Federated States of Micronesia

FY 2009

Fiscal Year 2009 Economic Review

SUMMARY DOCUMENT

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US Department of the Interior
Office of Insular Affairs

GRADUATE SCHOOL
PACIFIC ISLANDS TRAINING INITIATIVE
www.pitiviti.org

Currency Equivalents

Currency Unit	—	United States Dollar (US$)

Abbreviations

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

Note

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

Table of Contents

TABLES

FIGURES

FOREWORD

This Summary presents the major findings and conclusions of the FY2009 FSM Economic Review. The purpose of the Review is to assist the government of the Federated States of Micronesia and U.S. Department of the Interior in fulfilling their respective reporting obligations under the Compact of Free Association. The FSM is required under Title One, section 214, to report to the President of the U.S. on the use of sector grant assistance and progress in meeting mutually agreed-upon program and economic goals. In the case of the U.S., under Title One, Section 104.h, the President is required to submit a similar report to the Congress concerning developments in the FSM.

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

Mark Sturton

EXECUTIVE SUMMARY

Since the introduction of the amended Compact in FY2003, the FSM has experienced a decline in economic activity in four out of the initial six years. The reduction in Compact resources, capacity constraints in fulfilling the new fiscal procedures—especially with respect to infrastructure grant implementation, and the need to transition away from the use of the capacity-building sector grant from general government operations have caused a significant reduction in economic activity. Real per-capita incomes have fallen from $2,346 to $2,278, a reduction of 2.9 percent. The fall in economic activity has been accompanied by a reduction in employment, by 963 jobs, or 6% of those employed. As incomes have fallen, the economy has failed to provide productive opportunities to the population, outward migration has continued at 2.1% 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. However, since implementation of the adjustment measures, the fiscal deficit recorded a surplus of 2% of GDP for the first time in the amended Compact. The FSM has maintained a favorable external debt position, which has eased its fiscal position.

The new sector-grant approach resulted in a system that provided sufficient funding to maintain the operations of education and health sectors in particular, but was not designed to support the ongoing operational needs of many government functions. In order to reduce the cost of adjustment, the U.S. permitted the FSM to utilize the capacity-building sector grant to fund general operations, provided that this practice would be transitioned out over a five-year period. In the initial years, adjustment was achieved without difficulty due to the back-loading of adjustments by the state governments. Not unexpectedly, implementation of the transition in the final two years was a painful experience and required implementation of a reduction-in-force and other substantial fiscal reform measures in Chuuk and Kosrae. While employment levels in the public sector have now returned to those achieved after the reforms in the late 1990s, average wage costs have risen strongly by 20% or 3% per annum during the amended Compact period and are a cause of concern. Complementing the expenditure adjustments the FSM has focused on the implementation of revenue reforms and the adoption of a modern tax regime. These measures were intended to ease the adjustment to the amended Compact. However, progress has been painfully slow, and only recently has the suite of reform bills been transmitted to the Congress. With elections coming up in March of 2011 further delays are anticipated.

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. However, the Trust Fund Agreement specifies a withdrawal rule that is precisely based upon the FY2023 annual grant assistance level plus full inflation. If the returns in a post-2024 year are insufficient and if the "C" account, established as a buffer, is empty, the FSM would suffer a severe fiscal shock. Zero funds would be made available for budgetary or investment support in such an event. For this and several other compelling reasons it makes sense for the FSM and the US to consider modifications to Trust Fund Agreement to correct the poorly specified buffer account and withdrawal rules embedded in the Trust Fund Agreement so as to reduce the risk of a fiscal shock of such immense proportions. Such an effort should also correct the flaw that leaves only the nominal value of the Trust Fund protected, despite the fact that the parties almost assuredly thought they were designing a Trust Fund mechanism that would protect the real (inflation-adjusted) value of the *corpus*.

It is also imperative that the FSM Government makes every effort to assess the Trust Fund's performance against a sensible goal. That sensible goal is taken to be 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 $1.795 billion at the outset of FY2024. Comparing actual performance to a smooth trend line signifying "on-track" performance, the Trust Fund would have reached $247.3 million as of June 30, 2010; however, the actual value was just $160.5 million. Even if the returns from this date forward were to average the trend line rate of 10.75% annually, the final value of the fund at the outset of FY2024 would be just 83 percent of the target level, falling short by $301.8 million. To offset this trend to-date, the investment return required for the remaining 13.25 years of the amended Compact period is estimated at an annually compounded rate of return of 12.71%. This "catch-up" rate of return is highly unlikely to be achieved. To achieve such a return given the current investment policy established by the FSM Trust Fund Committee would require sustained market returns far in excess of asset class-weighted historical returns.

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 the status quo policy environment and resulted in a projection of substantial and sustained outmigration. However, performance of the FSM economy currently places it firmly below the dismal trajectory; economic growth has been negative, and there has been large outmigration resulting in negative population growth. The Summit focused on the need for private sector investment and policy reforms to lift growth. However, attention during the initial years of the amended Compact was directed toward fiscal adjustment to the reduced funding levels and modified procedures under the new regime: tax reform and fiscal compression. The adjustment is now complete and attention must now be directed to how to maintain public services in the face of the annual decrement and lack of full inflation indexation of the sector grants. While orderly "decrement" management is clearly essential, to improve the outcome in the remaining years of the amended Compact the need remains for the nation to return to, and presumably update, the policy agenda initiated during the 3rd Economic Summit: implement a sustained-growth strategy and take measures necessary to encourage private sector development.

I. ECONOMIC PERFORMANCE

From the start of Compact I until the mid-1990s both real GDP and real GDP per capita expanded significantly. Real GDP rose from $180 to $240 million in FY2004 prices, while GDP per capita increased from $1,998 to $2,267 (1987-1995) – or 3.6% and 1.6% per annum, respectively. However, performance from the mid-1990s through the end of Compact I and into the amended Compact period was far from satisfactory; GDP levels oscillated but overall fell by an annual average of 0.2%, while real per-capita incomes remained unchanged (1995-2009; see Fig. 1), aided, of course by the decline in population.

Positive growth in GDP and incomes during first 10 year of Compact I.

The period FY1995 through FY2009 can be usefully analyzed as three separate intervals: the impact of the second stepdown, FY1995-FY1997; recovery and the bump-up years, FY1997-FY2003; and the new, amended-Compact period, FY2004-FY2009. The impact of the second stepdown of Compact I funding in FY1997 was large and required a painful adjustment. Supported by an ADB Public Sector Reform Program Loan, an Early Retirement Program and associated fiscal reforms were initiated to reduce the number of public servants to an affordable level and to restore fiscal balance. By loan close-out in December 1999, the work force had been reduced by 23% against a target of 27%, and

Second step down in Compact I induces sharp contraction in the economy.

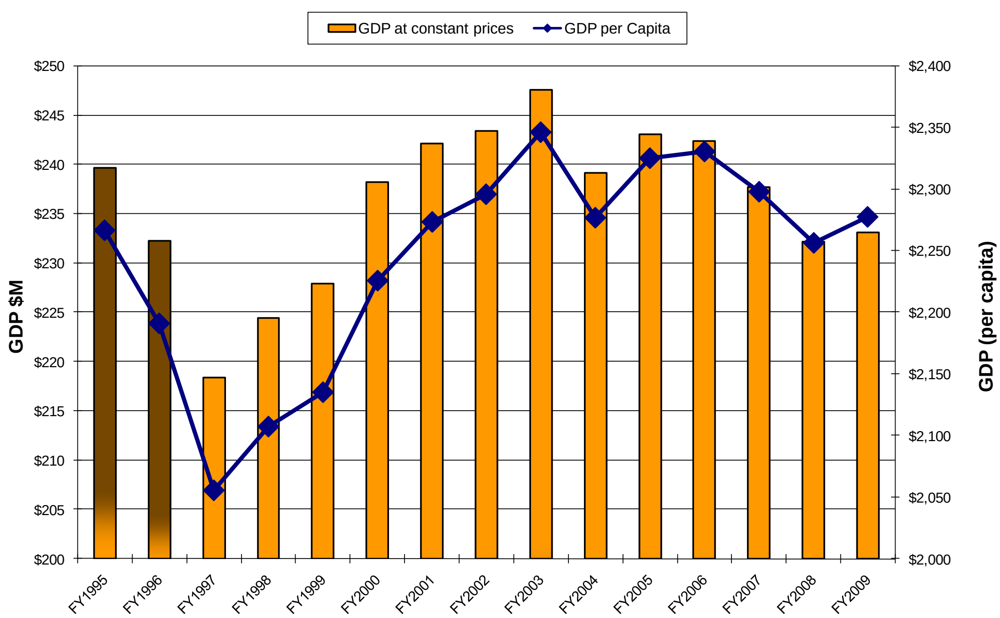


Figure 1 Real GDP and real GDP per capita

the wage bill had been cut by 29% against a target of 35%. Not unsurprisingly, the adjustment required to restore fiscal balance after the second stepdown had a significant negative impact on the economy.

Final years of Compact I experience moderate but sustained growth.

With the adjustment to the second step-down complete, the economy returned to a period of sustained economic growth during the last seven years of Compact I, FY1997-FY2003. During FY2002 and FY2003 the economy benefited from the infusion of the “bump-up” funds and continued to expand despite the need to set aside $30 million to the Compact Trust Fund (CTF). Overall, during the final years of Compact I the economy grew by an annual average of 2.1% per annum, and surpassed the level attained in FY1995.

Implementation of amended Compact initiates a period of decline.

GDP growth records a negative annual average of 1% during initial six years.

At the start of the start of the amended Compact the economy went into a period of decline, as the level of external transfers fell to the new, lower negotiated levels: a reduction from $84 million (the trend Compact I level 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.

Economy contracts sharply in FY2007 and FY2008 with the implementation of a Reduction in Force in Chuuk and Kosrae coupled with onset of world recession

In FY2004 the economy fell sharply by 3.4% with the reduction in funding. Some of the lost ground was recouped in FY2005, but growth turned negative in each of the subsequent three years. In FY2007 both Chuuk and Kosrae were required to implement a sizeable Reduction in Force (RIF), amongst other fiscal measures, to restore fiscal balance, as the capacity building sector grant was phased out from non-conforming purposes and the economy contracted by 1.9%. 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 2.3%. While the international economic conditions remained adverse in FY2009 strong growth in construction and airport renovation resulted in small but positive growth in the economy of 0.4%. Overall GDP growth fell in four out of the initial six years of the amended Compact and averaged a negative 1.0% over the period.

FSM economy is dominated by large public sector.

The structure of the FSM economy is dominated by a large public sector, with a dependent private sector producing non-traded goods and services to the government and its employees (Fig. 2). The share of government has declined significantly, by 10.9%, since the beginning of Compact I. This reflects three major forces: (i) a

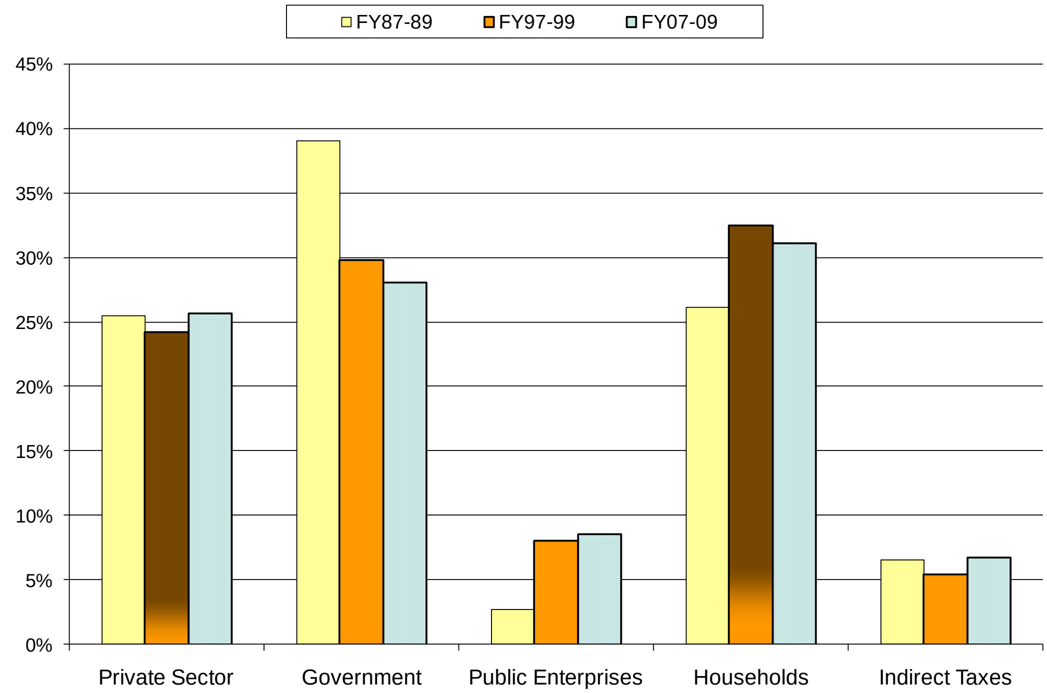


Figure 2 The institutional structure of the FSM economy (percent)

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

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

The share of the private sector since the start of Compact I has remained virtually unchanged at 25%. Given the reductions in the share of the public sector including PSEs this result is surprising. Compensating for the public sector decline the share of households has increased. The household sector includes market production of commodities, non-market production (subsistence) and home ownership. The total share of households has risen by 5.1% entirely offsetting the decline in the public sector. In essence the failure of the private sector to become the engine of growth has resulted in

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

households falling back on their own resources and devoting increase efforts to subsistence production.

Public investment in fisheries is unprofitable and enterprises are now either defunct or under private sector management.

Tourism has not lived up to potential

Reflecting the low share of the private sector, economic performance in the leading sectors of market agriculture, fisheries and tourism has not lived up to hopes or expectations. With a vast marine resource falling under FSM jurisdiction, it might be anticipated that fisheries would be a well-developed sector making a significant contribution to GDP. In the early 1990s, in an attempt to develop the economy, the FSM embarked upon a strategy of substantial public sector investment in fisheries facilities and enterprises. However, none of the fisheries enterprises achieved profitability, and over time the surviving entities were transferred to private ownership or management. This is a welcome development that hopefully sets a path for future expansion. Tourism, clearly a sector with comparative advantage for the FSM, has not fulfilled its potential, and sector GDP has declined by an annual average of 2.3% since 1995 and 4.5% during the amended Compact.

Real incomes stagnate and job prospects deteriorate during FY95-09.

Outmigration rises in response to the lack of economic opportunities.

The change in GDP per capita and employment in each of the FSM states is indicated in Fig. 3. In all states, real incomes have remained largely stagnant since FY1995, and employment opportunities have fallen with the exception of Pohnpei, reflecting the poor economic performance during the last 14 years. As a result of the decline or stagnation in incomes, outmigration as measured by

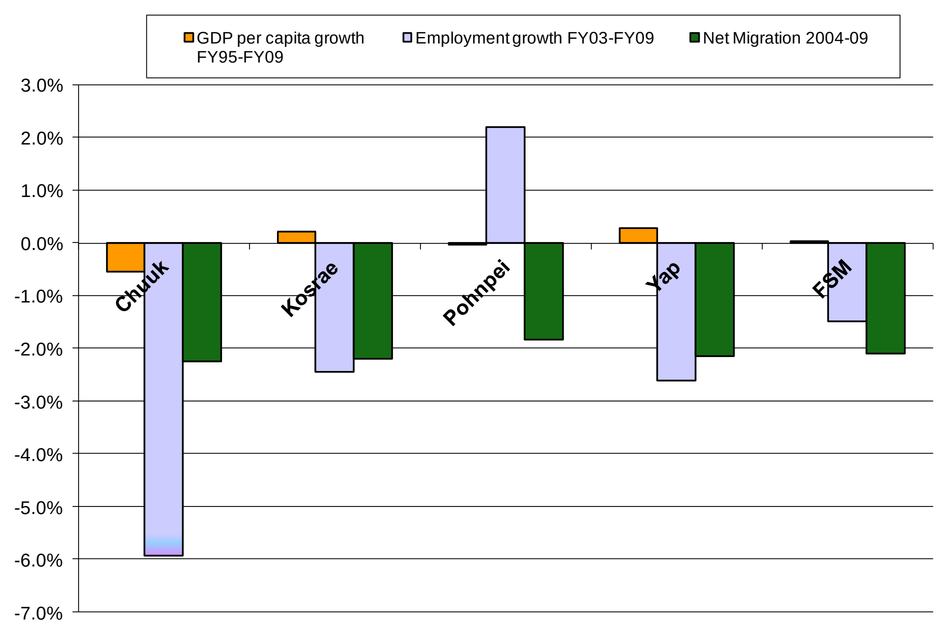


Figure 3 Growth in GDP in per capita, employment, and migration.

net movements of air passengers leaving the FSM during 2004-09 has also been large. Clearly, there is a strong association between economic performance, employment prospects and outmigration. Even in Pohnpei, where real incomes were stagnant but job opportunities improved slightly, outmigration was strong.

Reflecting the weak economic performance, employment has stagnated, and over 1,773 jobs were lost between FY1995 and FY2009. Much of the loss reflected the reduction in the size of the public sector (Fig. 4). Public sector jobs fell by 1,446, following the reductions in public service as part of the Early Retirement Program after the second step-down during the late 1990s. While public sector employment expanded in the early 2000s, it has dropped by 335 jobs since the implementation of the RIFs in Chuuk and Kosrae. Private employment surpassed the public sector as the largest employer for the first time in FY2000, but 269 private jobs have since been lost. Wage differentials between the private and public sectors remains substantial and have grown slightly since the mid 1990s. In Yap the wage differential fell significantly, but in Chuuk it widened significantly—primarily due to the composition of the RIF program which released many lower wage government employees—and remained little changed in Ko-

Employment levels fall reflecting public sector downsizing. Private sector employment fails to fill the gap.

Private public wage differentials remain largely unchanged.

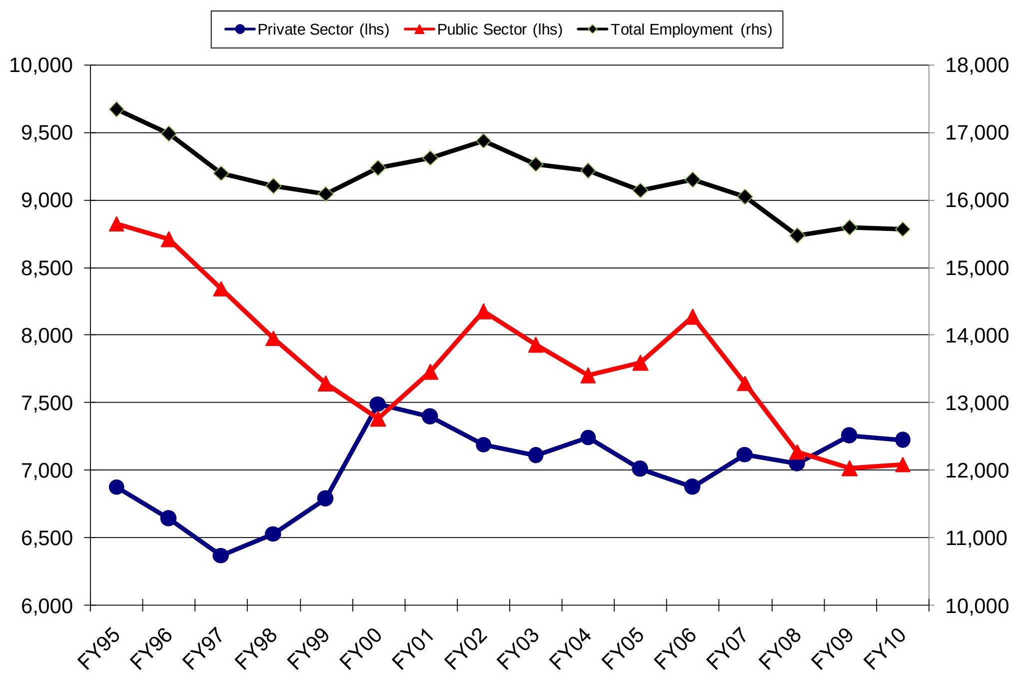


Figure 4 Employment by sector FY1995-FY2009.
Note lhs = left-hand side; rhs = right-hand side

srae and Pohnpei.

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

Inflation has generally been moderate in the FSM and has followed patterns in the U.S. However, recent increases in energy and food prices have altered these trends, and inflation reached double digits at the end of FY2008. Fig. 5 indicates changes in the CPI since the start of the amended Compact. In 2005 rising world energy prices caused a significant shock to the FSM economy. Inflation in the energy group of the CPI peaked at over 25% in the third quarter of 2005, and inflation in overall consumer prices rose to 5%, approximately 1% above U.S. rates. However, while the increase in the CPI was well above historical rates, the impact of increases in energy prices on the average household (due to the low weight of energy in the CPI) was not great. It was the very sizeable increases in world food prices during the second half of 2008 that resulted in a radical rise of the FSM's traditionally low inflationary profile, to double digits. The recent large reductions in energy prices, return to balance in world food markets, and impact of the world recession on imported items led to moderation in inflation by the end of FY2009.

Data from the banking sector have generally indicated a disappointing outcome. Total loans to the private sector (both commer-

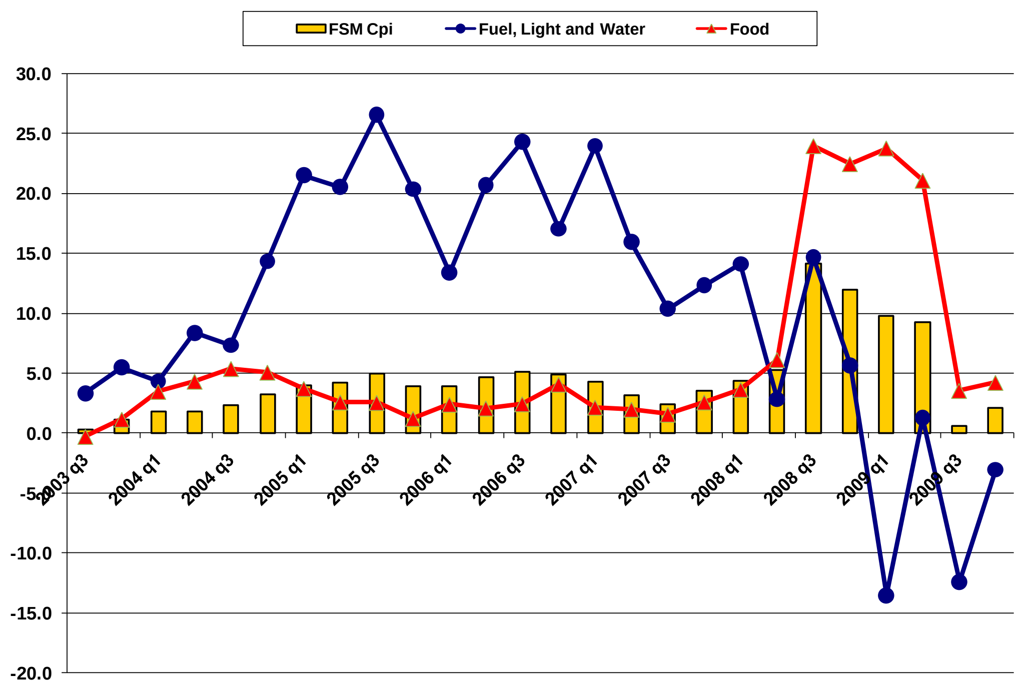
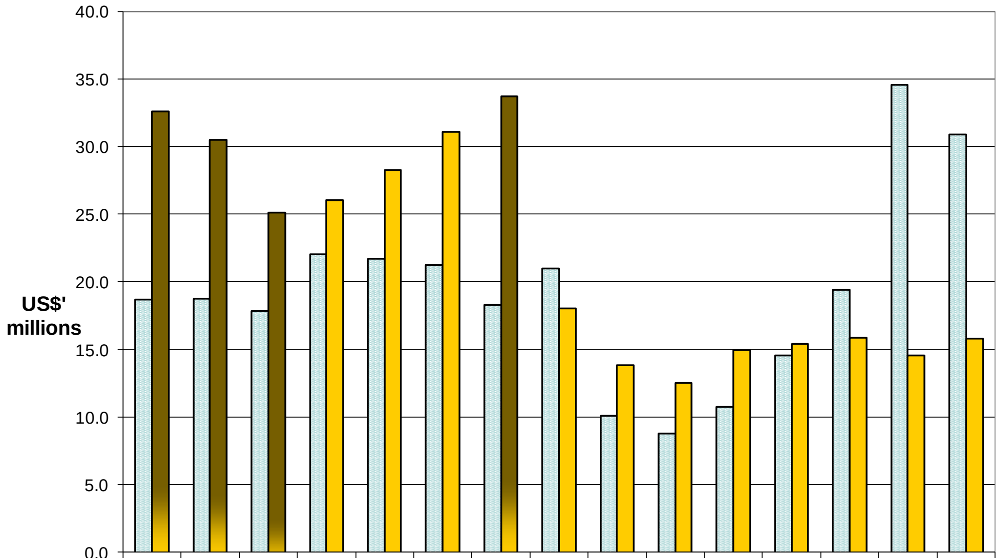


Figure 5 Inflation in consumer, food and energy prices (year on year percent change)



	1995	1996	1997	1998	1999	2000	2001	2002	2003	2004	2005	2006	2007	2008	2009
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
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

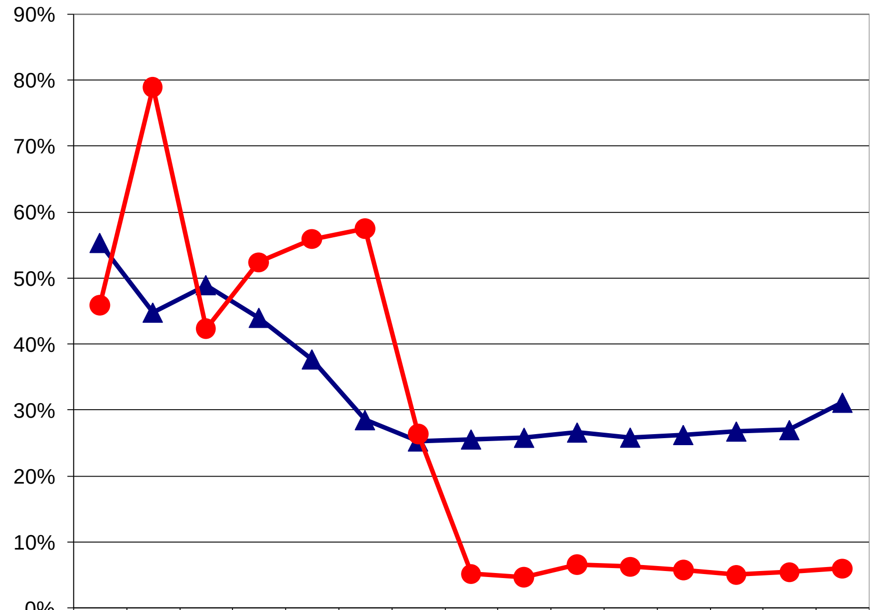
Figure 6 Commercial bank credit by sector, FY00-FY09.

cial and consumer) fell from a level of $52 million in FY2000 to $21 million in FY2004 (Fig. 6). This reflects a variety of factors. The Chuck state financial crisis in the early 2000s led to a reduction in consumer credit. Early in 2002 the Bank of Hawaii, the largest player in the FSM market, withdrew from the FSM, reflecting a corporate strategy to sell off many of its Pacific assets. Since that time the situation has shown signs of improvement, with lending to the commercial sector growing significantly, although this includes a large loan to the newly formed Micronesian Petro Corp and lending in Saipan by the Bank of the FSM. However, consumer credit remains weak. Despite these developments the FSM banking sector remains highly liquid, and the loans-to-deposit ratio was 35% at the end of FY2009. This reflects the high level of perceived risk in the FSM and "lack of bankable projects." Lack of collateral, inability to use land as security, and inadequate provision to secure transactions have inhibited development of the financial sector. With limited opportunities, commercial banks have preferred to invest their assets off-shore in less risky and more secure markets.

Lending to the private sector fell significantly between FY95 and FY04 but during the amended Compact has shown signs of improvement.

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

Although many of the economic indicators do not paint a favorable picture of recent performance, the FSM has maintained a favorable external debt profile (Fig. 7). After a period of sizeable borrowing in the early 1990s (secured against future Compact flows) to finance development projects, many of them in the fisheries sectors, external debt has fallen significantly. Debt-to-GDP has fallen



	FY1995	FY1996	FY1997	FY1998	FY1999	FY2000	FY2001	FY2002	FY2003	FY2004	FY2005	FY2006	FY2007	FY2008	FY2009
External Debt, % of GDP	55%	45%	49%	44%	38%	28%	25%	26%	26%	27%	26%	26%	27%	27%	31%
Debt Service, % of Exports	46%	79%	42%	52%	56%	57%	26%	5%	5%	7%	6%	6%	5%	5%	6%

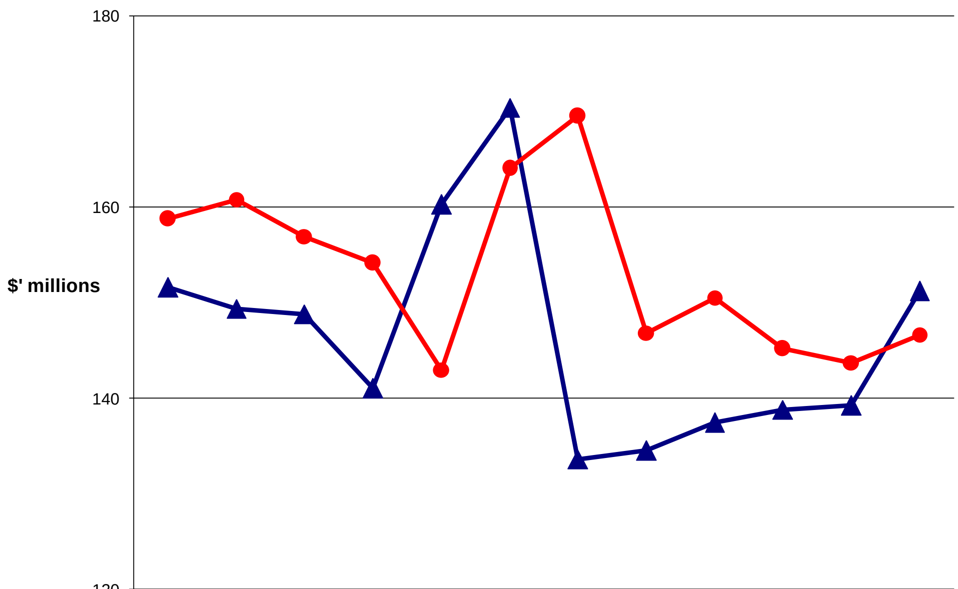
Figure 7 FSM external debt ratios, FY95-FY09

The FSM maintains a favorable external debt profile.

from 55% in FY1995 to 31% in FY2009, and debt service ratios remain very favorable by international standards, reflecting the concessionary nature of the remaining outstanding debt. There has been some increase in borrowing from the ADB in recent years, and in FY2009 FSM Telecom borrowed $11.1 million to finance installation of a fiber optic connection to the U.S. backbone. As a result the ratio of debt to nominal GDP has risen slightly.

FSM runs substantial deficits after second stepdown.

Subsequent to the second stepdown in funding of Compact I, the fiscal account came under severe pressure between FY1998 and FY2001, 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 (Fig. 8). The fiscal deterioration was compounded by a loss in fishing fee revenues, which fell from an average of $21 million per annum before the second step-down to $13 million during the remainder of Compact I. The large recorded deficits were financed through the drawdown of savings accumulated during the early phase of the Compact. The FSM fiscal accounts recorded overall surpluses during the two “bump-up” years in FY2002 and FY2003, as the nation was required to save the excess funds to contribute to the amended Compact Trust Fund (CTF).



	FY98	FY99	FY00	FY01	FY02	FY03	FY04	FY05	FY06	FY07	FY08	FY09
Revenues	151.6	149.4	148.8	141.1	160.3	170.4	133.6	134.6	137.5	138.8	139.2	151.2
Expenditures	158.8	160.8	156.9	154.2	143.0	164.1	169.5	146.9	150.5	145.2	143.7	146.7

Figure 8 FSM consolidated revenues and expenditures, FY98-FY09.

The first five years of the amended Compact witnessed a difficult period of fiscal adjustment, as the nation was forced to adapt to the new arrangements. At the start of the amended Compact in FY2004 the FSM recorded a deficit of $36 million (16% of GDP), reflecting the capital transfer of $30 million to the trust fund and the return to funding levels below those prevailing before the pre-bump-up period. In the subsequent years FY2005 and FY2006, deficits of $12 and $15 million—or 5% and 6% of GDP, respectively—were recorded. The amended Compact restricted the use of resources to specified sectors, and prohibited their use to fund general government. To ease the adjustment the U.S. permitted the use of the capacity building grant to fund specific activities, provided these were transitioned out over a five-year period. There was a gradual improvement in the fiscal position as the nation adjusted to the new requirements and implemented RIFs in Chuuk and Kosrae. By FY2009 the adjustment to the new sector grant approach was complete, and the FSM recorded a surplus of $5 million or 2% of GDP. However, while a surplus was recorded at the FSM level this disguised a substantial deficit and imbalance in Yap of 5% of state GDP.

After a period of fiscal surplus in the bump-up years, the FSM returns to deficit at the start of Compact II as the nation adjusts to the new arrangements.

FSM achieves fiscal surplus in FY2009 indicating adjustment to the sector grant approach is complete.

However, Yap recorded a significant imbalance.

II. POLICY DEVELOPMENTS, PROSPECTS, AND ISSUES

A major objective of the Compact has been the attainment of economic self-reliance. However, at the beginning of Compact I the policy environment in the FSM was hostile to the private sector, inward-oriented, and supportive of large government. With the awareness of the second Compact stepdown in 1995, the recognition emerged 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 state and national governments.

FSM embarks on a program of public sector reform and makes significant achievement in reduction of the number of public servants.

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. The major component of the PSRP was the compression of expenditures and reduction in workforce and payroll (Fig. 9). In terms of numbers of public servants the PSRP set a target reduction of 27%. By FY1999 a 16%

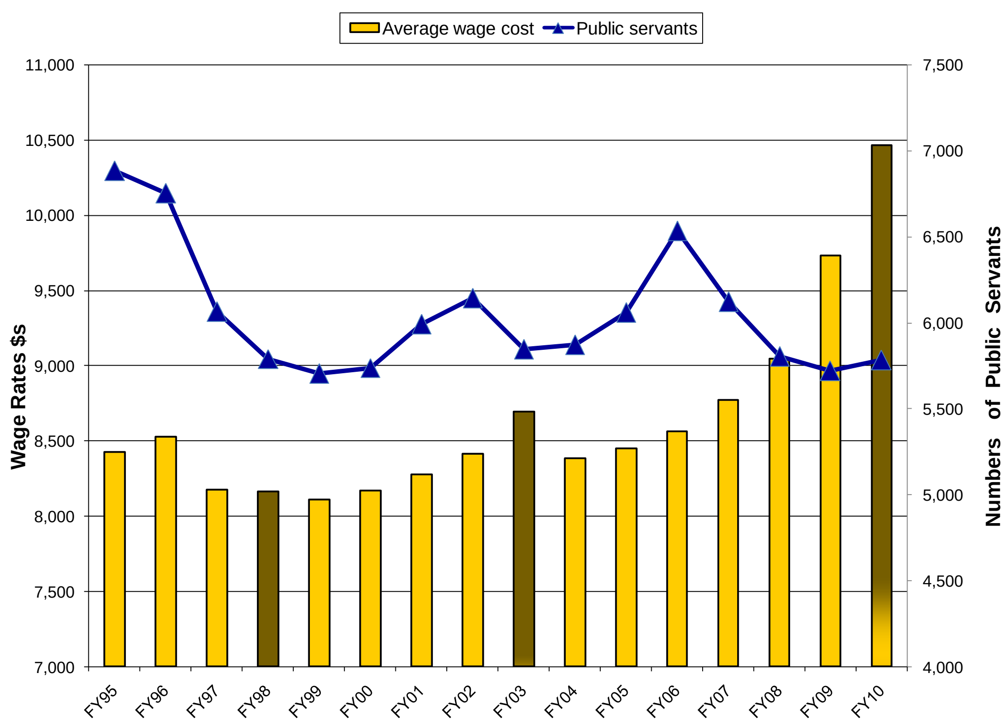


Figure 9 FSM public servant numbers and average wage cost FY95-FY10.

reduction had been achieved. While there was significant growth in numbers in the early 2000s this was reversed out by the RIFs in Chuuk and Kosrae, and at the current time, in FY2010, the reduction stands slightly lower at 15%, which is still a considerable achievement. The story, however, in terms of payroll cost is significantly different. From an initial target savings of 35% of payroll costs, the five governments of the FSM had attained 21% by the time of the PSRP closeout in FY1999. By FY2010, more than ten years later, the benefits of the PSRP had been completely eroded and payroll costs stood 6% above the original level and costs had increased by 2.9 million.

Significant growth in wage costs during amended Compact requires development of a wage policy consistent with financial stability and skill retention.

With numbers remaining in check, but payroll costs rising, average wages have risen strongly during the amended Compact. Wage costs have risen by 20% overall or by nearly 3% on an annualized basis since FY2003. This development raises the issue of public sector wage policy especially in the years going forward as the annual decrement and partial inflation indexation erode the real value of the annual grants. It would appear that containment of nominal wages will be difficult, and perhaps not even desirable, if the FSM wants to limit external migration and the potential loss of better qualified people. However, wage policy will need to be implemented in light of the need for financial stability. Only substantial local revenue increases, ideally in conjunction with renewed economic growth, can offset the effect of an otherwise ever-tightening fiscal envelope.

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

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

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

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

A proposal exists to develop an Integrated Planning and Budgeting (IPB) system that will enable uploads of budgeting information into the FMIS and downloads of financial information back into the budget module. While, this process will improve line item budgeting, it will fail to meet the requirements of economic or performance management. The chart of accounts adopted in the existing FMIS fails to capture the required information, and until this is rectified, the implementation of the IPB will be inadequate. Revision of the chart of accounts will not be achieved without cost, but is necessary if the FSM wishes to implement a modern approach to public financial management.

Amended Compact requires the FSM to make significant adjustments in both the near and long term.

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

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

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

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

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

Laws were subsequently drafted with the support of the IMF for the creation of a Unified Revenue Authority (URA), a Revenue Administration Act, national and state VAT, and NPT laws. In June of 2006, at the inauguration of the ESC, a high-level implementation plan (or master plan) was adopted by the Committee together with the creation of a Technical Working Group. A Tax Reform Unit (TRU) was created in the Department of Finance of the National Government and supported by AusAid, the Australian aid agency. However, progress in implementing the reforms has been painfully slow. Elections in 2007 delayed the process, and concerns at the state level on the delegation of administrative authority to the URA created by the national government have taken time to resolve. By the end of 2009 the TRU and ESC were ready to move forward, and in March of 2009 the President transmitted the draft legislation to the Congress. While there is support at the state level for the reform package the Congress is again nearing election time in March 2011 and passage in the short-term has met with opposition. Implementation is scheduled to take place over a year and a half, in six-month installments, by mid 2012: (i) creation of the URA; (ii) implementation of the NPT; and (iii) implementation of the VAT.

Tax reform implementation is painfully slow, but draft legislation is now with Congress.

Coming elections in March 2011 may yet again defer passage of draft bills.

The original intention of the tax reform initiative was for the reforms to precede the phasing out of the use of the capacity building sector grant from non-conforming purposes. However, this was not achieved, and the state governments were required to implement painful adjustments: expenditure cuts entailing a substantial loss of jobs, as well as additional revenue efforts. Table 1 indicates the magnitude of the fiscal adjustment required. In Chuuk and Kosrae each of the state governments was required to make very substantial expenditure cuts. In the most extreme case of Kosrae, the state

Transitioning of the use of the capacity building sector grant has been painful.

Table 1 Capacity building sector transition and compact fiscal adjustment, $1,000's

	FY07	FY08	FY09	Domestic Revenues	Annual Compression Required /1	3 Year Compression Required
Chuuk	884	884	884	6,988	11%	28%
Kosrae	92	462	462	2,124	18%	32%
Pohnpei	329	329	329	12,806	3%	7%
Yap	449	449	449	5,672	7%	19%
National				27,316		
FSM	1,753	2,123	2,123	54,907	4%	10%

Note /1 For Kosrae compression ratio refers to FY08 and FY09 levels

was required to compress non-Compact expenditures by 32%. In Chuuk the compression was 28%. In Yap the financing gap was 19%, which has been achieved through the use of the state's extensive reserves. While this policy has spared the state from the painful adjustments of Chuuk and Kosrae, the implicit perpetual fiscal deficit will require eventual resolution. Only Pohnpei state and the national government have been spared the need to transition.

Kosrae state leadership confronts the transition and adopts an adjustment package.

Fiscal balance restored in FY2009

The imminent and dire implications of a lack of response to the need for fiscal adjustment compelled the Kosrae leadership to confront the problem. At a leadership conference in May 2007, an adjustment package was worked out, not only in response to the capacity building transition, but also to rectify past deficit spending. The measures included: (i) expenditure reduction; (ii) enhanced revenue effort; and (iii) measures to mitigate the impact of the adjustment. Expenditure compression focused on the elimination of 110 positions from the FY2008 budget—76 positions were eliminated completely, and 34 vacant positions were removed, with a total cost savings of $874,000. Expenditure compression included a further $270,000 in a 5% across-the-board pay cut and $200,000 in non-payroll cost reductions. Revenue measures included hikes in state sales tax rates to raise a total of $500,000. The total impact of both the revenue and expenditure measures was $1,844,000. Measures to mitigate the impact of the RIF included a one-year salary payout, supported through a one-time use of the Compact building sector grant, and a similar amount funded through a grant from the PRC. However, while the adjustment program has been a success, state finances remained stressed, indicating the need for further adjustment.

Chuuk state was slow in undertaking adjustment, but makes eventual commitment as the fiscal position deteriorated.

While Kosrae State was able to make a timely and sizable adjustment in response to the fiscal challenge, Chuuk State took considerably longer to adjust. The State initially executed a series of MOU's, with the national government committing the State to the achievement of financial reforms, but these lacked credibility. By November of 2007 the state's fiscal position had deteriorated significantly, and Chuuk State leaders convened a conference to adopt more comprehensive adjustment measures. The adjustment program in Chuuk was similar to that of Kosrae, and an adjustment target was set at $3.36 million in annual adjustment through both expenditure compression and revenue enhancements. The magnitude of the adjustment reflected a need to remove the deficit ($1.97 million) and create a sustained surplus ($1.5 million) in order to address the state's problem of outstanding debt. The leadership committed to personnel reductions of over 375 positions, with a one-year payment financed by Compact sector grant assistance. An additional $200,000 of non-payroll general fund expenditure cuts was identified, and revenue raising measures yielded $600,000.

Chuuk state adjustment restores fiscal balance but fails to attain surplus to pay down debt.

During FY2008, 317 public servants took part in the RIF, with annual cost savings of $1.9 million. While additional revenue measures were identified, these have been restricted to enhancing revenue collection rather than increasing rates. The impact of the program has been to return the state to fiscal balance, but the objective of building a sustained surplus to pay down state debt has been only partially achieved with general fund surpluses over nearly three full years being directed to an approved payment list of creditors. More fiscal adjustment will be needed to accelerate the pace of reductions in Chuuk's outstanding debt.

Annual decrement and lack of full indexation of sector grants imply a 23% reduction in real resource flows during remainder of the amended Compact.

With transition to the sector grant approach now effectively complete attention has switched to the combined impact of partial inflation indexation and annual decrements on fiscal management during the remaining years of the amended Compact. Over the next 13 years the accumulated reduction in real funding equates to 23% of the current value of the Compact sector grants or an annual average real decline of 2%. The amended Compact was specifically designed to avoid the large impact of five yearly step-downs of Compact I and thus ease the process of adjustment. However, it is tempting to believe that the relatively small adjustment of 2% per annum can be easily achieved year by year on a long term basis without distorting the delivery of public services. In September 2009 in recognition of the impact of the annual real decline of Compact resources, JEMCO adopted a resolution that subsequently became known as the "decrement" management plan:

> *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*

Long-term fiscal framework (LTFF) required to manage reduced real resource flows.

> *decisions. The plans should include an evaluation of the ability of the health and education sectors to fulfill their strategic outcomes in fiscal years 2012-2014.*

The JEMCO resolution—while not specifying in complete terms the required response--actually requires the development of a long-term fiscal framework (LTFF) that would encompass not only short-term adjustment to the annual decrement and partial inflation adjustment, but also a long-term solution to fiscal management. This would necessarily involve not only the Compact sector grants but also public administration expenditures financed out of the general fund. A three part process can be envisaged:

Establishment of Long-Term Fiscal Framework (LTFF). This includes an economic modeling framework based on the structure of the FSM economy with a planning horizon through 2024. The framework would need to be designed to enable simulation of the main policy instruments available to government: expenditures and revenues by economic and functional category including sector grants, public servant employment, wage rates, taxes, etc.

Sector grant usage. Identification of services delivered in the education, health and minor Compact sectors and priorities through the remaining amended Compact period. Costing of the deliverables and projection of Compact sector grant usage and services falling under the general fund.

Review of recommendations by leaders at a conference. This would include a participatory meeting—or series of meetings—to review the LTFF, sector grant usage and delivery of general public services. The outcome of the conference would be the preparation of a public sector plan for endorsement by the FSM leadership to guide future budgetary allocations at the state and national levels.

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

The establishment of the Trust Fund for the People 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 in relation to distributions from FY2024 forward are explicitly tied to the inflation adjusted value of the Compact annual grant assistance provided in FY2023. Notwithstanding this design feature, 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 sustainably achieve distributions of any specific size.

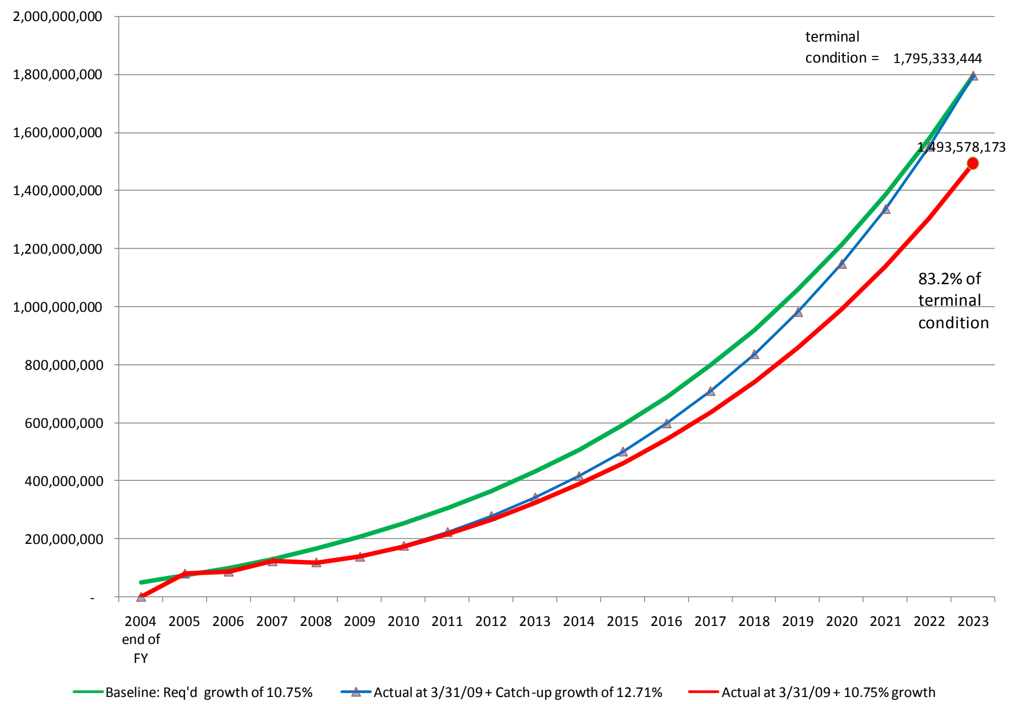
Despite the lack of a secure and sustained funding level the Trust Fund Agreement specifies a withdrawal rule that is precisely based upon the FY2023 annual grant assistance level plus full inflation, and each year thereafter the withdrawal rate specified is increased by full inflation. However, if the returns in a post-2024 year are insufficient and if the "C" account, established as a buffer, is empty, the FSM would suffer a severe fiscal shock. Zero funds would be made available for budgetary or investment support in such an event. Thus it makes sense for the FSM and the US to consider modifications to the poorly specified buffer account and withdrawal rules embedded in the Trust Fund Agreement so as to reduce the risk of a fiscal shock of such immense proportions. At a minimum, consideration should be given to modifying the operations of the "B" account which, as described now provides no benefit whatsoever, and of the "C" account which would be more reliably functional if it were created by *fiat* at the outset of FY2024. Subject to technical review, consideration should also be given to increasing the initial holding size and providing conservative guidelines for the investment policy of the buffer account.

Trust Fund currently below track—needs to grow at the high and unlikely to be sustained annual rate of 12.71% to meet the "terminal condition."

The current value of the FSM Trust Fund is significantly below the level consistent with a smooth growth trend line toward achieving sufficiency. The terminal condition for sufficiency of the Trust Fund is projected to be $1.795 billion at the outset of FY2024. In order to be precisely "on-track" to achieving that level as of June 30, 2010, the value would have grown to $247.3 million; however the actual value of the FSM Trust Fund at that date was $160.5 million. Even if the returns from this date forward were to average the (initially required) trend line rate of 10.75% annually, the final value of the fund at the outset of FY2024 would be just 83 percent of the target level, falling short by $301.8 million. To offset this trend to-date, the investment return required for the remaining 13.25 years of the amended Compact period is estimated at an annually compounded rate of return of 12.71% (Fig 10). This "catch-up" rate of return is highly unlikely to be achieved. To achieve such a return given the current investment policy established by the FSM Trust Fund Committee would require sustained market returns far in excess of asset class-weighted historical returns.

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

The Third 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 me-



dium-growth scenario, and a sustained growth scenario. While noting that the FSM might face a truly "dismal" scenario if the country's leadership failed to make needed economic adjustments to offset the drag on economic activity resulting from the structure of Compact assistance, the discussion focused primarily on the "moderate growth" and "sustained growth" scenarios. The Summit adopted a six-part strategy for transition and accelerated growth:

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

Current performance places the FSM below the dismal scenario.

The FSM Strategic Development Plan (SDP) examines the three growth scenarios in detail and makes projections of the likely economic growth and development patterns. Under the sustained growth scenario, economic growth is held back initially, as the economy adjusts to the structure of the amended Compact. How-

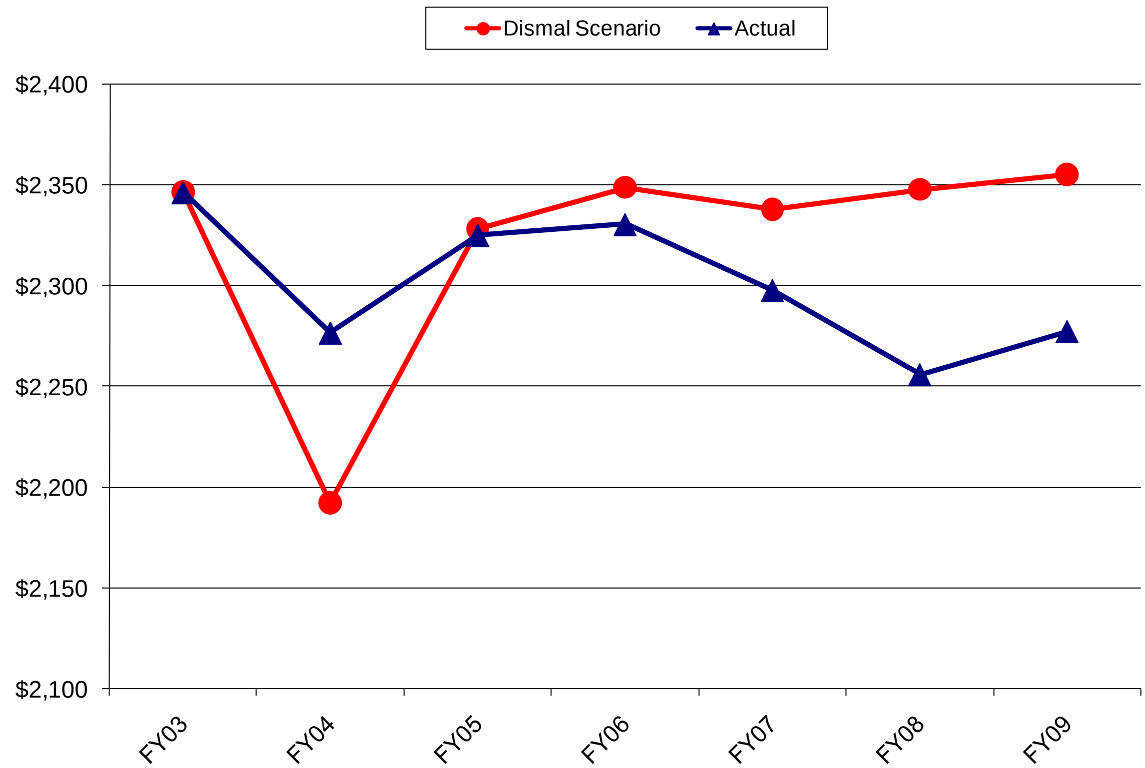


Figure 11 Comparison of the Third Summit dismal scenario with performance—GDP per capita.

ever, as the benefits of the sustained growth strategy take hold, the economy is projected to accelerate and attain an annual average rate of 2.6% over the whole period. On the other hand, under the dismal scenario, economic growth is weak, and the economy is projected to grow only 0.1% over the period.

Fig. 11 compares the projected dismal scenario with the actual performance since FY2003. The dismal scenario outperforms the actual performance, and since FY2005 the trajectories have been diverging. The model on which the SDP scenarios were based overstates the impact of the amended Compact in FY2004 and fails to capture the weak economic performance since FY2006, or the impact of the world recession in FY2008 and FY2009. It is clear that the initial years of the amended Compact have been dominated by adjustment to the new regime. While the process is now largely complete, Chuuk remains heavily in debt and Yap has postponed the adjustment and is drawing down on its reserves to fill the gap. Looking forward, and in the absence of economic growth, attention has shifted to the continuing fiscal adjustment that will be required due to the annual decrement and partial inflation indexation of the sector grants. The tax reform package is now with Congress, and if

Need to revisit the policy agenda initiated during the Third Economic Summit and to implement the sustained growth strategy.

passed will assist the FSM in making future adjustment. But successful passage is not guaranteed, and increasing the tax burden to maintain the level of public services with the present economic performance may not be well advised.

While orderly "decrement" management is clearly essential, to improve the outcome in the remaining years of the amended Compact the need remains for the nation to return to, and presumably update, the policy agenda initiated during the 3rd Economic Summit: implement a sustained-growth strategy and take measures necessary to encourage private sector development.