Federated States of Micronesia

Fiscal Year 2010 Economic Review

SUMMARY DOCUMENT

August 2011

US Department of the Interior
Office of Insular Affairs

Graduate School USA
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

FIGURES

FOREWORD

This Summary presents the major findings and conclusions of the FY2010 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 USA. 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.

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

Mark Sturton

Executive 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 reduction in resources from Compact I, capacity constraints in fulfilling the new fiscal procedures—especially with respect to infrastructure grant implementation—and the need to transition from the use of the capacity-building sector grant for general government operations, have generated a harsh economic climate. 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 5 years of the amended Compact. However, since implementation of the adjustment measures, the fiscal position has recorded an average level of 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 position.

The structure of the amended Compact resulted in the need for significant fiscal adjustment both in the near and long term. In the near term the new sector-grant approach favored education, health and selected sectors, but did not provide funding for the operation of general government. This required a substantial adjustment in the operation of non-Compact sectors to fit local revenues over a five year period. A reduction-in-force and other reforms required a painful adjustment in Chuuk and Kosrae. Once implemented, focus shifted to the need for 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 in the amended Compact period by 2.7% per annum. The levels of Compact sector grants are expected to remain constant over the remainder of the amended Compact, which might make current wage policy a cause of 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 makes every effort to assess the Trust Fund's performance against a sensible goal. That sensible goal is proposed by the authors of this report 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 $1.82 billion at the outset of FY2024. Comparing actual performance to a smooth trend line signifying "on-track" performance, the Trust Fund would 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 percent. 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. 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, or focus attention on the need to raise the rate of economic development. The focus on adjustment to the amended Compact during the last 7 years in both the short and longer term has diverted attention from the big picture and how to improve the lives of average Micronesians. As a result, there remains a lack of direction or policy debate, and a pressing need to reinvigorate aspirations with a broad vision on needs to reform, and the development of private sector growth.

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. Based on a "no policy change" regime, 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 the fall in real Compact transfers and rising expenditures. However, the national government is likely to generate a significant surplus if the additional savings are not diverted to "public projects". Although the impact of 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.

I. ECONOMIC PERFORMANCE

The Economy

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 (FY1987-FY1995) – 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 (FY1995-FY2010; see Fig. 1). While GDP has displayed a cyclical trend, only in FY2010 have both GDP and GDP per capita attained levels achieved in FY1995, This implies a zero rate of economic growth over a 15 year period.

GDP and GDP per capita stagnate between FY95 through FY10.

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 significant and required a painful adjustment. Supported by an ADB Public Sector Reform Program Loan and an Early Retirement Program, associated fiscal reforms were initiated to reduce the number of public servants to an affordable level and

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

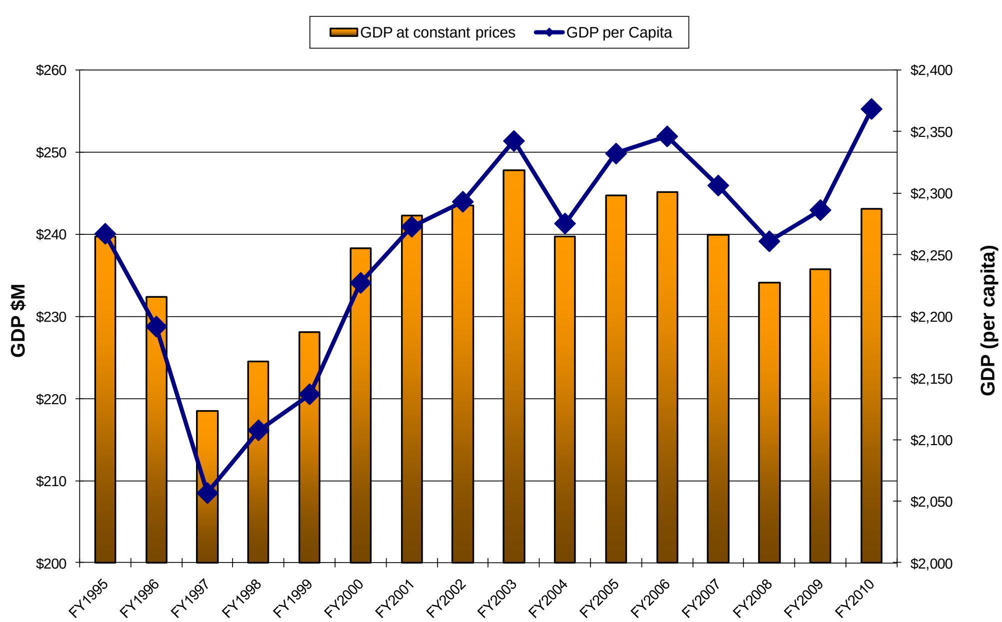


Figure 1 Real GDP and real GDP per capita

to restore fiscal balance. By loan close-out in December 1999, the workforce had been reduced by 23% against a target of 27%, and 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.

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

FSM economy grows by 3.1% in FY10 reflecting growth in construction and public services.

In FY2004 the economy fell sharply by 3.4% with the reduction in funding. Some of the lost ground was recouped in the following two years, but growth turned negative in FY2007 and FY2008. 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 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 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 0.7%. 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, but also growth in public administration, health and other dependent industries.

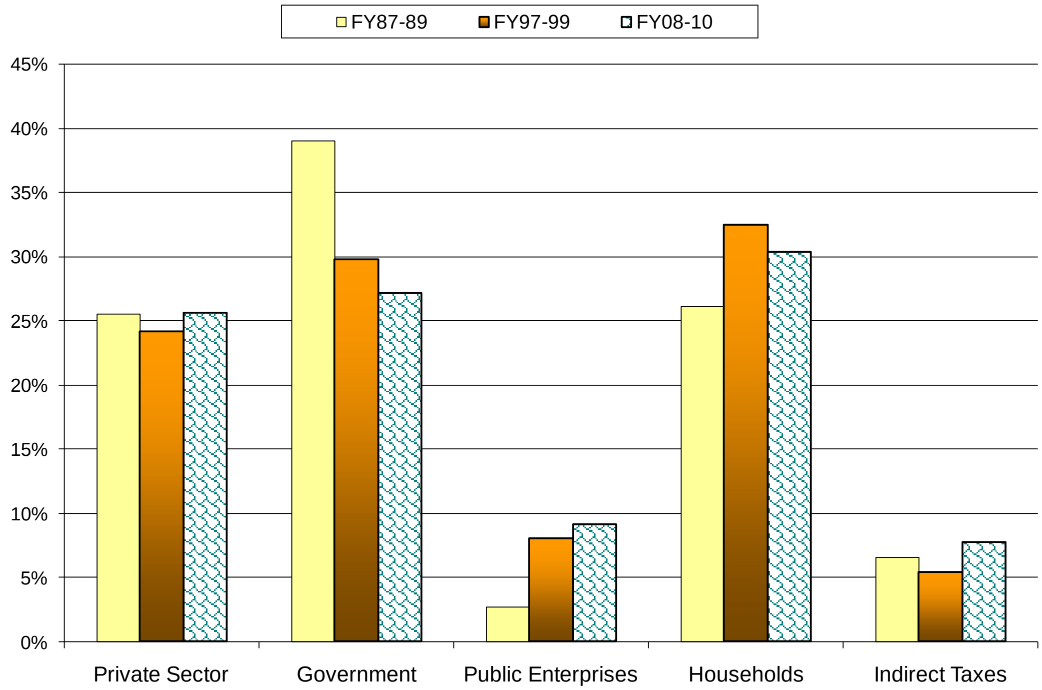


Figure 2 The institutional structure of the FSM economy (percent)

FSM economy dominated by large public sector.

The structure of the FSM economy is dominated by a large public sector, with a dependent private sector producing non-traded goods and services to the government and its employees (Fig. 2). The share of government has declined significantly, by 11.8%, since the beginning of Compact I. This reflects three major forces: (i) a reduction in the size of government due to the lower levels of Compact assistance 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.

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

The share of the private sector since the start of Compact I has remained virtually unchanged at 25%. Given the reductions in the share of the public sector, including PSEs, this result is surprising. Even when compensating for the public sector decline, the share of households has increased. The household sector includes market production of commodities, non-market production (subsistence) and home ownership. The total share of households has risen by 4.3%, offsetting the decline in the public sector. In essence the failure of the private sector to become the engine of growth has resulted in households falling back on their own resources and devoting increase efforts to subsistence production.

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

Reflecting a small share of the private sector, economic performance in the leading sectors of market agriculture, fisheries and tourism has not lived up to expectations. In the early 1990s, in an attempt to develop the economy, the FSM embarked upon a strategy of substantial public sector investment in fisheries facilities and enterprises. However, none of the fisheries enterprises achieved profitability, and over time the surviving entities were transferred to private ownership or management. There are currently signs of renewed foreign investment interest in the fishing industry and these are 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 2.1% since 1995, and 3.9% during the amended Compact.

Population, Migration and Employment

The change in GDP per capita and employment in each of the FSM states is indicated in Fig. 3. In all states, real incomes have re-

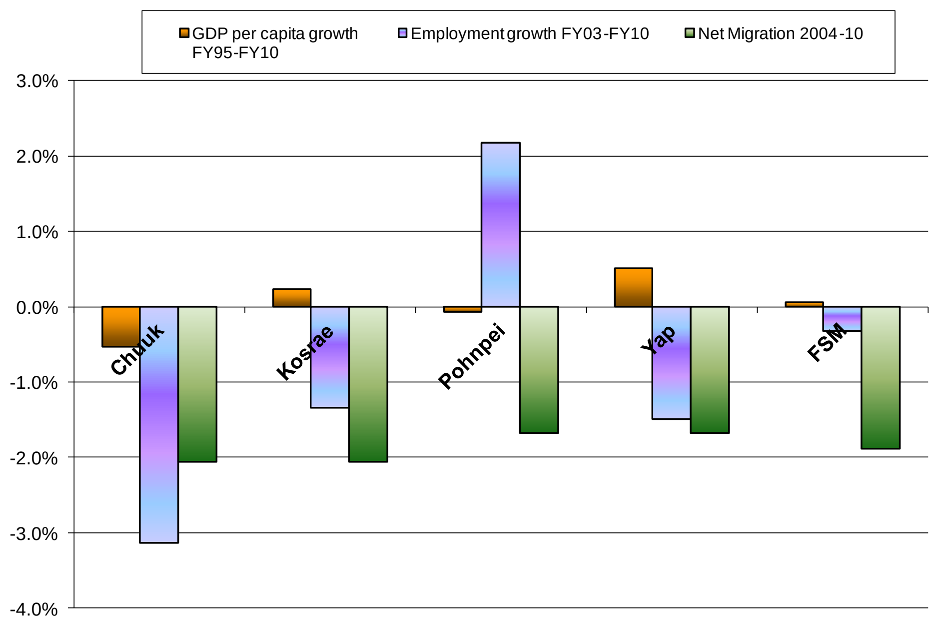


Figure 3 Growth in GDP in per capita, employment, and migration.

mained largely stagnant since FY1995, and employment opportunities have fallen with the exception of Pohnpei, reflecting the poor economic performance during the last 15 years. As a result of the decline or stagnation in incomes, outmigration as measured by net movements of air passengers leaving the FSM during 2004-10 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, outmigration was strong.

Real incomes stagnate and job prospects deteriorate during FY95-10.

Outmigration rises in response to the lack of economic opportunities.

Reflecting weak economic performance, employment has stagnated with over 1,184 jobs lost between FY1995 and FY2010. Much of this loss is 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 between FY1995 and FY2000. While public sector employment expanded in the early 2000s, it dropped by a further 313 jobs since FY2000 with the implementation of the RIFs in Chuuk and Kosrae. Private employment surpassed the public sector as the largest employer for the first time in FY2000, but subsequently contracted. However, FY2010 was a good year and private sector job employment reached 272 jobs above the FY2000 level. Wage differentials between the private and public sectors

Employment levels fall reflecting public sector downsizing. Private sector employment improves in FY2010 but fails to fill the gap.

Private public wage differentials remain little changed.

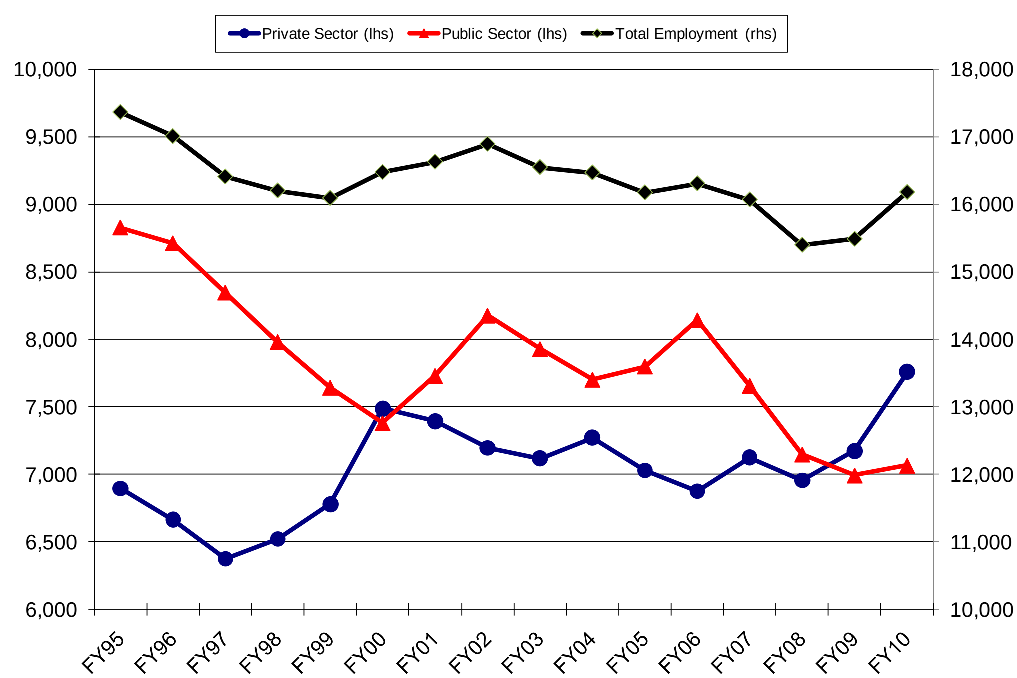


Figure 4 Employment by sector FY1995-FY2010.
Note lhs = left-hand side; rhs = right-hand side

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 Kosrae and Pohnpei.

Inflation

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

Inflation moderated in FY2009, but high fuel prices in FY2010 again kept inflation up.

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. While this 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. Rather, the sizeable increases in world food prices during the second half of 2008 resulted in a radical rise of the FSM's traditionally low inflationary profile. Reductions in fuel

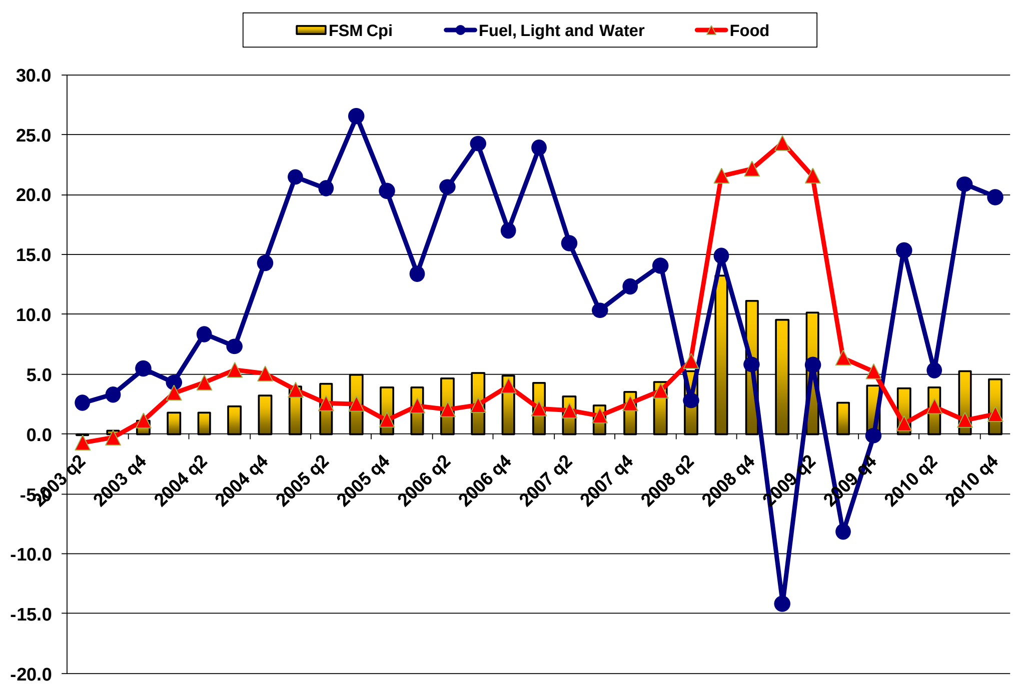


Figure 5 Inflation in consumer, food and energy prices (year on year percent change)

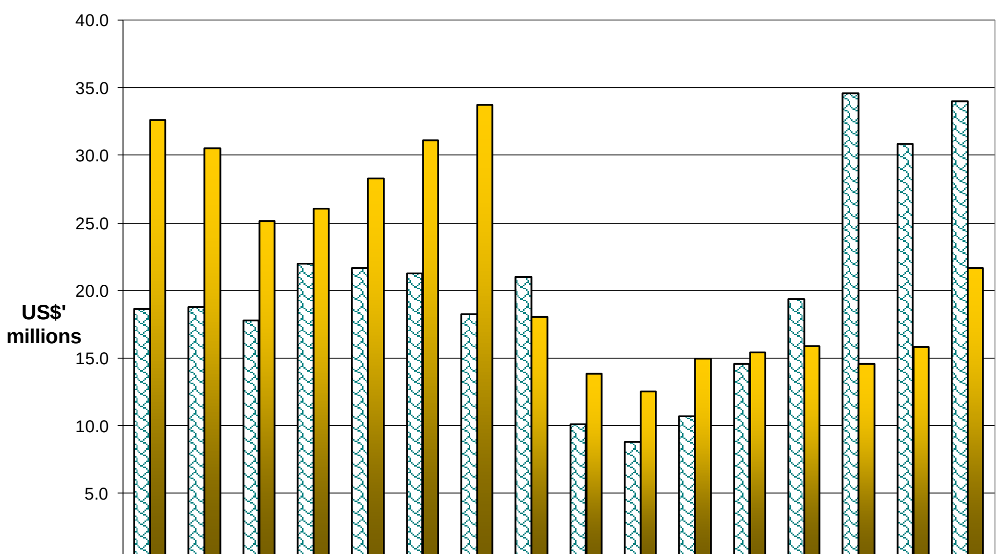
and a leveling of food prices resulted in CPI moderation towards the end of FY2009, but increase in fuel prices once again reasserted themselves in FY2010 with the CPI recording an inflation rate of 4.3% in FY2010.

The Banking Sector

Data from the banking sector have generally indicated a disappointing outcome. Total loans to the private sector (both commercial and consumer) fell from a level of $52 million in FY2000 to $21 million in FY2004 (Fig. 6). This reflects a variety of factors. The Chuck state financial crisis in the early 2000s led to a reduction in consumer credit. Early in 2002 the Bank of Hawaii, then the largest player in the FSM market, withdrew from the FSM as part of a corporate strategy to sell off its Pacific assets. Since that time the banking sector has shown signs of improvement, with lending to the commercial sector growing significantly, although this included a large loan to the newly formed Micronesian Petroleum Corporation (MPC), which has subsequently been paid down, and lending in Saipan by the Bank of the FSM. While consumer credit has been weak there was significant growth in FY2010. Despite these developments, the FSM banking sector remains highly liquid, and the loans-to-deposit ratio was 36% at the end of FY2010. This reflects the high level of perceived risk in the FSM and "lack of bankable projects." Overall, lack of collateral, the inability to use

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.



	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

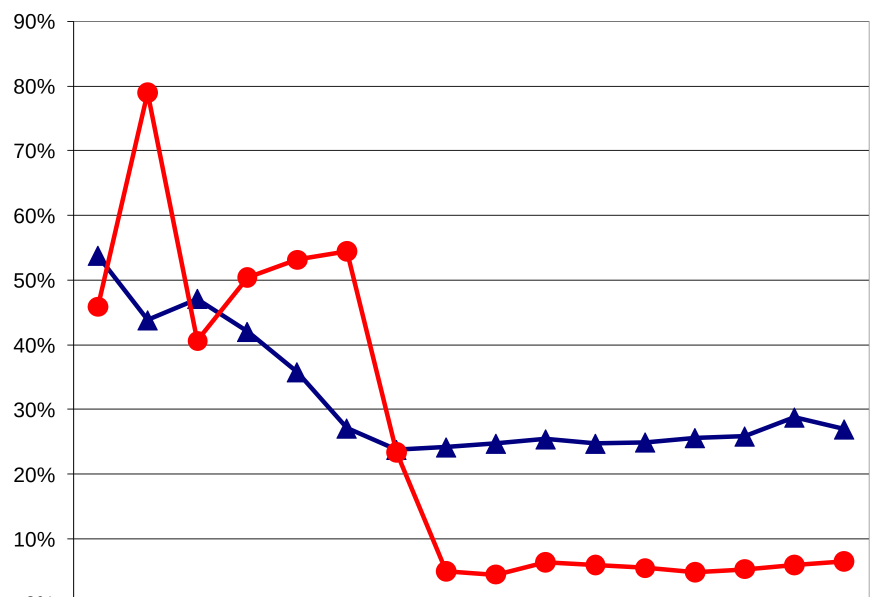
Figure 6 Commercial bank credit by sector, FY00-FY10.

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.

External Debt

The FSM maintains a favorable external debt profile.

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 to finance development projects—many in the fisheries sectors—external debt has fallen significantly. Debt-to-GDP has fallen from 54% in FY1995 to 27% in FY2010, 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 with a further small draw down in FY2010. As a result the ratio of debt to nominal GDP has risen slightly.



	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 7 FSM external debt ratios, FY1995-FY2010

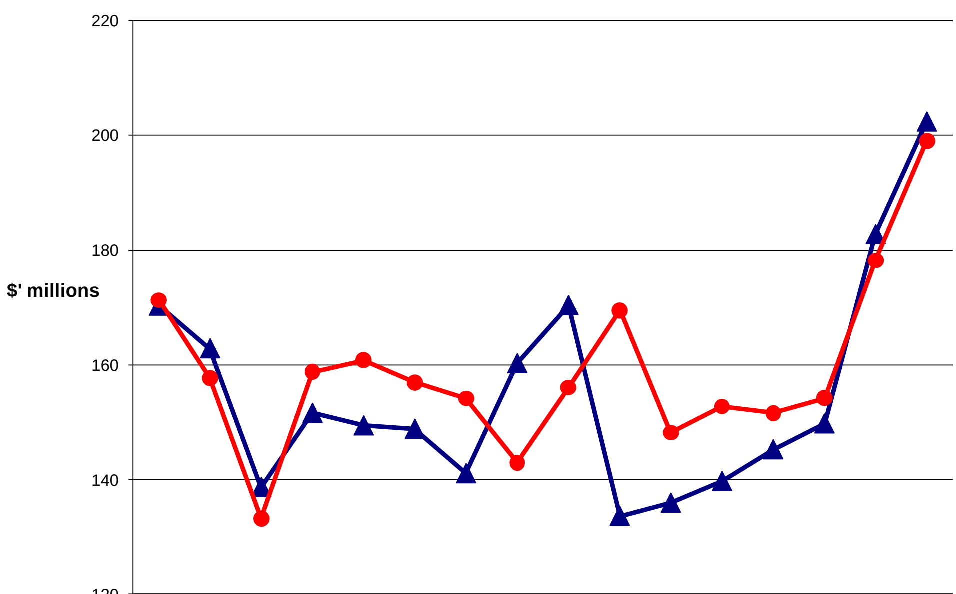
Fiscal Situation

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 4% 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).

FSM runs substantial deficits after second stepdown.

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 (15% 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,

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.



	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 8 FSM consolidated revenues and expenditures, FY98-FY2010.

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

deficits of $12 and $13 million—or 5% of GDP in each year—were recorded. The amended Compact restricted the use of resources to specified sectors, and prohibited their use to fund general government. To ease the adjustment the U.S. permitted the use of the capacity building grant to fund specific activities, provided these were transitioned out over a five-year period. There was a gradual improvement in the fiscal position as the nation adjusted to the new requirements and implemented RIFs in Chuuk and Kosrae. 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. In FY2009 the FSM was to receive significant FAA grants for airport improvement, which pushed up both revenues and expenditures significantly. A similar outturn was recorded in FY2010 with continuing airport improvement projects, but a slightly smaller surplus of $3 million was generated representing 1% of GDP.

II. Policy Developments, Prospects, and Issues

Government Payroll Issues

A major objective of the Compact has been the attainment of economic self-reliance. At the beginning of the Compact the policy environment in the FSM was hostile to the private sector, inward-oriented, and supportive of large government. With the awareness of the large reductions in Compact funding in mid 90s, the recognition of a need for change emerged. 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 embarked on a program of public sector reform in the mid 90s and made 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

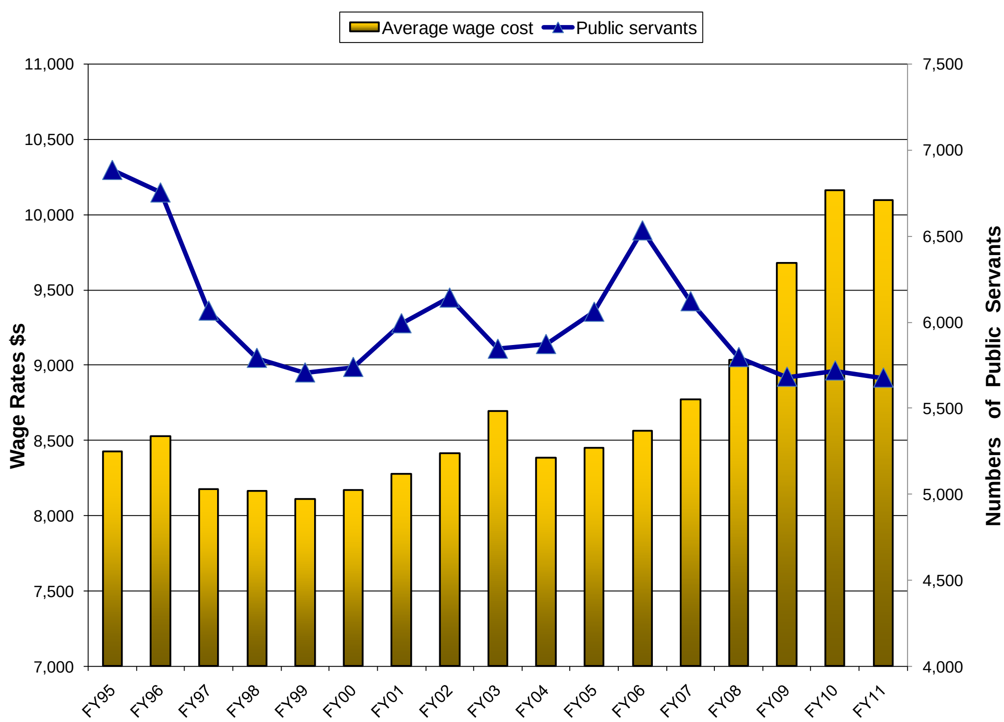


Figure 9 FSM public servant numbers and average wage cost FY95-FY11.

While numbers of public servants remains in check during the amended Compact, average wage costs rise rapidly by an annual average of 2.7%.

workforce and payroll (Fig. 9). In terms of numbers of public servants the PSRP set a target reduction of 27%. By FY1999 a 16% reduction had been achieved. While there was significant growth in numbers in the early 2000s, this was balanced through subsequent RIFs in Chuuk and Kosrae. As of FY2011, the reduction in public servants compared with original PSRP targets still stands at 16%, and remains a considerable achievement. The story, however, in terms of payroll cost, is significantly different. The PSRP targeted 35% savings in payroll cost and achieved 21% savings before the program closed in FY1999. Ten years later, by FY2011, payroll costs have grown steadily and reverted to FY1999 levels, completely eroding the progress made through the program.

With employee number constant but payroll costs rising, average wage costs per employee have risen strongly during the amended Compact. Average wage costs have risen every year since FY2004 with the exception of FY2011 when the upward trend was held in check. Overall, average wage costs have risen by 20% or by 2.7% on an annualized basis. This trend contradicts the assertion that nominal wage rates have been held constant in the FSM. Statistics based on actual payroll data extracted from the four states and national governments suggest that although wage rates may have been held constant, the average costs per employee has steadily risen.

Growth in average wage costs requires development of a personnel and wage policy consistent with financial stability and skill retention.

This development raises the issue of public sector wage policy, especially through FY2023 as the annual decrement and partial inflation indexation erode the real value of annual Compact grants. It would appear that containment of average wage costs may be difficult, even if the FSM was to adopt a policy of holding nominal wage rates constant. However, holding nominal wage rates constant may not be a desirable policy if the FSM wants to retain better qualified staff and limit external migration. A policy of limited wage increases, offset by rationalization of the work force and efficiency gains, may be more appropriate in an otherwise ever-tightening fiscal envelope.

Performance Management

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

At the start of the amended Compact, the FSM had inherited a disparate set of financial accounting systems in the five governments. It was clear that the old systems would not be able to support the kind of financial and performance information required in the fiscal procedures of the amended Compact. Following an RFP and implementation of a new FMIS, all five government were using the same system by FY2008. However, implementation of the system 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 replace the existing stand alone Budget Preparation (BPS) and Performance Reporting Systems (PRS) with an Integrated Planning and Budgeting (IPB) system that interfaces with the FMIS. The new system would enable download of financial information into the budget module for budget preparation, and then upload approved budgets back into the FMIS for execution. The PRS reporting module would also utilize a direct download from the FMIS to enable monitoring. While this process will improve the budgeting process and enable budgets to reference current financial performance, it will fail to meet the requirements of economic or performance management. The chart of accounts adopted in the existing FMIS fails to provide a coding system of outputs (service delivery), and in its absence the IPB intends to map inputs by organization in fixed proportions to outputs. Until the chart of accounts is revised to include output specification, the implementation of the IPB will fall short. 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.

FSM proposes to develop an integrated planning and budgeting system, but this will fall short of its objectives until the existing chart of accounts is revised.

Adjustment to the Amended Compact

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

Chuuk and Kosrae undergo painful adjustments to restore fiscal balance.

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

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

JEMCO requests decrement management plan.

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 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%. The amended Compact was specifically designed to avoid the large impact of five yearly step-downs as seen in Compact I, thereby easing the adjustment process. However the relatively small adjustment of 2% per annum cannot be easily achieved year-to-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 decisions. The plans should include an evaluation of the ability*

of the health and education sectors to fulfill their strategic outcomes in fiscal years 2012-2014.

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

FSM fails to deliver "decrement management plan".

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

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

As a result of this 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 the office of Statistics, Budget, Economic Management, Overseas Development Assistance and Compact Management or SBOC. 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:

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

NES adopts a set of four resolutions including the LTFF.

- Endorsing 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.
- Endorsing the national long term fiscal and economic framework. The LTFF was to be returned to the States after the symposium for their endorsement, and submitted to JEMCO before the annual 2011 meeting.
- Reforming the FSM tax code.
- Prioritizing infrastructure lists (also required by JEMCO).

While the FSM approach to the JEMCO was appropriate, the LTFF fell well short of providing the intended long-term macroeconomic framework envisioned. Importantly, the LTFF failed to provide a comprehensive and integrated framework which should have included projections of GDP by industry, linkages to the fiscal accounts, and a reliance on balance of payments or banking data. Instead, the LTFF presented a set of revenue projections based on six-year trends since the start of the amended Compact—too short a period to conduct econometric analysis that is unrelated to the tax base. In addition, no clear fiscal account was presented, which should have indicated revenues, expenditures and fiscal balance. Moreover, the Compact Trust Fund was not integrated into the framework and thus indications of the likely fiscal shortfall in FY2023 were 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. In short, the LTFF failed to provide an adequate response to the JEMCO resolution.

LTFF presented to NES falls way short of JEMCO requirements and remains outstanding.

Tax reform

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

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

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.

Laws were subsequently drafted with the support of the IMF for the creation of a Unified Revenue Authority (URA), a Revenue Administration Act (RAA), state Value-Added Tax (VAT), and Net Profits Tax (NPT) laws. In June of 2006, at the inauguration of the ESC, a high-level implementation plan (or master plan) was adopted by the Committee together with the creation of a Technical Working Group. A Tax Reform Unit (TRU) was created in the Department of Finance of the National Government and supported by AusAid. However, progress in implementing the reforms has been painfully slow. Elections in 2007 delayed the process, and it was not until March of 2009 the President transmitted the draft legislation to the Congress. After resolution of state and national jurisdiction issues, and a further election, FSM Congress finally passed the URA law in April 2011. This sets the stage for the states and national legislatures to work towards implementing the remaining pieces of legislation. The current schedule calls for completion of the legislative process by the end of 2011, and establishment of the URA within one year of passage to law. Implementation of the NPT is scheduled for end of FY2012; and implementation of the VAT one year later end of FY2013.

Tax reform implementation has been painfully slow, and now in final do or die stage.

National Government passed URA law which initiates the process.

The Compact Trust Fund

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 features of the Trust Fund related to distributions to the FSM from FY2024 and thereafter 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 be able to sustainably achieve distributions of any specific size.

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

Despite the lack of a secure and sustained funding level, the withdrawals specified under current rules would occur even if it was known by all parties that the Trust Fund had not achieved a sufficient size to reliably support such withdrawals over the long-term—an all-too-likely result given the projections provided in this report. This is a serious technical flaw if the real value of the Trust Fund is meant to be protected and if the stability of annual flows to the FSM is a shared objective. 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. Immense and repeated fiscal shocks are more likely to arise due to the identified design flaws. Thus it makes sense for the FSM and the US to consider modifications to the poorly specified buffer account and withdrawal rules. At a minimum, the "C" account could 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 of the "C" account and to providing sensible guidelines for the investment policy of the assets held in the buffer account. Consideration should also be given to the basic annual withdrawal rule which provides no feedback mechanism to relate the annual withdrawal rate to the actual size—and therefore the sustainability—of the Trust Fund. Again this is of paramount performance if the FSM, as seems likely absent significant mobilization of Trust Fund contributions, is likely to face a serious shortfall in the Trust Fund versus the identified terminal condition.

Trust Fund currently below track—needs to grow at a high (and unlikely) annual rate of 12.7% to meet the "terminal condition."

With the actual level of sustainable Trust Fund distributions not being guaranteed, it is also imperative that the FSM Government makes every effort to monitor the progress of the Trust Fund to assess performance against a sensible goal. That sensible goal is proposed by the authors 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. By definition, that means the target value of the Trust Fund at the outset of FY2024 will 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.

The value of the FSM Trust Fund as of June 30, 2011, remains significantly below the level consistent with a smooth growth trend line toward meeting the terminal condition for sufficiency. The terminal condition for sufficiency of the Trust Fund is projected to be $1.82 billion at the outset of FY2024. 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. To offset this trend to-date, the investment return required for the remaining 12.25 years of the accumulation period for the Trust Fund is estimated at an annually compounded rate of return of 12.66 percent (Fig. 10). This "catch-up" rate of return is virtually unachievable over the remaining 12.75 years of the 20-year accumulation period.

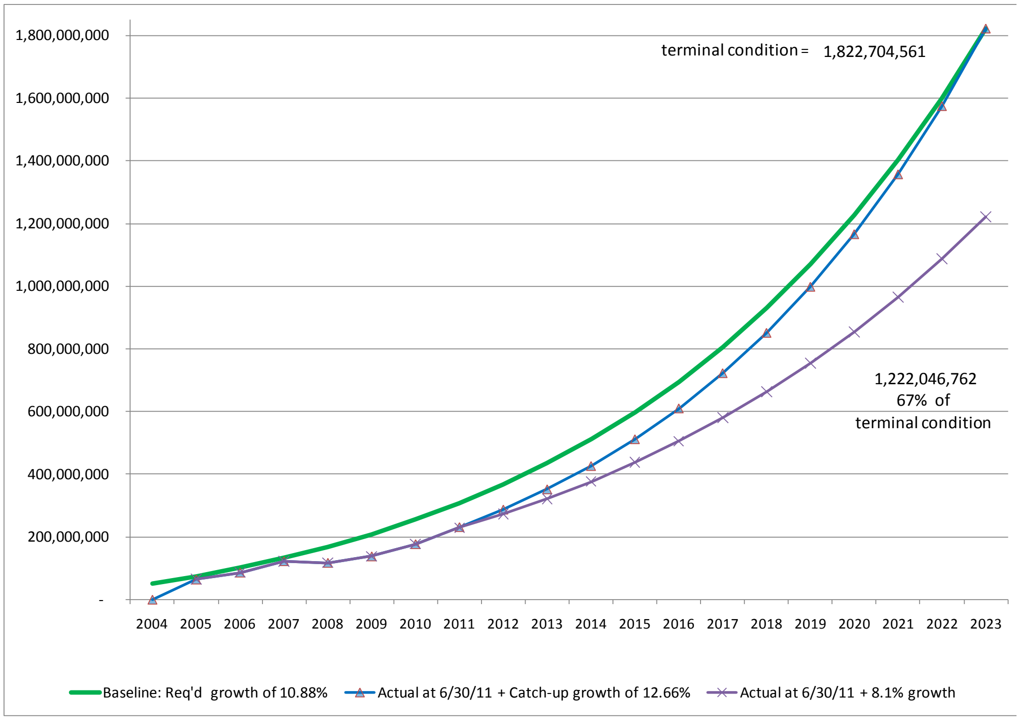


Figure 10 Compact Trust Fund Sufficiency, FY2004 – FY2024, $'millions.

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.

Third FSM Economic Summit and NES

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

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

- macroeconomic stability;
- good governance: improving effectiveness and efficiency of government;

- developing an outward-oriented, private sector-led economy;
- investing in human resource development;
- investing in infrastructure; and
- long-term sustainability.

For the first time in the amended Compact GDP per capita rises above the dismal scenario and level attained in FY2003.

The FSM Strategic Development Plan (SDP) examines the three growth scenarios in detail and makes projections of the likely economic growth and development patterns. Under the sustained growth scenario, economic growth is held back initially, as the economy adjusts to the structure of the amended Compact. However, as the benefits of the sustained growth strategy take hold, the economy is projected to accelerate and attain an annual average rate of 2.6% over the whole period. On the other hand, under the dismal scenario, economic growth is weak, and the economy is projected to grow only 0.1% over the period. Fig. 11 compares the projected dismal scenario with the actual performance since FY2003. In many years the dismal scenario has outperformed the actual performance, and it was only in FY2010 that the economy

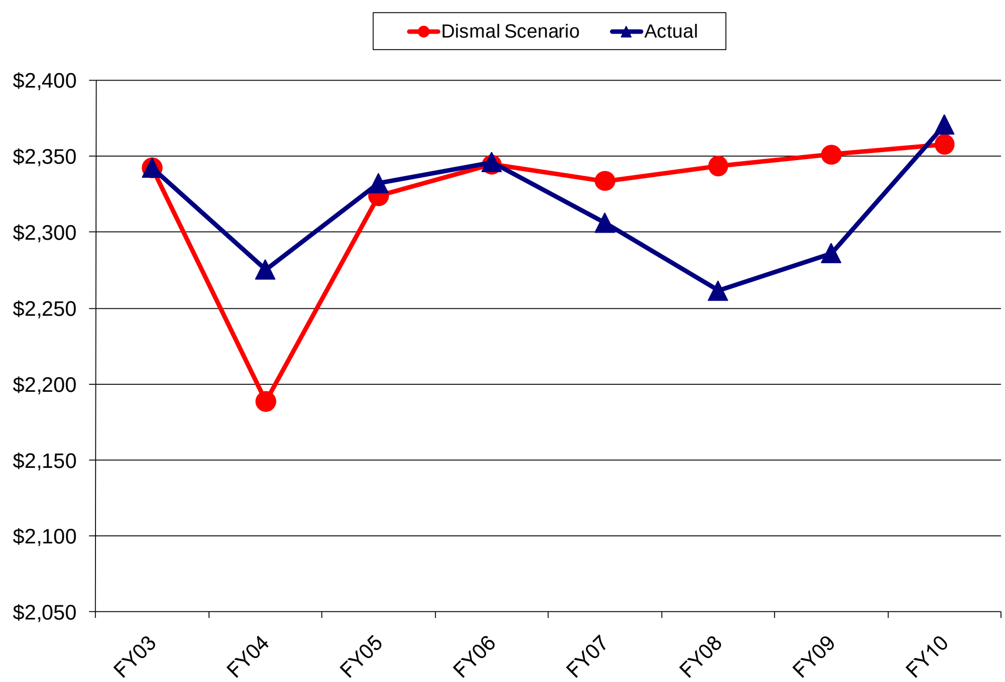


Figure 11 Comparison of the Third Summit dismal scenario with performance—GDP per capita.

finally rose above the dismal scenario and the level of GDP prevailing in FY2003.

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 how 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 managemen,t 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 reforms necessary and vision of the future contained in the “sustained” growth scenario.

NES fails to refocus the nation’s attention on the need to achieve a higher rate of economic growth that was committed to at the 3rd economic summit.

III. The Medium Term Economic Framework

FY2010 economic review incorporates medium term economic framework.

As part of the FY2010 review, a preliminary medium term economic framework has been prepared based on GDP by industry and 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.

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.

The Baseline

Fig. 12 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 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 Projects (AIP) come 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.

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

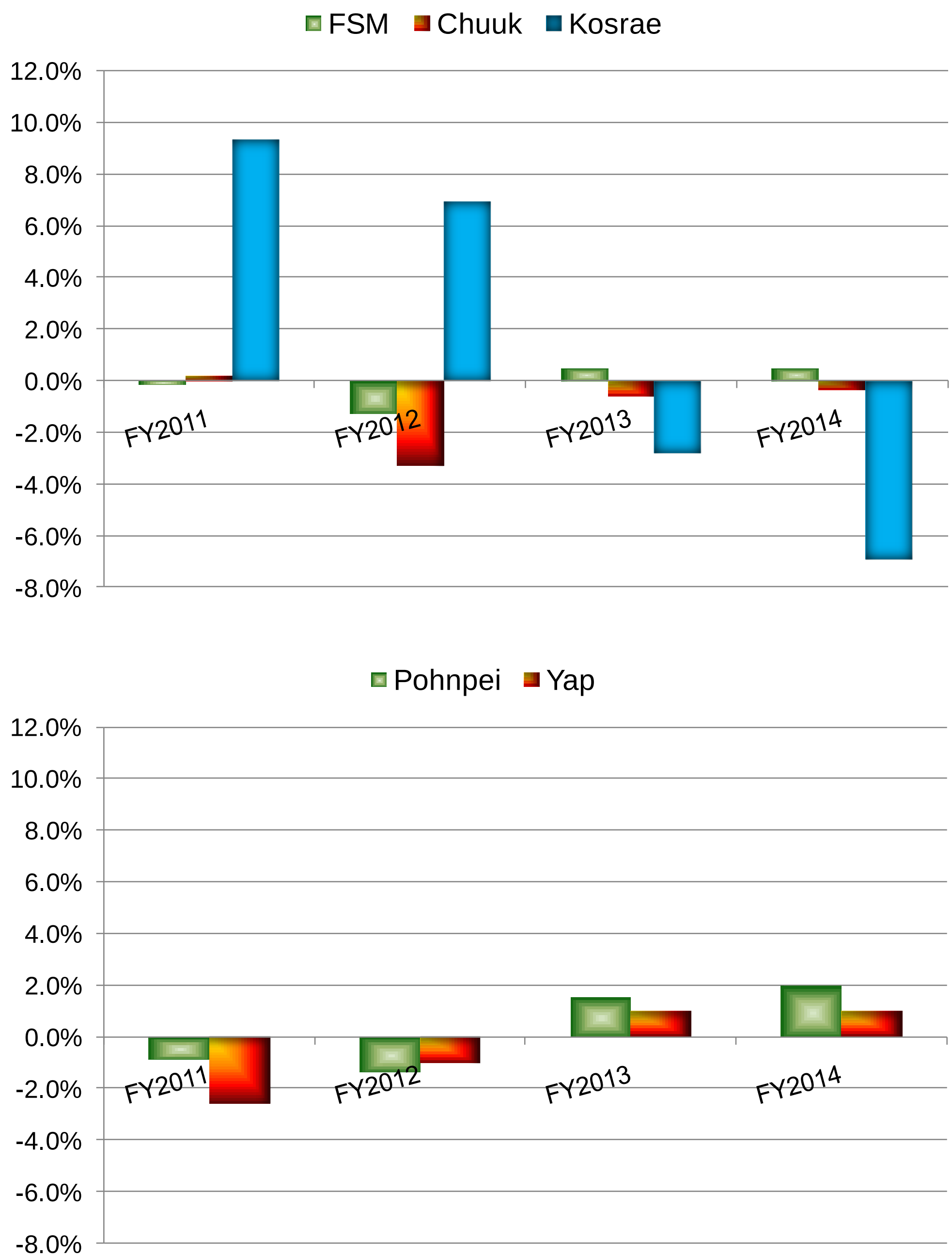


Figure 12 Baseline GDP projections of the state and FSM economies, FY2011-FY2014

the AIP are completed despite a pickup in the use of the infrastructure grant. Overall the economy expands by 5.8% over the period.

In Pohnpei, the earlier years show negative growth as a result of the completion of the AIP projects, and in the outer years, the

Projections reveal significant different trajectories by state, but for the FSM growth remains negative over the period and fails to rise above the dismal scenario

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.

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.

Fig. 13 describes the fiscal outturn based on the GDP projections, anticipated receipt of the Compact sector grants, trends in payroll and use of goods and services. In Chuuk, tax revenues are forecast to grow in line with the tax base, while Compact sector grants are anticipated to remain constant in line with the decrement and partial inflation adjustment. On the expenditure side, wages reflect changes in numbers of employees and existing trends in average wages costs. Use of goods and services are set to remain constant in real 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, the projection methodology remains similar, but due to the improving economy, tax revenue is set to grow while payroll costs deteriorate, despite the state wage policy holding employee numbers constant. Overall, however, there is no projected deterioration in the state's fiscal position.

Fiscal projections indicate declining fiscal position at the state level, but significant potential surplus at the national.

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, and ignoring the off trend results for FY2010, the overall deficit remains 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 expend 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.

Reform Scenario

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 might provide an exit strategy from the dismal scenario.

Analysis suggests reform scenario might include tax reforms, distribution of national surplus to states or CTF, and measures to invigorate the private sector.

.

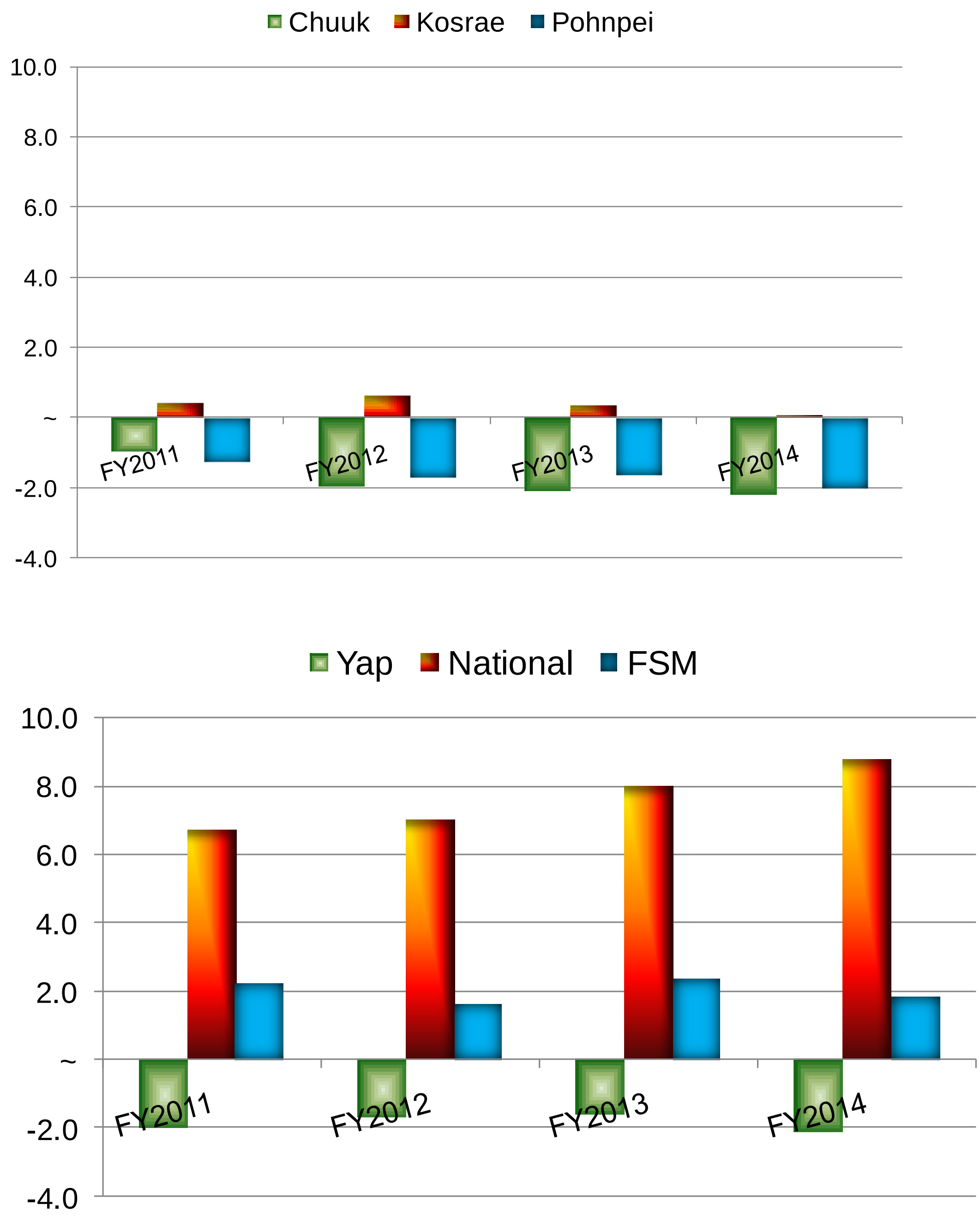


Figure 13 Projected fiscal outturn for the state and FSM economies, FY2011-FY2014