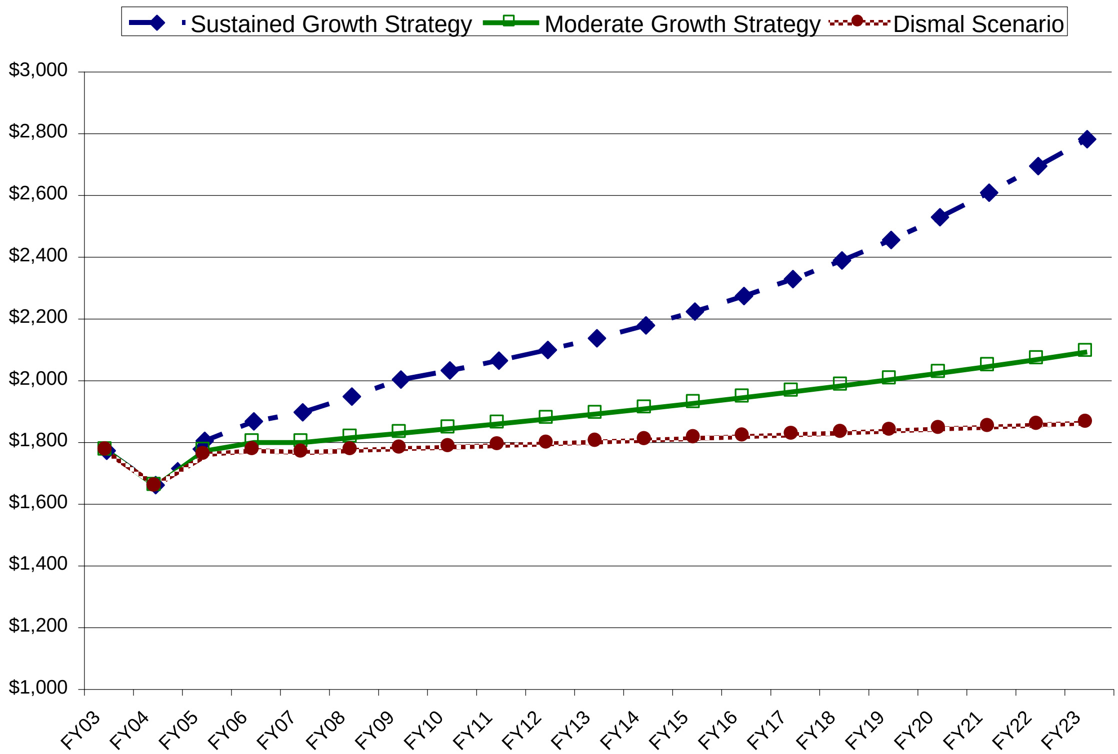


Figure 22 Alternative growth scenarios, GDP per capita, $s 1998 prices.

174. In February 2011, the FSM convened a National Economic Summit (NES) primarily designed to come up with a long-term decrement management plan, but also to identify impediments to economic growth and to prepare state and national action plans to overcome these problems. However, the objectives of the NES were not programmed to revisit the outcome of the Third Economic Summit outlined in the sustained growth strategy - or to devise ways to raise the level of economic growth above the dismal scenario. The need to implement a series of painful adjustments during the first five years of the amended Compact (and subsequent focus on decrement management) has diverted attention from the need to raise the level of economic growth. The NES thus missed an important opportunity to regain the high road and recommit to the necessary reforms and to the “sustained” growth scenario and its vision of the future.

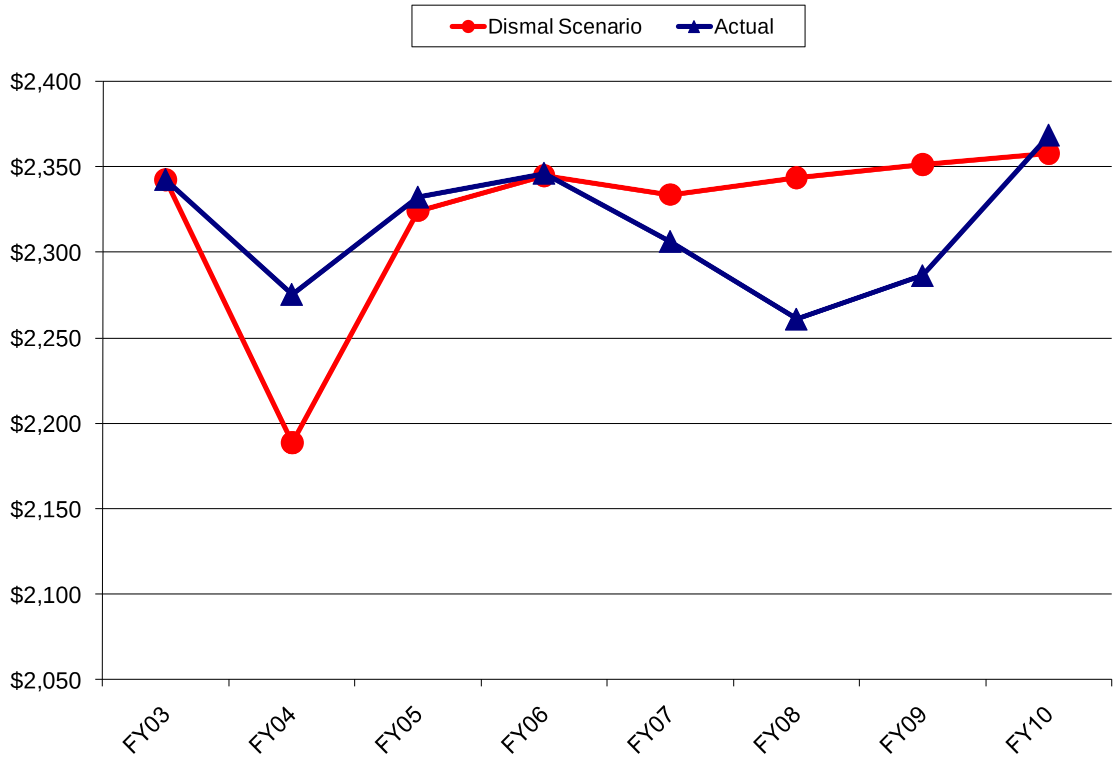


Figure 23 Comparison of the Third Summit dismal scenario with performance—GDP per capita, $s 1998 prices.

IV THE MEDIUM TERM ECONOMIC FRAMEWORK

175. As part of the FY2010 review, a preliminary medium term economic framework has been prepared based on GDP by industry and for the fiscal account. Typically a medium term framework would also include the balance of payments and the monetary accounts. However, in the FSM it is necessary to compile the balance of payments and monetary surveys for each of the four states, which currently does not exist. This is a therefore a task for future reviews. However, in the FSM the national and fiscal accounts are the most important of the four and thus this initial limited projection of the macroeconomic system is presented herein.

176. The framework is interconnected; variables in one part of the system are interrelated to variables in another. In the current case the national accounts are important drivers of the fiscal account. The goal of the framework is to provide projections for the year in progress (in this case, FY2011) as well as three additional future years (FY2012 through FY2014). Such frameworks are often used to develop a policy or reform scenario. While there are no comprehensive reform programs currently under consideration in the FSM, the results of the baseline projection might inform the components of a reform scenario.

A Baseline Projection

1 ECONOMIC ACTIVITY

177. This section describes the likely evolution of the major industrial activities in the FSM and state economies (see Table A1 of Appendix 1). Projections have been made for current and constant price GDP by industry and compensation of employees by industry. Five main methods of forecasting have been used, these include:

- Trend either linear, exponential or growth factor,
- Moving average,
- Prior knowledge based on intended investment intentions,
- Linked to other economic variables in the system, and
- Held constant.

178. Economic activity is projected industry by industry, and essentially the same method is applied to each industry regardless of state, but with noted exceptions where state circumstances differ. The general method is described first with state variations, followed by a discussion of the overall results at the state and FSM levels. Agriculture and Fisheries are comprised of subsistence (non-market) and commercial fishing. Subsistence activities in both agriculture and fisheries are projected according to recent population trends. Both Pohnpei and Yap run commercially operated purse seiners and these have been projected as moving averages on the assumption there is no expansion of fleets. Both Pohnpei and Kosrae have seen expansion in shore based activity operated by Luen

Thai. These have been projected on trend. The recent proposals for a large scale joint venture between Luen Thai and the FSM governments in fish loining and shore based activities has been ignored in these forecasts.

179. With the closure of the Yap garment factories, manufacturing in the FSM states is confined to production for the home market. Both manufacturing and electricity have been linked to the overall level of economic activity in all states. Construction activity is decomposed into three components: domestic construction supporting the domestic economy, airport improvement, and projects funded out of the Compact infrastructure grant. The domestic component is forecast as a moving average with the exception of Pohnpei that has displayed an upward trend. AIP projects have been forecast according to known plans: construction in Chuuk and Yap was complete in FY2011, and the Pohnpei ARFF was completed in FY2011 and the runway extension anticipated for completion in FY2012. Major runway improvements are due to get underway in Kosrae in FY2011 for completion in FY2013. After a very poor start to the effective use of the Compact infrastructure grant, it is anticipated the activity will increase significantly in the coming 3 years. Projections have been based on infrastructure projects in the pipeline.

180. Wholesale and retail trading is linked to the general level of economic activity. Hotels and restaurants (tourism) has been forecast on trend for Chuuk (3.2%), Pohnpei (3.6), and Yap (0.9%), but as a moving average in Kosrae, which has a very limited level of tourism activity. Transport, financial intermediation, business and personal community services have all been projected in line with economic activity. Owner occupied dwellings (imputed rent) has been projected in line with population growth.

181. Public administration (state governments) has been forecast as a moving average reflecting the adverse funding environment, with the exception of Pohnpei where constraints are not as severe and an upward trend has been experienced. National government public administration (in the states and Pohnpei) has been trended reflecting the favorable fiscal position of the national government with the exception of Yap that has been forecast as a moving average. Education services have been split between general services and the College of Micronesia (COM). General services, largely funded out of Compact sector grants, has been forecast as a moving average in Kosrae and Pohnpei, but as a downward trend in Chuuk and Yap reflecting recent reductions. COM activity is assumed to remain unchanged over the period. Finally, health services have been projected as moving averages in each state.

182. Net indirect taxes comprise four components: import taxes, the Gross Receipts Tax (GRT), state sales taxes, and subsidies. Import taxes are linked to the level of economic activity, while the GRT is projected in line with those activities that form part of the tax base. State sales taxes are linked to the output of wholesaling and retailing, while subsidies have been forecast as a moving average.

183. Fig. 24 indicates rates of economic growth projected for the five FSM governments on the assumption of no policy changes. In Chuuk, the primary forces of growth

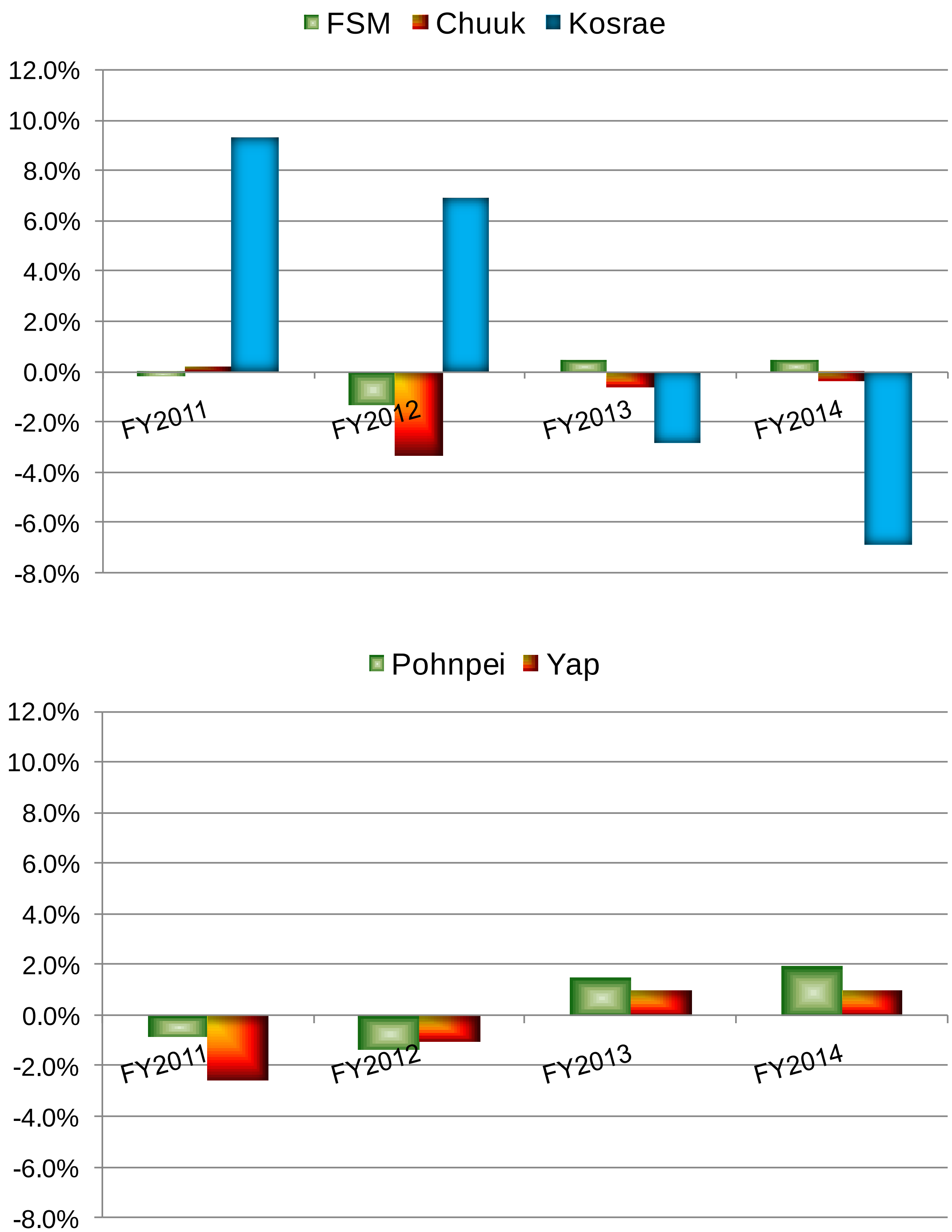


Figure 24 Baseline GDP projections of the state and FSM economies, FY2011-FY2014

are concentrated in the construction sector, government and the impact of a declining population. Government employment is assumed to hold steady with the exception of education where some decline is forecast due to the planned layoff of unqualified teachers. In FY2011 the Airport Improvement Project (AIP) comes to an end and GDP falls in FY2012 without the additional stimulus. In the outer years there is some increase in the use of the infrastructure grant, but this is offset by declines in population and government. Overall GDP is set to decline by -4.1% over the period.

184. In Kosrae the economy booms in FY2011 and FY2012 reflecting the construction of the AIP projects, even after accounting for the large off-shore components of the project. Population is also expected to decline in Kosrae, while government maintains a constant level of public services. Overall, after the large increases in the earlier years, GDP turns negative in FY2013 and FY2014 once the AIP projects are completed despite a pickup in the use of the infrastructure grant. Overall the economy expands by 5.8% over the period.

185. In Pohnpei, the earlier years show negative growth as a result of the completion of the AIP projects, and in the outer years, the pickup in the use of the infrastructure grant yields positive results. Population is forecast to expand at 0.5% per annum and government administration at both the state and national levels continue to expand on trend. There is also some expansion in tourism reflecting recent trends. Education and health services are set to remain constant under pressure from real declines in the sector grants. Overall Pohnpei state is forecast to grow by 1.4% over the period.

186. In Yap the story is similar. The AIP projects come to completion. Population remains essentially static, government administration and education services remain constant, and there is a pickup in health services on trend. Tourism is also set to grow slightly. Over the period GDP declines by 1.7%. The results for the FSM, reflecting movements in the four states, are that the overall economy moreorless ends up where are it started, but declines by -0.6% over the period.

2 Fiscal Projections

187. The methodology used to project the fiscal accounts follows the same general principals outlined for the GDP projections. Indirect taxes are projected in line with the GDP projections but adjusted for current prices. Separate projections have been made for compensation of employees based on constant price GDP projections and wage rate trends. These are used to drive the estimates of the wage tax collections. Non-tax revenues are generally forecast as moving averages, with the exception of interest and dividend earnings in Yap and fishing fee receipts of the national government; the latter have been projected on trend. Compact sector grants are projected in line with the schedule of grant receipts in the Compact agreement and adjusted for inflation by World Bank projections of the U.S. GDP deflator. Federal program grants are assumed to stay constant in real terms but are adjusted by projections of the U.S. CPI.

188. On the expenditure side projections of wage and salary costs are linked to real GDP change in public administration, education and health adjusted for recent trend rises in wage rates. Use of goods and services, including travel, has been assumed to remain constant in real terms and adjusted for inflation. Other elements of current expenditures are projected as moving averages. Use of the Compact infrastructure grant has been treated as a national government expense in the audits despite the fact that the vast majority of the expenditures are at the state level. The total use of the infrastructure grant used on the GDP projections provides both the level of the receipt of capital grants and level of expenditures. There are also small capital outlays at the state government level that have been projected as moving averages.

189. Fig. 25 describes the fiscal outturn based on the projection methodology described above. In Chuuk, tax revenues are forecast to remain static as the economy declines but are offset by inflation. Compact sector grants are anticipated to remain constant in line with the decrement and partial inflation adjustment. On the expenditure side, wages costs are projected to decline reflecting the reduction in employment despite rising wage rates. Use of goods and services are set to remain constant in real terms but rise in nominal terms. The overall result is that Chuuk can expect to see a decline in its fiscal position of $0.9 million compared with FY2010. For Kosrae, tax revenue is set to grow with the improving economy, but payroll costs also expand despite the state wage policy of holding employee numbers constant. Overall, increasing revenues outpace increasing costs in FY2011 and FY2012, and the fiscal position improves, but in the outer two years FY2013 and FY2014, the situation deteriorates without the stimulus effect of the FAA AIP projects and as costs continue to rise.

190. In Pohnpei, tax revenues grow reflecting changes in economic activity and inflation. Payroll costs also grow reflecting increases in hiring and wage policy. Overall the deficit deteriorates by -$1.6 million. In Yap the overall forces are similar, but interest and dividend receipts have been forecast to improve after the weak market yields in FY2008-FY2009. Ignoring the off trend results for FY2010, the overall deficit is projected to remain largely unchanged. For the national government the outcome is totally different. Tax revenues reflect state collections, and the national government share of the Compact sector grants remains unchanged. However, the national government receives significant receipts from fishing royalties which are projected to grow on trend by 7% per annum. The result is that while expenditures on payroll and use of goods and services are projected to expand as in other states, the overall fiscal surplus is anticipated to grow by $5.5 million over the period. This result precludes any increase in public projects to offset the rising surplus. For the FSM the fiscal result reflects the consolidation of the five government outturns, but is dominated by the national government; overall for the FSM a surplus is projected, but anticipated to decline by -$1.5 million.

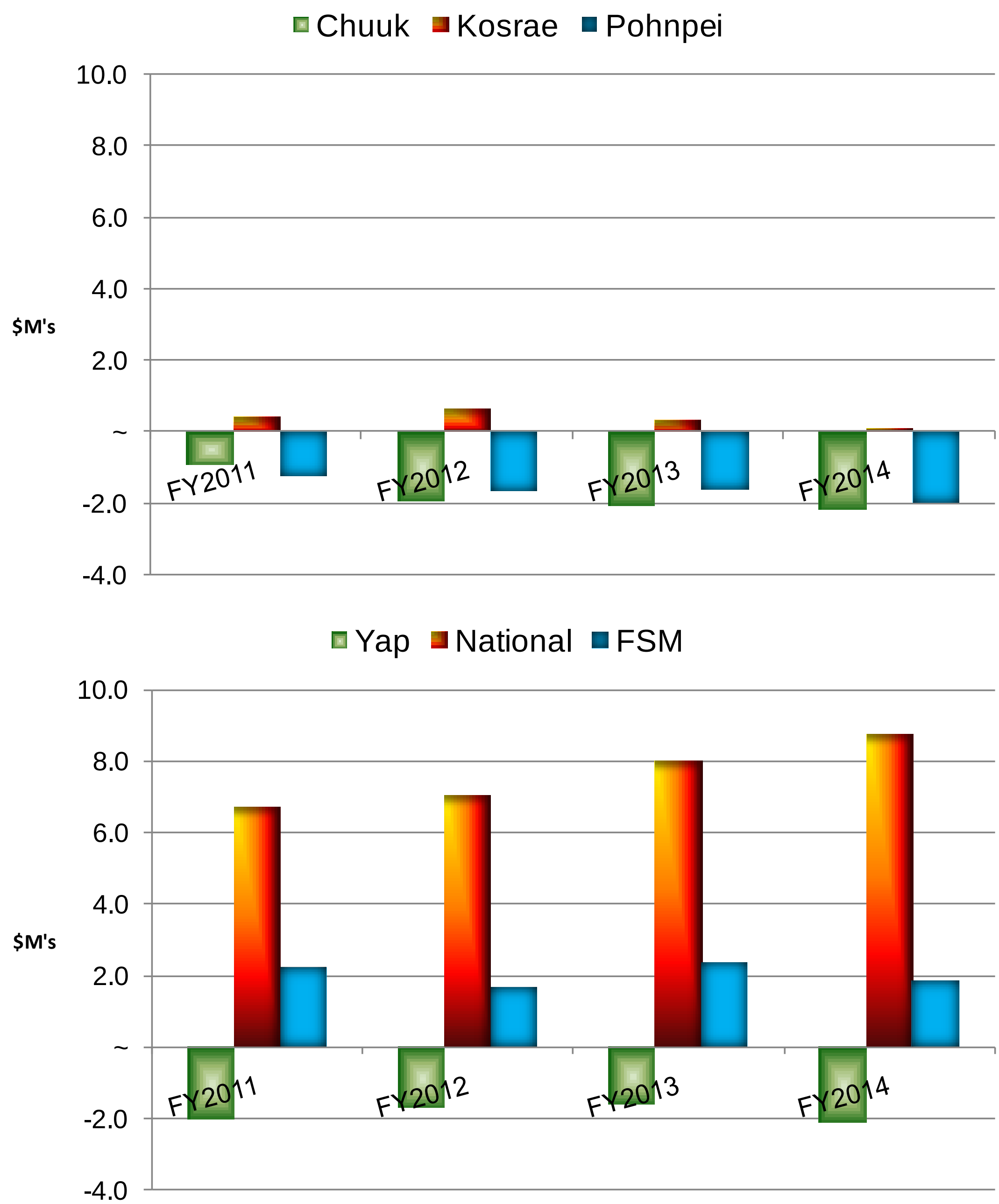


Figure 25 Projected fiscal outturn for the state, national and FSM governments, $M's, FY2011-FY2014

B Reform Scenario

191. There are no reform programs currently under consideration in the FSM. However the current review and medium-term projections suggest elements of a program. Firstly,

the FSM tax reform initiative is due for implementation over the next 2 years. If the reforms are implemented as proposed the macroeconomic framework presented in this part of the review coupled with existing studies would provide an ideal framework to examine the impact. Secondly, the baseline indicates a mixed fiscal result, increasing fiscal pressure at the state level, and growing potential surpluses at the national. Rather than continuation of the status quo and a matching rise in public project outlays, the additional resources could be used to assist the states in the delivery of public services as the real value of the Compact sector grants decline. Alternatively a proportion of the additional funds could be set aside to build up the Compact Trust Fund to reduce the anticipated short fall in FY2023. Lastly, the baseline indicates that the FSM economy is not anticipated to drag itself off the "dismal scenario" trajectory; overall the economy is projected to decline by -0.6% over the period. A reform program focused on the private sector could provide an exit strategy from the dismal scenario.

V APPENDIX 1 STATISTICAL PROJECTIONS

Table A1 GDP in constant prices, FSM and States, FY2004, $M's (FY2008-FY2014)

FSM	FY2008	FY2009	FY2010	FY2011	FY2012	FY2013	FY2014
Agriculture, Hunting and Forestry	33.9	33.9	34.2	34.1	34.0	33.9	33.8
Fisheries	23.8	23.2	23.5	23.9	24.1	24.3	24.4
Mining and Quarrying	-	-	-	-	-	-	-
Manufacturing	1.0	0.9	1.0	1.0	1.0	1.0	1.0
Electricity, Gas and Water Supply	4.2	4.3	4.3	4.4	4.3	4.3	4.4
Construction	6.3	10.1	12.5	11.4	9.7	10.2	10.6
Wholesale and Retail Trade and R	27.1	25.3	26.2	26.3	25.8	26.1	26.3
Hotels and Restaurants	4.3	3.9	3.8	3.8	3.9	4.0	4.1
Transport, Storage and Communic	13.9	13.6	14.1	14.1	13.8	13.9	14.1
Financial Intermediation	4.6	3.7	4.0	4.0	3.9	3.9	4.0
Real Estate, Renting, Business Acti	28.7	28.7	29.5	29.4	29.2	29.2	29.2
Public Administration	25.5	25.3	26.7	27.1	27.5	27.8	28.2
Education	33.7	34.2	33.5	33.4	32.8	32.2	31.7
Health and Social Work	10.8	11.1	11.8	12.0	12.0	12.1	12.1
Other Community, Social, Persona	3.1	3.1	3.4	3.4	3.3	3.3	3.4
less intermediate FISIM	-3.5	-3.1	-3.2	-3.2	-3.2	-3.2	-3.2
GDP at basic prices	217.4	218.3	225.2	224.9	222.2	223.1	224.0
Indirect Taxes	16.7	17.4	18.1	18.0	17.5	17.7	18.0
GDP at market prices	234.2	235.7	243.3	242.9	239.7	240.8	241.9
Growth	-2.4%	0.7%	3.2%	-0.2%	-1.3%	0.5%	0.5%

Chuuk	FY2008	FY2009	FY2010	FY2011	FY2012	FY2013	FY2014
Agriculture, Hunting and Forestry	13.2	13.1	13.0	12.8	12.7	12.6	12.5
Fisheries	9.4	9.4	9.2	9.1	9.0	8.9	8.9
Mining and Quarrying	-	-	-	-	-	-	-
Manufacturing	0.2	0.1	0.1	0.1	0.1	0.1	0.1
Electricity, Gas and Water Supply	0.8	0.8	0.7	0.7	0.7	0.7	0.7
Construction	0.7	1.1	2.9	3.1	2.4	2.8	3.3
Wholesale and Retail Trade and R	6.1	5.9	6.1	6.2	5.9	5.8	5.8
Hotels and Restaurants	1.1	1.0	0.8	0.9	1.0	1.0	1.0
Transport, Storage and Communic	3.4	3.3	3.5	3.5	3.3	3.3	3.3
Financial Intermediation	1.3	1.0	1.0	1.1	1.0	1.0	1.0
Real Estate, Renting, Business Acti	11.2	11.1	11.2	11.1	11.0	10.9	10.8
Public Administration	3.8	3.6	4.2	4.2	4.2	4.2	4.2
Education	10.0	11.0	10.6	10.4	9.9	9.4	8.9
Health and Social Work	3.8	3.9	4.1	4.2	4.2	4.2	4.2
Other Community, Social, Persona	0.5	0.5	0.4	0.4	0.4	0.4	0.4
less intermediate FISIM	-1.1	-0.9	-1.0	-1.0	-0.9	-0.9	-0.9
GDP at basic prices	64.4	64.8	67.0	67.1	65.0	64.5	64.2
Indirect Taxes	4.2	4.4	5.1	5.1	4.8	4.8	4.9
GDP at market prices	68.6	69.1	72.1	72.2	69.8	69.4	69.1
Growth	-6.1%	0.8%	4.3%	0.2%	-3.3%	-0.6%	-0.4%

Table A1 Continued

Kosrae	FY2008	FY2009	FY2010	FY2011	FY2012	FY2013	FY2014
Agriculture, Hunting and Forestry	0.9	0.9	0.9	0.8	0.8	0.8	0.8
Fisheries	0.8	1.0	1.0	1.1	1.1	1.1	1.2
Mining and Quarrying	-	-	-	-	-	-	-
Manufacturing	0.2	0.2	0.2	0.3	0.3	0.3	0.2
Electricity, Gas and Water Supply	0.4	0.4	0.4	0.4	0.5	0.5	0.4
Construction	1.1	1.8	1.4	2.1	2.8	2.5	1.8
Wholesale and Retail Trade and R	1.7	1.8	2.0	2.2	2.4	2.3	2.1
Hotels and Restaurants	0.2	0.2	0.2	0.2	0.2	0.2	0.2
Transport, Storage and Communic	0.7	0.7	0.7	0.8	0.8	0.8	0.8
Financial Intermediation	0.3	0.2	0.3	0.3	0.3	0.3	0.3
Real Estate, Renting, Business Acti	1.7	1.7	1.7	1.8	1.8	1.8	1.7
Public Administration	2.4	2.3	2.3	2.3	2.3	2.3	2.3
Education	2.9	2.9	2.7	2.8	2.8	2.8	2.8
Health and Social Work	1.1	1.2	1.2	1.2	1.2	1.2	1.2
Other Community, Social, Persona	0.2	0.1	0.1	0.1	0.1	0.1	0.1
less intermediate FISIM	-0.2	-0.2	-0.2	-0.2	-0.3	-0.3	-0.2
GDP at basic prices	14.4	15.1	14.9	16.2	17.2	16.8	15.7
Indirect Taxes	1.0	1.1	1.0	1.1	1.3	1.2	1.1
GDP at market prices	15.4	16.2	15.9	17.3	18.6	18.0	16.8
Growth	-4.4%	4.8%	-1.9%	9.4%	7.0%	-2.8%	-6.9%

Pohnpei	FY2008	FY2009	FY2010	FY2011	FY2012	FY2013	FY2014
Agriculture, Hunting and Forestry	11.1	11.4	11.6	11.7	11.7	11.8	11.8
Fisheries	8.0	7.7	8.5	8.5	8.7	9.0	9.2
Mining and Quarrying	-	-	-	-	-	-	-
Manufacturing	0.5	0.5	0.6	0.6	0.6	0.6	0.6
Electricity, Gas and Water Supply	2.4	2.4	2.5	2.5	2.5	2.5	2.6
Construction	3.4	4.3	5.9	4.9	3.4	3.7	4.2
Wholesale and Retail Trade and R	14.4	13.0	13.6	13.5	13.2	13.4	13.8
Hotels and Restaurants	1.7	1.6	1.6	1.5	1.6	1.6	1.7
Transport, Storage and Communic	7.0	7.1	7.4	7.3	7.2	7.3	7.5
Financial Intermediation	2.7	2.1	2.2	2.2	2.1	2.2	2.2
Real Estate, Renting, Business Acti	11.9	12.0	12.7	12.7	12.7	12.8	12.9
Public Administration	16.5	16.6	16.9	17.4	17.7	18.1	18.5
Education	16.1	15.7	15.8	15.8	15.8	15.8	15.8
Health and Social Work	4.7	4.7	5.1	5.1	5.1	5.1	5.1
Other Community, Social, Persona	2.0	2.0	2.3	2.3	2.3	2.3	2.4
less intermediate FISIM	-2.0	-1.7	-1.8	-1.7	-1.7	-1.7	-1.8
GDP at basic prices	100.4	99.5	105.1	104.3	103.0	104.5	106.5
Indirect Taxes	8.1	8.3	8.7	8.5	8.2	8.4	8.7
GDP at market prices	108.5	107.7	113.8	112.8	111.2	112.9	115.1
Growth	-0.6%	-0.7%	5.6%	-0.9%	-1.4%	1.5%	2.0%

Table A1 Continued

Yap	FY2008	FY2009	FY2010	FY2011	FY2012	FY2013	FY2014
Agriculture, Hunting and Forestry	8.7	8.6	8.7	8.7	8.7	8.7	8.7
Fisheries	5.5	5.2	4.8	5.2	5.2	5.2	5.1
Mining and Quarrying	-	-	-	-	-	-	-
Manufacturing	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Electricity, Gas and Water Supply	0.7	0.7	0.7	0.7	0.7	0.7	0.7
Construction	1.2	3.0	2.3	1.2	1.0	1.2	1.4
Wholesale and Retail Trade and R	4.8	4.6	4.5	4.5	4.4	4.5	4.6
Hotels and Restaurants	1.3	1.1	1.1	1.2	1.2	1.2	1.2
Transport, Storage and Communic	2.8	2.4	2.5	2.5	2.4	2.5	2.5
Financial Intermediation	0.5	0.4	0.4	0.4	0.4	0.4	0.4
Real Estate, Renting, Business Acti	3.9	3.9	3.8	3.8	3.8	3.8	3.8
Public Administration	2.7	2.8	3.2	3.2	3.2	3.2	3.2
Education	4.7	4.7	4.4	4.3	4.3	4.2	4.1
Health and Social Work	1.2	1.3	1.4	1.4	1.5	1.5	1.6
Other Community, Social, Persona	0.5	0.5	0.5	0.5	0.5	0.5	0.5
less intermediate FISIM	-0.3	-0.3	-0.3	-0.3	-0.3	-0.3	-0.3
GDP at basic prices	38.2	39.0	38.2	37.3	36.9	37.3	37.5
Indirect Taxes	3.5	3.7	3.4	3.2	3.1	3.2	3.3
GDP at market prices	41.7	42.7	41.6	40.5	40.1	40.5	40.9
Growth	0.2%	2.4%	-2.7%	-2.6%	-1.0%	1.0%	1.0%

Table A2 GDP in constant prices, FY2004 prices, FSM and States, % growth on previous year (FY2008-FY2014)

FSM	FY2008	FY2009	FY2010	FY2011	FY2012	FY2013	FY2014
Agriculture, Hunting and Forestry	-0.6%	0.1%	0.8%	-0.3%	-0.3%	-0.3%	-0.3%
Fisheries	0.8%	-2.3%	1.3%	1.3%	1.0%	0.7%	0.4%
Mining and Quarrying							
Manufactuing	7.1%	-5.8%	12.6%	1.9%	0.2%	0.3%	-0.4%
Electricity, Gas and Water Supply	-8.0%	2.7%	1.1%	0.4%	-1.3%	0.9%	1.0%
Construction	24.3%	59.3%	23.3%	-8.3%	-15.1%	5.0%	4.3%
Wholesale and Retail Trade and Repairs	-1.0%	-6.5%	3.5%	0.4%	-1.7%	0.9%	1.0%
Hotels and Restaurants	-6.4%	-10.9%	-2.3%	1.0%	2.4%	2.3%	2.4%
Transport, Storage and Communications	-15.4%	-2.4%	3.7%	0.1%	-2.0%	1.0%	1.2%
Financial Intermediation	-9.7%	-19.5%	5.6%	0.4%	-1.9%	0.8%	0.9%
Real Estate, Renting, Business Activities	-0.9%	-0.2%	2.8%	-0.3%	-0.6%	-0.1%	-0.1%
Public Administration	-8.1%	-0.6%	5.4%	1.5%	1.4%	1.3%	1.4%
Education	0.1%	1.4%	-2.0%	-0.4%	-1.7%	-1.7%	-1.7%
Health and Social Work	5.6%	2.7%	6.5%	1.4%	0.5%	0.3%	0.2%
Other Community, Social, Personal Servic	-0.9%	-0.3%	7.6%	-0.4%	-1.8%	1.3%	1.7%
less intermediate FISIM	-1.0%	-12.9%	5.1%	0.4%	-2.0%	0.8%	0.9%
GDP at basic prices	-2.1%	0.4%	3.2%	-0.1%	-1.2%	0.4%	0.4%
Indirect Taxes	-6.3%	4.2%	3.7%	-0.6%	-2.6%	1.2%	1.3%
GDP at market prices	-2.4%	0.7%	3.2%	-0.2%	-1.3%	0.5%	0.5%

Chuuk	FY2008	FY2009	FY2010	FY2011	FY2012	FY2013	FY2014
Agriculture, Hunting and Forestry	-2.7%	-0.6%	-0.7%	-1.0%	-1.0%	-1.0%	-1.0%
Fisheries	-3.4%	-0.8%	-1.2%	-1.2%	-1.0%	-1.0%	-1.1%
Mining and Quarrying							
Manufactuing	-11.3%	-22.7%	-4.7%	1.2%	-5.0%	-0.3%	0.1%
Electricity, Gas and Water Supply	-14.9%	6.8%	-15.0%	1.2%	-5.0%	-0.3%	0.1%
Construction	65.5%	44.4%	175.2%	6.8%	-22.6%	15.9%	18.3%
Wholesale and Retail Trade and Repairs	-8.1%	-3.9%	4.0%	1.2%	-5.0%	-0.3%	0.1%
Hotels and Restaurants	-3.6%	-12.4%	-12.9%	13.1%	2.5%	2.5%	2.4%
Transport, Storage and Communications	-21.2%	-3.2%	4.8%	1.2%	-5.0%	-0.3%	0.1%
Financial Intermediation	-12.6%	-19.2%	1.9%	1.2%	-5.0%	-0.3%	0.1%
Real Estate, Renting, Business Activities	-1.1%	-1.0%	1.2%	-0.9%	-1.4%	-1.0%	-1.0%
Public Administration	-32.7%	-5.8%	18.2%	-0.7%	0.9%	0.6%	0.2%
Education	-1.7%	9.7%	-3.9%	-1.4%	-4.8%	-5.1%	-5.4%
Health and Social Work	10.9%	4.8%	3.8%	3.4%	-0.2%	-0.2%	-0.6%
Other Community, Social, Personal Servic	6.7%	-6.8%	-6.1%	1.2%	-5.0%	-0.3%	0.1%
less intermediate FISIM	-5.0%	-13.3%	3.6%	1.2%	-5.0%	-0.3%	0.1%
GDP at basic prices	-5.8%	0.6%	3.5%	0.1%	-3.1%	-0.7%	-0.5%
Indirect Taxes	-10.4%	3.6%	15.9%	1.3%	-6.0%	0.5%	1.1%
GDP at market prices	-6.1%	0.8%	4.3%	0.2%	-3.3%	-0.6%	-0.4%

Table A2 Continued

Kosrae	FY2008	FY2009	FY2010	FY2011	FY2012	FY2013	FY2014
Agriculture, Hunting and Forestry	-4.1%	-2.1%	-3.4%	-1.6%	-1.6%	-1.6%	-1.6%
Fisheries	-2.0%	13.7%	3.6%	5.5%	4.4%	4.2%	4.0%
Mining and Quarrying							
Manufacturing	-3.7%	-21.1%	24.1%	11.2%	8.2%	-2.9%	-7.4%
Electricity, Gas and Water Supply	-3.3%	-2.5%	8.0%	11.2%	8.2%	-2.9%	-7.4%
Construction	17.5%	63.7%	-21.9%	56.5%	31.5%	-11.3%	-29.6%
Wholesale and Retail Trade and Repairs	-6.8%	6.5%	10.5%	11.2%	8.2%	-2.9%	-7.4%
Hotels and Restaurants	-2.8%	-11.9%	9.6%	-6.8%	1.2%	-0.3%	0.8%
Transport, Storage and Communications	-11.3%	5.2%	-3.6%	11.2%	8.2%	-2.9%	-7.4%
Financial Intermediation	-7.9%	-19.1%	35.3%	11.2%	8.2%	-2.9%	-7.4%
Real Estate, Renting, Business Activities	-4.8%	-1.6%	2.5%	1.9%	1.3%	-2.0%	-3.5%
Public Administration	-12.3%	-4.8%	0.1%	-0.2%	-0.3%	-0.3%	-0.3%
Education	-0.3%	-1.1%	-4.3%	2.4%	0.2%	-0.3%	-0.2%
Health and Social Work	1.2%	1.4%	3.8%	1.1%	-0.1%	0.1%	-0.2%
Other Community, Social, Personal Servic	-20.5%	-11.5%	-21.8%	11.2%	8.2%	-2.9%	-7.4%
less intermediate FISIM	1.9%	-13.0%	30.6%	11.2%	8.2%	-2.9%	-7.4%
GDP at basic prices	-4.1%	4.4%	-1.1%	8.7%	6.4%	-2.6%	-6.4%
Indirect Taxes	-7.4%	9.8%	-12.3%	20.5%	14.2%	-5.1%	-13.2%
GDP at market prices	-4.4%	4.8%	-1.9%	9.4%	7.0%	-2.8%	-6.9%

Pohnpei	FY2008	FY2009	FY2010	FY2011	FY2012	FY2013	FY2014
Agriculture, Hunting and Forestry	1.8%	2.3%	2.4%	0.5%	0.5%	0.5%	0.5%
Fisheries	3.7%	-2.9%	9.2%	0.6%	2.7%	2.6%	2.6%
Mining and Quarrying							
Manufacturing	21.3%	11.0%	14.6%	-1.1%	-1.8%	1.8%	2.3%
Electricity, Gas and Water Supply	-7.8%	2.1%	4.6%	-1.1%	-1.8%	1.8%	2.3%
Construction	26.5%	28.1%	36.1%	-16.8%	-29.8%	6.8%	13.2%
Wholesale and Retail Trade and Repairs	0.7%	-9.9%	4.5%	-1.1%	-1.8%	1.8%	2.3%
Hotels and Restaurants	-4.1%	-8.3%	1.0%	-4.6%	3.6%	3.6%	3.6%
Transport, Storage and Communications	-16.1%	1.7%	4.0%	-1.1%	-1.8%	1.8%	2.3%
Financial Intermediation	-6.5%	-20.9%	4.5%	-1.1%	-1.8%	1.8%	2.3%
Real Estate, Renting, Business Activities	-0.6%	0.7%	6.2%	0.0%	-0.2%	0.9%	1.1%
Public Administration	0.3%	0.4%	2.1%	2.7%	1.9%	2.0%	2.1%
Education	1.0%	-2.7%	0.8%	0.2%	-0.1%	0.0%	0.0%
Health and Social Work	2.0%	0.3%	9.5%	-0.3%	0.3%	-0.1%	0.0%
Other Community, Social, Personal Servic	-1.8%	0.1%	14.7%	-1.1%	-1.8%	1.8%	2.3%
less intermediate FISIM	2.4%	-13.6%	3.1%	-1.1%	-1.8%	1.8%	2.3%
GDP at basic prices	-0.3%	-0.9%	5.7%	-0.7%	-1.3%	1.5%	1.9%
Indirect Taxes	-4.7%	2.4%	5.2%	-2.5%	-3.0%	2.2%	2.9%
GDP at market prices	-0.6%	-0.7%	5.6%	-0.9%	-1.4%	1.5%	2.0%

Table A2 Continued

Yap	FY2008	FY2009	FY2010	FY2011	FY2012	FY2013	FY2014
Agriculture, Hunting and Forestry	**0.0%**	**-1.2%**	**1.4%**	**-0.1%**	**-0.1%**	**-0.1%**	**-0.1%**
Fisheries	**5.0%**	**-6.4%**	**-6.5%**	**6.5%**	**0.9%**	**-0.1%**	**-1.5%**
Mining and Quarrying							
Manufactuing	**15.0%**	**-28.0%**	**-2.5%**	**-1.1%**	**-1.8%**	**1.8%**	**2.3%**
Electricity, Gas and Water Supply	**-1.7%**	**2.8%**	**4.5%**	**-1.1%**	**-1.8%**	**1.8%**	**2.3%**
Construction	**7.4%**	**155.8%**	**-23.4%**	**-45.3%**	**-18.1%**	**17.8%**	**14.5%**
Wholesale and Retail Trade and Repairs	**6.5%**	**-4.5%**	**-2.6%**	**-1.1%**	**-1.8%**	**1.8%**	**2.3%**
Hotels and Restaurants	**-12.0%**	**-12.9%**	**0.0%**	**1.3%**	**0.9%**	**0.9%**	**0.9%**
Transport, Storage and Communications	**-5.9%**	**-13.5%**	**3.2%**	**-1.1%**	**-1.8%**	**1.8%**	**2.3%**
Financial Intermediation	**-19.1%**	**-11.8%**	**5.1%**	**-1.1%**	**-1.8%**	**1.8%**	**2.3%**
Real Estate, Renting, Business Activities	**0.8%**	**0.2%**	**-2.7%**	**-0.3%**	**-0.4%**	**0.3%**	**0.4%**
Public Administration	**-4.7%**	**4.5%**	**13.4%**	**-0.9%**	**0.2%**	**-0.1%**	**-0.1%**
Education	**0.8%**	**-0.5%**	**-5.1%**	**-2.5%**	**-1.4%**	**-1.4%**	**-1.5%**
Health and Social Work	**8.2%**	**6.3%**	**6.7%**	**2.0%**	**3.6%**	**3.5%**	**3.3%**
Other Community, Social, Personal Servic	**4.2%**	**8.7%**	**-0.7%**	**-1.1%**	**-1.8%**	**1.8%**	**2.3%**
less intermediate FISIM	**-9.1%**	**-6.7%**	**6.5%**	**-1.1%**	**-1.8%**	**1.8%**	**2.3%**
GDP at basic prices	**0.6%**	**2.0%**	**-2.1%**	**-2.4%**	**-0.9%**	**0.9%**	**0.8%**
Indirect Taxes	**-4.1%**	**7.3%**	**-9.3%**	**-4.5%**	**-2.4%**	**2.5%**	**3.0%**
GDP at market prices	**0.2%**	**2.4%**	**-2.7%**	**-2.6%**	**-1.0%**	**1.0%**	**1.0%**

Table A3 Statement of Government Operations, States, National and FSM, $M's (FY2008-FY2014)

Chuuk	FY2008	FY2009	FY2010	FY2011	FY2012	FY2013	FY2014
Total revenue and grants	27.2	31.2	32.8	31.6	30.9	30.7	30.4
Total revenue	5.0	5.4	7.4	7.1	6.9	7.1	7.1
Tax revenue	4.2	4.8	6.2	6.2	6.0	6.1	6.2
Wages and salary tax	0.7	0.9	1.0	1.0	0.9	0.9	0.9
Gross revenue tax	0.7	0.7	1.0	1.1	1.0	1.0	1.1
Import tax:Fuel	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Import tax:All others	0.9	0.9	1.3	1.3	1.2	1.2	1.3
Corporate tax	–	–	–				
All other tax (National)	–	–	–				
State tax revenue	1.9	2.1	2.8	2.9	2.8	2.8	2.9
Nontax revenue	0.9	0.6	1.2	0.9	0.9	1.0	0.9
Fishing access revenue	–	–	–				
Dividend and interest income	–	–	0.2	0.1	0.1	0.1	0.1
Other nontax revenues	0.9	0.6	1.0	0.8	0.8	0.9	0.9
Grants	22.2	25.8	25.4	24.4	24.0	23.6	23.2
Grants from abroad	22.2	25.7	25.4	24.4	24.0	23.6	23.2
Current grants	22.2	25.7	25.1	24.4	24.0	23.6	23.2
Compact General	–	–	–	–	–	–	–
Compact Special	18.5	25.6	24.9	24.1	23.7	23.3	23.0
Other:Current	3.7	0.2	0.3	0.3	0.3	0.3	0.3
Capital grants	–	–	0.3	–	–	–	–
Compact CIP	–	–	0.3	–	–	–	–
Other:Capital	–	–	–	–	–	–	–
Grants from national government	–	0.0	–				
Current	–	0.0	–				
Capital	–	–	–				
Total expenditure and net lending	-26.5	-28.7	-34.1	-32.5	-32.8	-32.8	-32.6
Total expenditure	-26.5	-28.7	-34.1	-32.5	-32.8	-32.8	-32.6
Current expenditure	-26.5	-27.0	-31.8	-31.2	-31.1	-31.0	-31.0
Expenditure on goods and services	-26.3	-26.9	-31.8	-31.1	-31.0	-31.0	-30.9
Wages and salaries	–	-15.8	-17.2	-16.3	-15.9	-15.5	-15.1
Travel	–	-0.6	-1.2	-1.2	-1.2	-1.3	-1.3
Other	-26.3	-10.5	-13.4	-13.6	-13.9	-14.2	-14.5
Interest payments	–	–	–				
Subsidies	-0.2	-0.0	-0.0	-0.1	-0.1	-0.1	-0.1
Transfers	–	-0.1	–	-0.0	-0.0	-0.0	-0.0
Less transfers to state govs	–	–	–				
Capital expenditure	–	-1.6	-2.3	-1.3	-1.8	-1.8	-1.6
Acquisition of fixed capital	–	-1.6	-2.3	-1.3	-1.8	-1.8	-1.6
Capital projects	–	–	–				
Capital transfers	–	–	–				
Net lending (domestic)	–	–	–				
Overall Balance	0.7	2.5	-1.3	-0.9	-1.9	-2.1	-2.2
Current Balance	0.7	4.2	0.7	0.4	-0.2	-0.3	-0.6
Capital Balance	–	-1.6	-2.0	-1.3	-1.8	-1.8	-1.6
Overall % GDP	0.9%	3.2%	-1.5%	-1.1%	-2.3%	-2.5%	-2.6%

Table A3 Continued

Kosrae	FY2008	FY2009	FY2010	FY2011	FY2012	FY2013	FY2014
Total revenue and grants	10.2	11.4	10.9	11.1	11.4	11.4	11.3
Total revenue	2.7	2.5	2.7	2.8	3.1	3.1	2.9
Tax revenue	2.2	2.0	1.9	2.2	2.4	2.4	2.2
Wages and salary tax	0.3	0.3	0.3	0.4	0.4	0.4	0.4
Gross revenue tax	0.3	0.3	0.3	0.4	0.5	0.5	0.4
Import tax:Fuel	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Import tax:All others	0.4	0.3	0.3	0.4	0.4	0.4	0.4
Corporate tax	--	--	--				
All other tax (National)	--	--	--				
State tax revenue	1.1	0.9	0.9	1.0	1.1	1.1	1.0
Nontax revenue	0.4	0.5	0.8	0.6	0.6	0.7	0.6
Fishing access revenue	--	--	--				
Dividend and interest income	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Other nontax revenues	0.3	0.4	0.7	0.5	0.5	0.6	0.5
Grants	7.5	8.9	8.2	8.3	8.4	8.3	8.4
Grants from abroad	7.4	8.9	8.1	8.2	8.3	8.3	8.4
Current grants	7.3	8.2	7.9	7.9	7.9	8.0	8.0
Compact General	--	--	--	--	--	--	--
Compact Special	6.9	8.0	7.7	7.7	7.7	7.8	7.8
Other:Current	0.4	0.2	0.2	0.2	0.2	0.2	0.2
Capital grants	0.1	0.6	0.2	0.3	0.4	0.3	0.3
Compact CIP	0.1	0.6	0.2	0.3	0.4	0.3	0.3
Other:Capital	--	--	--	--	--	--	--
Grants from national government	0.1	0.0	0.1	0.1	0.1	0.1	0.1
Current	--	--	--				
Capital	0.1	0.0	0.1	0.1	0.1	0.1	0.1
Total expenditure and net lending	-10.9	-11.0	-10.8	-10.7	-10.8	-11.1	-11.2
Total expenditure	-10.9	-11.0	-10.8	-10.7	-10.8	-11.1	-11.2
Current expenditure	-10.5	-10.2	-10.2	-10.4	-10.6	-10.8	-10.9
Expenditure on goods and services	-10.4	-10.2	-10.1	-10.4	-10.5	-10.7	-10.9
Wages and salaries	-5.7	-4.9	-4.9	-5.1	-5.1	-5.2	-5.3
Travel	-0.5	-0.5	-0.4	-0.4	-0.4	-0.4	-0.4
Other	-4.3	-4.7	-4.8	-4.9	-5.0	-5.1	-5.2
Interest payments	--	--	-0.0				
Subsidies	--	--	--	--	--	--	--
Transfers	-0.1	-0.1	--	-0.1	-0.0	-0.0	-0.0
Less transfers to state govs	--	--	--				
Capital expenditure	-0.3	-0.8	-0.6	-0.3	-0.2	-0.3	-0.3
Acquisition of fixed capital	-0.3	--	-0.5	-0.3	-0.2	-0.3	-0.3
Capital projects	-0.0	-0.8	-0.1				
Capital transfers	--	--	--				
Net lending (domestic)	--	--	--				
Overall Balance	-0.7	0.4	0.1	0.4	0.6	0.3	0.1
Current Balance	-0.6	0.5	0.4	0.7	0.9	0.7	0.3
Capital Balance	-0.1	-0.1	-0.3	0.1	0.1	-0.0	0.1
Overall % GDP	-3.8%	1.8%	0.6%	1.8%	2.6%	1.4%	0.3%

Table A3 Continued

Pohnpei	FY2008	FY2009	FY2010	FY2011	FY2012	FY2013	FY2014
Total revenue and grants	29.7	30.6	31.9	31.8	32.0	32.6	32.9
Total revenue	9.4	10.3	11.6	11.5	11.7	12.1	12.2
Tax revenue	8.3	9.2	9.8	10.1	10.3	10.6	10.8
Wages and salary tax	2.0	2.1	2.4	2.7	2.9	2.9	2.9
Gross revenue tax	1.6	1.9	2.2	2.2	2.1	2.2	2.3
Import tax:Fuel	0.3	0.4	0.3	0.4	0.3	0.3	0.3
Import tax:All others	1.7	1.8	1.8	1.8	1.8	1.9	2.0
Corporate tax	–	–	–				
All other tax (National)	–	–	–				
State tax revenue	2.8	2.9	3.0	3.0	3.1	3.2	3.3
Nontax revenue	1.1	1.1	1.8	1.3	1.4	1.5	1.4
Fishing access revenue	–	–	–				
Dividend and interest income	–	–	–	–	–	–	–
Other nontax revenues	1.1	1.1	1.8	1.3	1.4	1.5	1.4
Grants	20.3	20.4	20.2	20.3	20.3	20.5	20.6
Grants from abroad	20.2	20.3	20.2	20.2	20.3	20.4	20.5
Current grants	20.2	20.3	20.2	20.2	20.3	20.4	20.5
Compact General	–	–	–	–	–	–	–
Compact Special	18.0	17.8	17.7	17.7	17.7	17.8	17.9
Other:Current	2.2	2.4	2.5	2.5	2.6	2.6	2.7
Capital grants	–	–	–	–	–	–	–
Compact CIP	–	–	–	–	–	–	–
Other:Capital	–	–	–	–	–	–	–
Grants from national government	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Current	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Capital	–	–	–	–	–	–	–
Total expenditure and net lending	-33.4	-32.0	-32.3	-33.0	-33.7	-34.2	-34.9
Total expenditure	-33.4	-32.0	-32.3	-33.0	-33.7	-34.2	-34.9
Current expenditure	-32.8	-30.4	-31.3	-32.0	-32.6	-33.2	-33.8
Expenditure on goods and services	-31.2	-29.8	-31.0	-31.1	-32.1	-32.7	-33.4
Wages and salaries	-18.0	-17.9	-18.4	-18.4	-19.1	-19.5	-19.8
Travel	-1.0	-0.7	-1.0	-1.0	-1.1	-1.1	-1.1
Other	-12.3	-11.2	-11.5	-11.7	-11.9	-12.2	-12.5
Interest payments	–	–	–				
Subsidies	-1.6	-0.4	-0.4	-0.8	-0.4	-0.4	-0.4
Transfers	–	-0.2	–	-0.1	-0.1	-0.1	-0.1
Less transfers to state govs	–	–	–				
Capital expenditure	-0.6	-1.5	-0.9	-1.0	-1.1	-1.0	-1.1
Acquisition of fixed capital	-0.5	-1.1	-0.9	-0.8	-1.0	-0.9	-0.9
Capital projects	-0.1	-0.4	-0.0	-0.2	-0.2	-0.1	-0.2
Capital transfers	–	–	–				
Net lending (domestic)	–	–	–				
Overall Balance	-3.7	-1.3	-0.4	-1.2	-1.7	-1.6	-2.0
Current Balance	-3.1	0.2	0.5	-0.2	-0.6	-0.6	-0.9
Capital Balance	-0.6	-1.5	-0.9	-1.0	-1.1	-1.0	-1.1
Overall % GDP	-2.9%	-1.0%	-0.3%	-0.9%	-1.2%	-1.1%	-1.3%

Table A3 Continued

Yap	FY2008	FY2009	FY2010	FY2011	FY2012	FY2013	FY2014
Total revenue and grants	23.2	20.9	23.3	21.6	21.8	22.2	22.5
Total revenue	4.5	5.2	8.3	6.7	6.9	7.1	7.3
Tax revenue	3.5	3.8	4.0	3.4	3.5	3.6	3.7
Wages and salary tax	0.8	0.4	0.7	0.7	0.7	0.8	0.8
Gross revenue tax	0.5	0.9	1.2	0.6	0.6	0.7	0.7
Import tax:Fuel	0.1	0.1	0.1	0.1	0.1	0.1	0.1
Import tax:All others	0.8	0.9	0.7	0.7	0.7	0.7	0.8
Corporate tax	-	-	-				
All other tax (National)	-	-	-				
State tax revenue	1.4	1.6	1.3	1.3	1.3	1.4	1.4
Nontax revenue	0.9	1.5	4.3	3.3	3.4	3.5	3.6
Fishing access revenue	-	-	-				
Dividend and interest income	0.0	0.1	2.0	2.1	2.2	2.3	2.4
Other nontax revenues	0.9	1.3	2.3	1.2	1.2	1.2	1.2
Grants	18.7	15.7	15.0	14.8	14.9	15.1	15.2
Grants from abroad	18.1	15.3	14.5	14.3	14.5	14.6	14.7
Current grants	18.1	15.2	14.1	14.2	14.2	14.4	14.5
Compact General	-	-	-	-	-	-	-
Compact Special	12.7	11.4	11.6	11.5	11.6	11.6	11.7
Other:Current	5.4	3.8	2.6	2.6	2.7	2.7	2.8
Capital grants	-	0.1	0.4	0.2	0.2	0.3	0.2
Compact CIP	-	0.1	0.4	0.2	0.2	0.3	0.2
Other:Capital	-	-	-	-	-	-	-
Grants from national government	0.6	0.4	0.5	0.5	0.5	0.5	0.5
Current	0.0	0.1	0.0	0.0	0.0	0.0	0.0
Capital	0.5	0.4	0.5	0.5	0.4	0.4	0.4
Total expenditure and net lending	-25.5	-23.3	-21.7	-23.6	-23.5	-23.8	-24.7
Total expenditure	-25.5	-23.3	-21.7	-23.6	-23.5	-23.8	-24.7
Current expenditure	-20.3	-19.4	-19.2	-19.7	-20.1	-20.6	-21.2
Expenditure on goods and services	-19.1	-18.4	-18.5	-18.8	-19.2	-19.8	-20.3
Wages and salaries	-7.6	-8.0	-8.5	-8.6	-8.9	-9.2	-9.4
Travel	-1.1	-1.2	-1.1	-1.1	-1.1	-1.1	-1.1
Other	-10.5	-9.2	-9.0	-9.1	-9.3	-9.5	-9.7
Interest payments	-	-0.0	-0.1	-0.0	-0.0	-0.0	-0.0
Subsidies	-0.5	-0.8	-0.3	-0.5	-0.6	-0.5	-0.5
Transfers	-0.7	-0.2	-0.3	-0.4	-0.3	-0.3	-0.3
Less transfers to state govs	-	-	-				
Capital expenditure	-5.2	-3.8	-2.5	-3.8	-3.4	-3.2	-3.5
Acquisition of fixed capital	-3.4	-1.9	-2.0	-2.4	-2.1	-2.2	-2.2
Capital projects	-1.8	-2.0	-0.5	-1.4	-1.3	-1.1	-1.3
Capital transfers	-	-	-				
Net lending (domestic)	-	-	-				
Overall Balance	-2.3	-2.4	1.6	-2.0	-1.7	-1.6	-2.1
Current Balance	2.4	1.0	3.3	1.8	1.7	1.6	1.3
Capital Balance	-4.7	-3.4	-1.6	-3.7	-3.2	-3.0	-3.3
Overall % GDP	-4.9%	-4.6%	3.2%	-4.0%	-3.4%	-3.1%	-4.0%

Table A3 Continued

National	FY2008	FY2009	FY2010	FY2011	FY2012	FY2013	FY2014
Total revenue and grants	60.3	89.2	104.2	93.0	86.2	93.1	96.4
Total revenue	33.8	35.9	36.2	38.3	39.8	42.0	44.0
Tax revenue	11.1	12.0	13.4	14.4	14.7	15.2	15.6
Wages and salary tax	3.6	3.5	3.5	4.8	5.0	5.1	5.0
Gross revenue tax	3.4	3.9	4.1	4.3	4.3	4.4	4.5
Import tax:Fuel	0.1	0.2	0.1	0.1	0.1	0.1	0.1
Import tax:All others	4.0	4.4	4.8	4.2	4.1	4.2	4.3
Corporate tax	0.0	0.1	0.8	1.0	1.2	1.4	1.6
All other tax (National)	--	--	--				
State tax revenue	--	--	--				
Nontax revenue	22.7	23.9	22.8	23.9	25.1	26.8	28.4
Fishing access revenue	17.0	20.0	17.7	19.0	20.5	22.0	23.6
Dividend and interest income	0.3	0.5	0.5	0.4	0.5	0.4	0.4
Other nontax revenues	5.3	3.4	4.6	4.4	4.1	4.4	4.3
Grants	26.4	53.4	68.0	54.7	46.5	51.1	52.4
Grants from abroad	26.4	53.4	68.0	54.7	46.5	51.1	52.4
Current grants	11.2	15.0	18.2	18.4	18.7	19.1	19.4
Compact General	--	--	--	--	--	--	--
Compact Special	1.9	2.9	4.0	4.0	4.1	4.1	4.1
Other:Current	9.3	12.1	14.2	14.4	14.7	15.0	15.4
Capital grants	15.3	38.3	49.8	36.3	27.7	32.0	33.0
Compact infrastructure	4.7	6.8	15.5	10.5	15.9	27.5	33.0
Other:Capital	10.5	31.6	34.3	25.8	11.8	4.5	--
Grants from national government	--	--	--				
Current	--	--	--				
Capital	--	--	--	--	--	--	--
Total expenditure and net lending	-58.8	-83.9	-100.9	-86.3	-79.2	-85.1	-87.6
Total expenditure	-58.8	-83.9	-100.9	-86.3	-79.2	-85.1	-87.6
Current expenditure	-41.8	-44.9	-49.5	-50.0	-51.5	-53.1	-54.6
Expenditure on goods and services	-40.4	-43.6	-47.7	-48.5	-50.0	-51.5	-53.1
Wages and salaries	--	-16.5	-17.4	-17.8	-18.6	-19.4	-20.3
Travel	--	-5.3	-6.3	-6.4	-6.5	-6.7	-6.8
Other	-40.4	-21.8	-24.0	-24.4	-24.9	-25.5	-26.0
Interest payments	--	-0.1	--				
Subsidies	-0.6	-1.2	-1.8	-1.2	-1.4	-1.4	-1.3
Transfers	-0.7	-0.0	-0.1	-0.3	-0.1	-0.2	-0.2
Less transfers to state govs	--	--	--				
Capital expenditure	-17.0	-39.0	-51.4	-36.3	-27.7	-32.0	-33.0
Acquisition of fixed capital	-10.5	-33.4	-34.3	-25.8	-11.8	-4.5	--
Capital projects	-6.5	-5.6	-15.5	-10.5	-15.9	-27.5	-33.0
Capital transfers	--	--	-1.6				
Net lending (domestic)	--	--	--				
Overall Balance	1.5	5.4	3.3	6.7	7.0	8.0	8.8
Current Balance	3.2	6.0	4.9	6.7	7.0	8.0	8.8
Capital Balance	-1.7	-0.7	-1.6	--	--	--	--
Overall % GDP	0.6%	1.9%	1.1%	2.2%	2.3%	2.6%	2.8%

Table A3 Continued

FSM	FY2008	FY2009	FY2010	FY2011	FY2012	FY2013	FY2014
Total revenue and grants	149.8	182.8	202.5	188.3	181.7	189.4	192.9
Total revenue	55.4	59.3	66.2	66.4	68.2	71.4	73.6
Tax revenue	29.3	31.7	35.3	36.4	36.8	37.9	38.6
Wages and salary tax	7.3	7.1	7.9	9.5	10.0	10.1	9.9
Gross revenue tax	6.4	7.8	8.9	8.7	8.5	8.8	9.0
Import tax:Fuel	0.7	0.8	0.8	0.7	0.7	0.7	0.6
Import tax:All others	7.7	8.4	8.9	8.3	8.3	8.5	8.7
Corporate tax	0.0	0.1	0.8	1.0	1.2	1.4	1.6
All other tax (National)	--	--	--	--	--	--	--
State tax revenue	7.1	7.5	8.0	8.2	8.2	8.4	8.7
Nontax revenue	26.1	27.6	30.9	30.0	31.4	33.5	35.0
Fishing access revenue	17.0	20.0	17.7	19.0	20.5	22.0	23.6
Dividend and interest income	0.5	0.7	2.7	2.7	2.8	2.9	3.0
Other nontax revenues	8.6	6.8	10.5	8.3	8.1	8.6	8.3
Grants	94.3	123.5	136.2	121.9	113.5	118.0	119.3
Grants from abroad	94.3	123.5	136.2	121.9	113.5	118.0	119.3
Current grants	79.0	84.4	85.6	85.1	85.2	85.5	85.7
Compact General	--	--	--	--	--	--	--
Compact Special	57.9	65.8	65.9	65.1	64.8	64.6	64.4
Other:Current	21.1	18.7	19.7	20.0	20.4	20.9	21.3
Capital grants	15.4	39.1	50.7	36.8	28.3	32.6	33.6
Compact CIP	4.9	7.5	16.3	11.0	16.5	28.1	33.6
Other:Capital	10.5	31.6	34.3	25.8	11.8	4.5	--
Grants from national government	--	--	--	0.7	0.6	0.6	0.6
Current	--	--	--	0.1	0.1	0.1	0.1
Capital	--	--	--	0.5	0.5	0.5	0.5
Total expenditure and net lending	-154.2	-178.2	-199.1	-186.1	-180.1	-187.1	-191.0
Total expenditure	-154.2	-178.2	-199.1	-186.1	-180.1	-187.1	-191.0
Current expenditure	-131.1	-131.4	-141.4	-143.3	-145.8	-148.7	-151.6
Expenditure on goods and services	-127.5	-128.9	-139.1	-139.9	-142.8	-145.7	-148.6
Wages and salaries	-31.3	-63.1	-66.4	-66.2	-67.6	-68.7	-69.9
Travel	-2.5	-8.3	-10.0	-10.1	-10.3	-10.6	-10.8
Other	-93.8	-57.5	-62.7	-63.6	-64.9	-66.4	-67.9
Interest payments	--	-0.1	-0.1	-0.0	-0.0	-0.0	-0.0
Subsidies	-2.9	-2.3	-2.5	-2.6	-2.3	-2.4	-2.3
Transfers	-1.5	-0.6	-0.4	-0.8	-0.6	-0.6	-0.7
Less transfers to state govs	0.8	0.6	0.6	--	--	--	--
Capital expenditure	-23.1	-46.8	-57.7	-42.7	-34.3	-38.4	-39.4
Acquisition of fixed capital	-14.7	-38.0	-40.0	-30.6	-16.9	-9.7	-5.0
Capital projects	-8.4	-8.8	-16.0	-12.1	-17.4	-28.7	-34.4
Capital transfers	--	--	-1.6	--	--	--	--
Net lending (domestic)	--	--	--	--	--	--	--
Overall Balance	-4.5	4.6	3.4	2.2	1.7	2.4	1.8
Current Balance	3.2	12.3	10.4	8.2	7.6	8.2	7.7
Capital Balance	-7.7	-7.7	-7.0	-5.9	-5.9	-5.8	-5.9
Overall % GDP	-1.7%	1.6%	1.1%	0.7%	0.5%	0.8%	0.6%