Republic of the Marshall Islands

Fiscal Year 2009 Economic Review

SUMMARY DOCUMENT

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Currency Equivalents

Currency Unit	—	United States Dollar (US$)

Abbreviations

ADB	—	Asian Development Bank
Amended Compact	—	The second phase of the Compact, FY04-FY23
CIP	—	Capital Improvement Project
Compact	—	RMI Compact of Free Association with the US
Compact I	—	First 17 years of the Compact, FY1987-2003
CTF	—	Compact Trust Fund
EPPSO	—	Economic Policy, Planning, and Statistics Office
FDI	—	Foreign Direct Investment
GDP	—	Gross Domestic Product
IMF	—	International Monetary Fund
MEC	—	Marshalls Energy Company
MIDB	—	Marshall Island Development Bank
MIITF	—	Marshall Island Intergenerational Trust Fund
MISSA	—	Marshall Islands Social Security Administration
MTBIF	—	Medium Term Budget Investment Framework
NTA	—	National Telecommunications Authority
NGO	—	Non-Governmental Organization
PM&O	—	Philippines Micronesia and Orient Line
PSE	—	Public Sector Enterprise
PSRP	—	Public Sector Reform Program
RIF	—	Reduction in Force
ROC	—	Republic of China
RMI	—	Republic of the Marshall Islands
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

		Page
Foreword	iv	
I.	Executive Summary	v
I.	Economic Performance	1
II.	Policy Developments, Prospects and Issues	11
Figures		
Figure 1	RMI Real GDP Growth	1
Figure 2	Structure of the RMI Economy by Institutional Sector	3
Figure 3	Constant GDP per capita	4
Figure 4	Employment by Sector	5
Figure 5	Change in CPI and selected commodity groups	6
Figure 6	Commercial Bank Credit by Sector	7
Figure 7	External Debt and Debt Servicing	8
Figure 8	Consolidated Revenues and Expenditures	9
Figure 9	Government Payroll and Employees	11
Figure 10	External Debt, Total Debt and ADB Debt Servicing	12
Figure 11	State owned enterprises, net operating profit	12
Figure 12	Compact Trust Fund Sufficiency	12

FOREWORD

This summary economic report has been prepared to assist the government of the Republic of the Marshall Islands (RMI) and the United States of America (U.S.) to fulfill their respective reporting obligations under the Compact of Free Association. The RMI is required under Title One, Section 215, to report to the President of the United States 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 RMI.

This report was prepared under a grant from the U.S. Department of the Interior, Office of Insular Affairs, and administered by the Graduate School. It is not intended to directly fulfill the reporting requirements of the two governments, but rather to assess RMI's economic performance and its policy environment and to provide an updated set of economic statistics. Much of the material will be directly relevant to the two reports. However, the reporting requirements of the two governments are different; thus, not all the material will be relevant to both reports.

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

Mark Sturton

I. Executive Summary

During the first four years of the amended Compact, the economy of the Marshall Islands experienced sustained growth, averaging 2.6% per annum. However, that economic expansion had largely been based on substantial increases in grant assistance from the U.S. and the Republic of China. Initial usage of Compact funds was constrained by capacity limitations in adaptation to the new fiscal procedures, but by FY2007 these had largely been overcome. In FY2008 the expansion in the economy came to an end with the onset of the world recession and rapidly rising food and fuel prices. The economy contracted by 1.6% in FY2008 and again in FY2009 by a further 2.1%. Employment grew strongly at the end of the 1990s and early 2000s, but has largely stagnated during the initial years of the amended Compact. The lack of gainful employment opportunities has encouraged many Marshallese to seek jobs in the U.S., with outmigration averaging 1.7% annually during the first six years of the amended Compact.

Expansionary fiscal policy was the main driving force behind the economic growth at the start of the amended Compact. Public Expenditures grew by an annual average rate of growth of 12% between FY2003 and FY2007, and employment in the public sector expanded by 521 jobs (35%) since FY1999 and 13% since the start of the amended Compact. The various forces that permitted the rapid expansion came to a halt in FY2007, and as the increasing expenditures hit their ceilings, the RMI fiscal position was left in a severely stressed position, with the government suffering persistent cash flow problems. In addition, debt service on ADB loans had grown significantly as grace periods expired. Further, subsidies to state-owned enterprises had reached high levels—exceeding 30% of general fund revenues. This situation was exacerbated by weak management and poor policies within the Marshal Energy Company (MEC), rising world energy prices, and increasing competition from high-seas fuel distributors. The financial crisis of the MEC required continuing cash injections from the government to sustain electricity production, and threatened the fiscal stability of the nation. Looking forward, fiscal pressure will continue to grow due to the combined effect of annual decrements and partial inflation indexation in the Compact sector grants. Thus a strong fiscal policy

response will be required in order to even maintain the capacity of the government to provide essential services.

The Trust Fund for the People of the RMI was created "to contribute to the long-term budgetary self-reliance of the RMI… [and] to provide the Government of the RMI 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 any post-2024 year are negative and if the "C" account, established as a buffer, is empty, the RMI 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 RMI 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 RMI Government continues 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 RMI. The terminal condition for sufficiency of the Trust Fund is projected to be $737 million at the outset of FY2024. Comparing actual performance to a smooth trend line signifying "on-track" performance, the Trust Fund would have reached $133.4 million as of June 30, 2010; however, the actual value was just $101.4 million. If the returns from this date forward were to average the trend line rate of 7.87% annually, the final value of the fund at the outset of FY2024 would be just 88 percent of the target level, falling short by $87 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 9.24%. This "catch-up" rate of return remains achievable, though by no means assured. To achieve such a return, given the current investment policy established by the RMI Trust Fund Committee, would require market returns in excess of asset class-weighted historical returns.

Realizing the economic and financial circumstances facing the nation, the RMI leadership initiated a series of reforms in FY2008. The Comprehensive Adjustment Program (CAP) Advisory Group and Tax and Revenue Reform and Modernization Commission (TRAM) were both created, and the reports of these groups were endorsed by the Cabinet. A report on the SOE sector was also initiated, and the MEC adopted a comprehensive recovery program. The ADB will support these reform efforts through a Public Sector Program, including a loan to refinance the external debt of the MEC. However, all of these initiatives now require the political will to implement the reforms that have been endorsed. Reduction in the size of an oversized public service and introduction of a modern tax regime will not be popular measures, especially with elections looming. While the current focus on the public sector is appropriate, attention will need to switch in the longer-term to engendering an environment conducive to private sector development if the economy is to generate an increasing level of living standards for its citizens.

I. ECONOMIC PERFORMANCE

Recent economic performance from FY1997 through FY2009 can be considered in three distinct periods: first, a depressed state in the late 1990s with negative rates of growth, followed by a more expansionary era in the initial part of the 2000s, and most recently, a third phase with a return to economic contraction. The late 1990s were marked by an extended period of economic contraction and fiscal instability resulting from the reduction in Compact grants to fund government operations and the need to repay bonds issued in the early 90s. A Public Sector Reform Program (PSRP) was initiated with assistance from the Asian Development Bank (ADB), to assist with the fiscal adjustment. A reduction in force (RIF) was the major component of the reforms intended to reduce the cost of government, but there were further objectives: to improve tax administration, to reform public enterprises, and to improve the environment for the private sector.

Economic performance in the late 1990s marked by negative rates of growth.

By the start of FY2000 circumstances began to improve. In 1999, the RMI recognized the ROC and was to receive $10 million annually in grant assistance. This significantly eased fiscal pressure and permitted an expansion in government expenditures. By FY2002 repayment of the prior bond issues was complete; Compact funds that had in prior years been absorbed in debt repayment

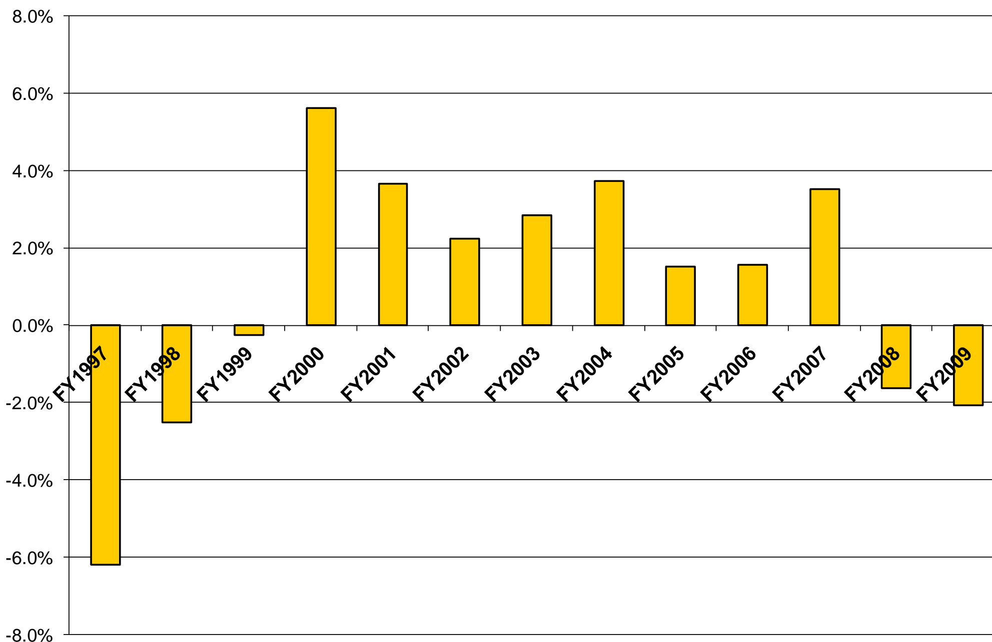


Figure 1 RMI Real GDP Growth

became available to support current expenditures. FY2002 and FY2003 were also the "bump-up" years of Compact I, with an infusion of additional resources. However, the RMI had committed to contribute $30 million to a Compact Trust Fund at the start of FY2004. This had the impact of sterilizing a large component of what otherwise would have been a sizeable infusion of resources. FY2004 marked the start of the amended Compact, and the RMI had negotiated a favorable assistance package that resulted in an increase in funding of $10 million above the pre-bump-up levels. FY2004 thus represented another year of fiscal stimulus.

RMI economy undergoes strong economic growth in the initial 2000s,

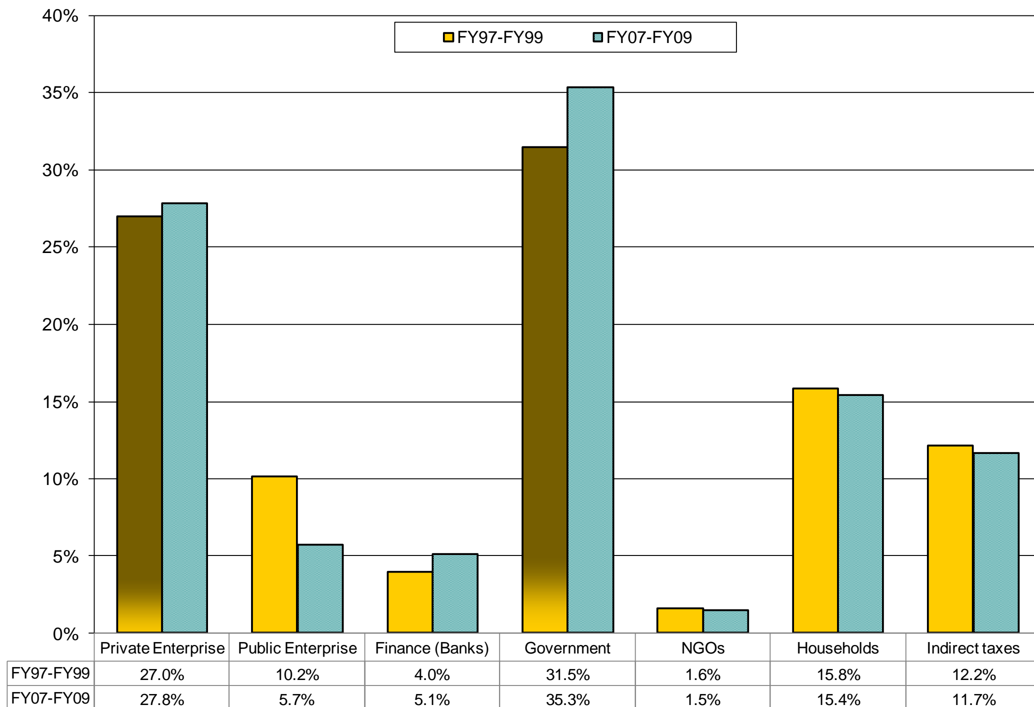
By FY2005, the substantial increase in Compact resources over the FY1999-FY2004 period had peaked. This, together with the closure of the PMO fish loining plant, meant that FY2005 should have been the culmination of a period of rapid economic growth. However, while the fiscal stimulus of additional Compact resources had peaked, the forward momentum in public expenditures continued. The private sector maintained economic activity, with additional investment demand arising from the Compact infrastructure grant, renovation of the Majuro airport, and the Taiwanese-funded convention center. The fish loining plant also underwent renovation and reopened under new ownership.

Recession hits the RMI in 2008 and the economy records the first year of negative growth of the amended Compact period.

By FY2008 the economy had peaked and GDP fell, for the first time in the decade, by 1.6%. The large number of construction projects had come to an end and further expansion in government was no longer possible as expenditures hit or exceeded their revenue ceilings. FY2008 also saw the end of rapid expansion in the world economy as fuel and food prices reached record levels. Inflation in the RMI reached 15 percent, eroding domestic real incomes and reducing demand for local business. Compounding these problems, the Marshall Energy Company (MEC) underwent a severe cash flow crisis as fuel prices reached record levels. In the absence of a timely policy response to pass along increased costs or to manage demand, MEC required substantial cash infusions from government. These forces prompted the RMI leadership to declare a first-ever "state of economic emergency." Although inflation fell back to 0.7% in FY2009 and restored household incomes, the same general economic forces exerted themselves and GDP fell by a further 2.1%.

Share of government increases significantly over 10 year period

Given the rapid rate of growth in public expenditures, the contribution of government to GDP grew significantly, increasing from 32% to 35% (Fig. 2). Public enterprises as a share of the sector fell by 4%, reflecting a large increase in subsidies. As a result of the deteriorated position of the SOEs, the share of the public sector



	Private Enterprise	Public Enterprise	Finance (Banks)	Government	NGOs	Households	Indirect taxes
FY97-FY99	27.0%	10.2%	4.0%	31.5%	1.6%	15.8%	12.2%
FY07-FY09	27.8%	5.7%	5.1%	35.3%	1.5%	15.4%	11.7%

Figure 2 Structure of the RMI Economy by Institutional Sector.

(including both government and SOEs) has actually fallen from 42% to 41%. The private sector has increased its contribution, but the small increase reflects its inability to break away from its dependant status and assume a more dynamic role as an engine of economic growth. The share of the household sector continued to decline as the economy grew, representing the reduced importance of non-marketed subsistence production. The share of the other sectors in the economy remained largely unaltered, although the finance sector shows some increase.

Fig. 3 shows the changes in constant price per capita GDP since 1981. The advent of the Compact in the late 1980s saw a large improvement in income levels in the run-up to the Compact. After a period of stagnation in the earlier years, growth was boosted in the early to mid-1990s through a series of bond issues that enabled the nation to embark on a number of risky ventures. However, the gamble on public sector involvement in productive activities did not pay off, and the nation was forced into a difficult period of decline as the economy adjusted to low levels of net aid transfers depleted by the need to repay failed investments.

Real incomes grow strongly between 1981 and 1995, but collapse as Compact money dries up in the late 1990s.

In FY2000, matters improved, as fiscal stability was restored with new donor assistance, repayment of the debt, and a favorable fi-

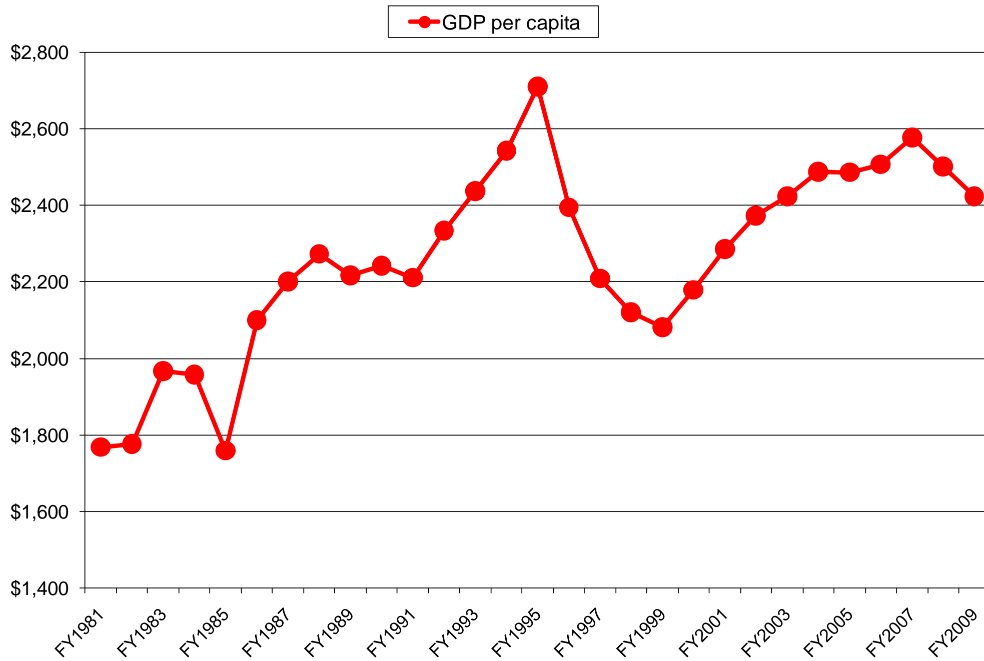


Figure 3 Constant GDP per capita, 2000 prices

Real incomes improve during the initial part of the 2000s, but falter in FY2008 and FY2009 with the onset of the world recession.

nancial outcome of the amended Compact negotiations. Between FY2000 and FY2007, GDP per capita expanded by $398, or at an average annual rate of 2.3%. However, it failed to regain the level achieved in the mid-1990s. In FY2008 and FY2009 GDP per capita faltered and took a sharp downward turn as the economy went into recession. This current downturn signals serious challenges that lie ahead in transforming the economy from public- to private-sector-driven, if the experience of the late 1990s is not to repeat itself.

Failure to generate sustained economic growth results in substantial out-migration in 2000s.

Population in the RMI has historically grown at very high rates. During the period 1980-1988, in the lead-up to Compact I, the annual average rate of growth was 4.3%. This pattern changed radically between the next two census points in 1988 and 1999. Population growth slowed down significantly to 1.5%, reflecting the emergence of large out-migration to the U.S. under the provisions of the Compact. More recent data, as measured by net movements of air passengers departing the RMI, indicates that out-migration as a percent of the population reached 2.3% between 1997 and 2003 and 1.7% during the first five years of the amended Compact. Clearly, the limited job opportunities and depressed economy of the late 1990s encouraged large-scale out-migration in search of employment opportunities and higher wages in the U.S. While

economic performance improved during the amended Compact, earnings differentials with the U.S. continue to be a strong motivation to emigrate.

From a declining level of employment in the late 1990s, public sector employment expanded strongly between FY1999 and FY2007, growing by 27% or at an annual average rate of 3% (Fig. 4). In FY2008 and FY2009 national government employment sustained their employment level, while employment in the two local governments dropped, resulting in an overall decline in public employment. Developments in private sector employment in the first part of the 2000s were dominated by public-sector-led expansion in the economy and the opening of the PMO fish loining plant in FY2000. In FY2005 employment in the private sector fell with the closure of PMO, but expanded in FY2006 and FY2007 as construction activity created a strong demand for additional labor. In FY2008 the fish loining plant reopened adding 160 jobs and a further 250 in FY2009, which compensated for a reduction in construction activity. The result of these trends is that employment in the economy as a whole expanded strongly between FY1999 and FY2004 at an annual rate of 3.5%. In FY2008 and FY2009 retrenchment in the US base at Kwajalein offset the reopening of the loining plant and employment fell by 8% and 6%, respectively.

Strong job growth in the early 2000s in both public and private sectors, but demand for jobs has plateaued since FY2004.

Fig. 5 indicates changes in the CPI for selected commodity groups since Q1 of 2004. After relatively modest rates of inflation through

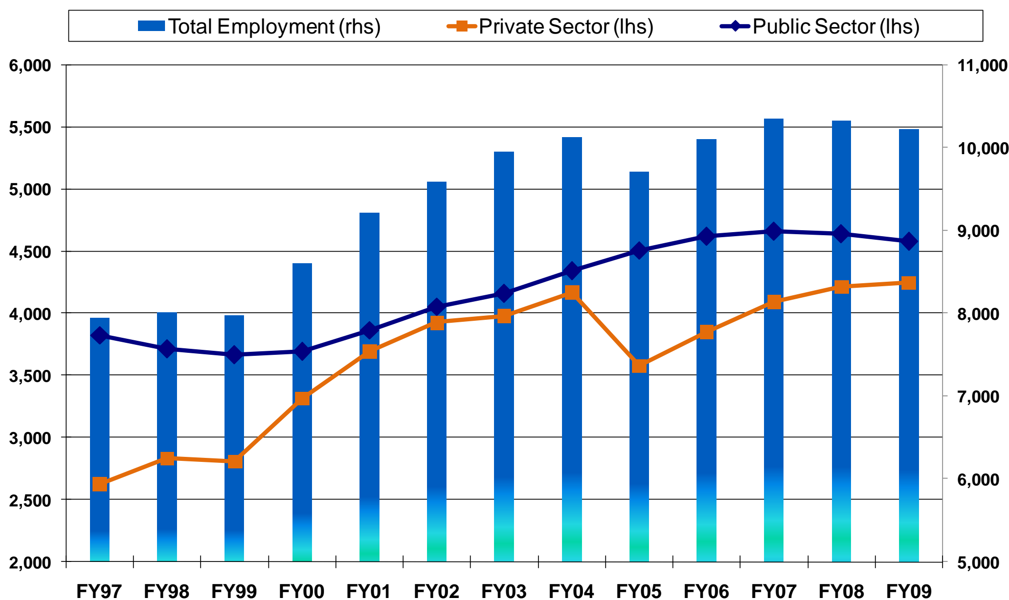


Figure 4 Employment by Sector FY97-FY09

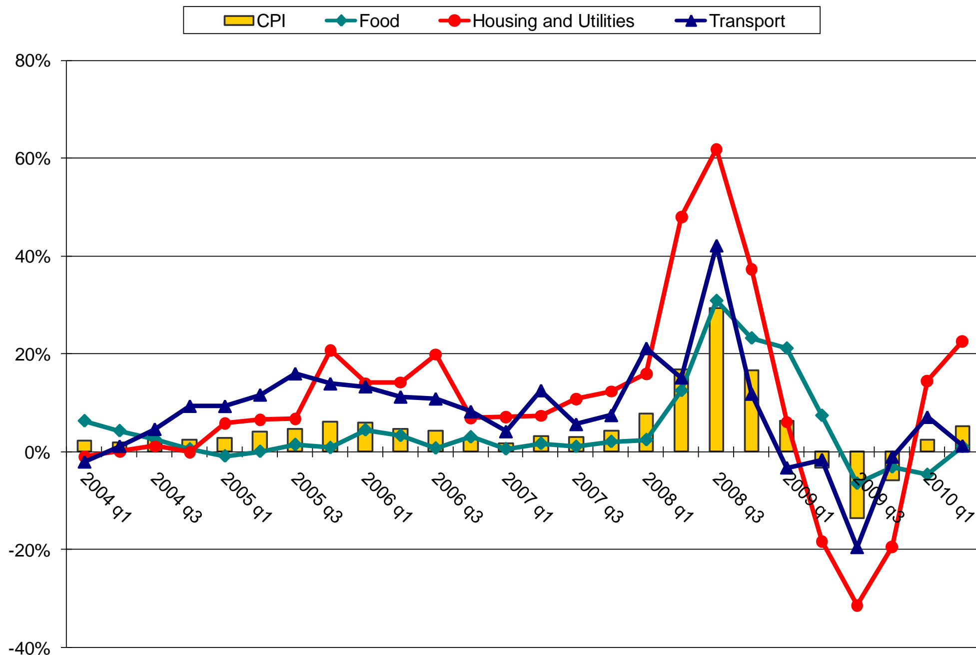
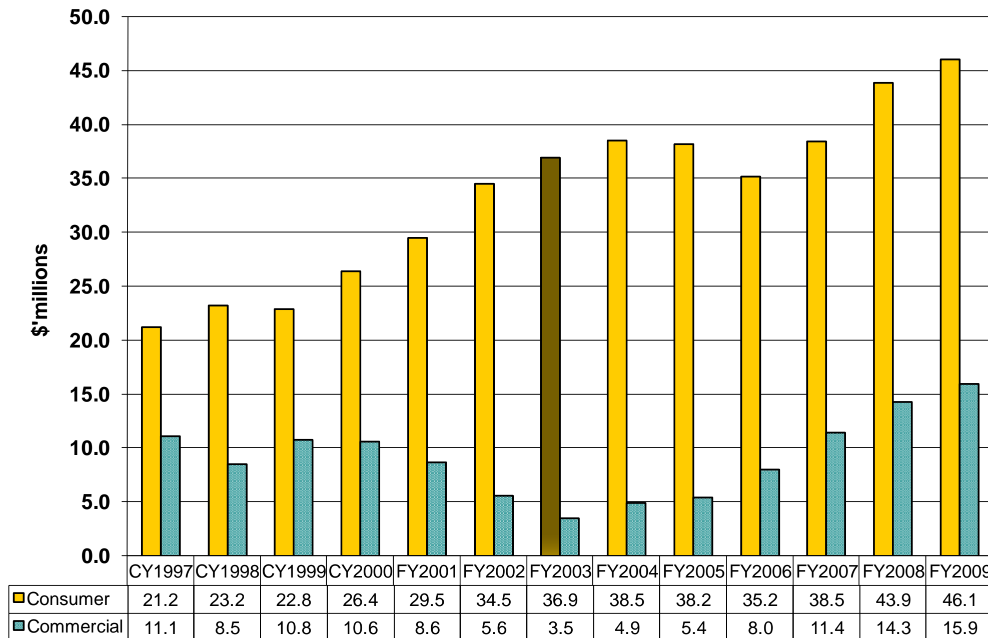


Figure 5 Change in CPI and selected commodity groups, FY04-FY09

Inflation rises at alarming rates in 2008 reflecting increases in food, electricity and world energy prices.

the end of 2007, consumer prices increased at alarming rates in 2008. Clearly, the most dominant price change has been in the housing and utility section of the CPI, reflecting the impact of higher utility prices, which peaked at 62% in Q3 of 2008. The changing environment confronting the MEC required large changes in electricity prices because of both a hike in world fuel prices and a need to charge prices more closely related to the basic costs of operations. The direct impact of higher fuel prices can be seen more clearly in transportation prices, which rose by 42% in the same quarter. Meanwhile, the food section of the CPI, reflecting the increases in world food prices, rose by 31%. The combination of these forces caused overall CPI to rise by 15%, rates not experienced since the mid-90s. In 2009 food and fuel prices moderated significantly to levels below the 2008 levels. In Q3 of 2009 fuel prices had fallen by 31% and food prices by 20%. By 2010 prices changes were less erratic and the overall CPI rose by 2.5% and 5.2% in the first and second quarter, respectively, although the housing and utility section had again recorded a rate of inflation of 23%.

Fig. 6 indicates the extension of credit to the private sector in the consumer and commercial markets since 1997. After a weak period in the late 1990s, consumer credit expanded rapidly in the initial



	CY1997	CY1998	CY1999	CY2000	FY2001	FY2002	FY2003	FY2004	FY2005	FY2006	FY2007	FY2008	FY2009
Consumer	21.2	23.2	22.8	26.4	29.5	34.5	36.9	38.5	38.2	35.2	38.5	43.9	46.1
Commercial	11.1	8.5	10.8	10.6	8.6	5.6	3.5	4.9	5.4	8.0	11.4	14.3	15.9

Figure 6 Commercial Bank Credit by Sector

2000s, as confidence in the economy returned, and the government embarked on a rapid increase in the size of the public service sector. Between 1999 and FY2009, consumer credit grew by an annual average of 7.3% and consumer lending stood at 47% of total employee compensation. This indicates a high level of household indebtedness, which will not only place stress on household finances, but also pose a threat to the banking system. For the commercial sector, lending collapsed after 2000, with the departure of the Bank of Hawaii. From a figure of $10.6 million in commercial lending in 2000, the market fell to $3.4 million in FY2003. Since FY2003, commercial lending to the private sector has improved, and by FY2009 had risen to $15.9 million. However, private sector commercial lending is severely constrained by a lack of bankable collateral. With the recent improvements in the "secure transactions" law passed by the Nitijela in March FY2007, it is hoped that this segment of the market, which is of critical importance to private sector development, will show signs of expansion.

Consumer credit expands rapidly incurring high levels of household indebtedness.

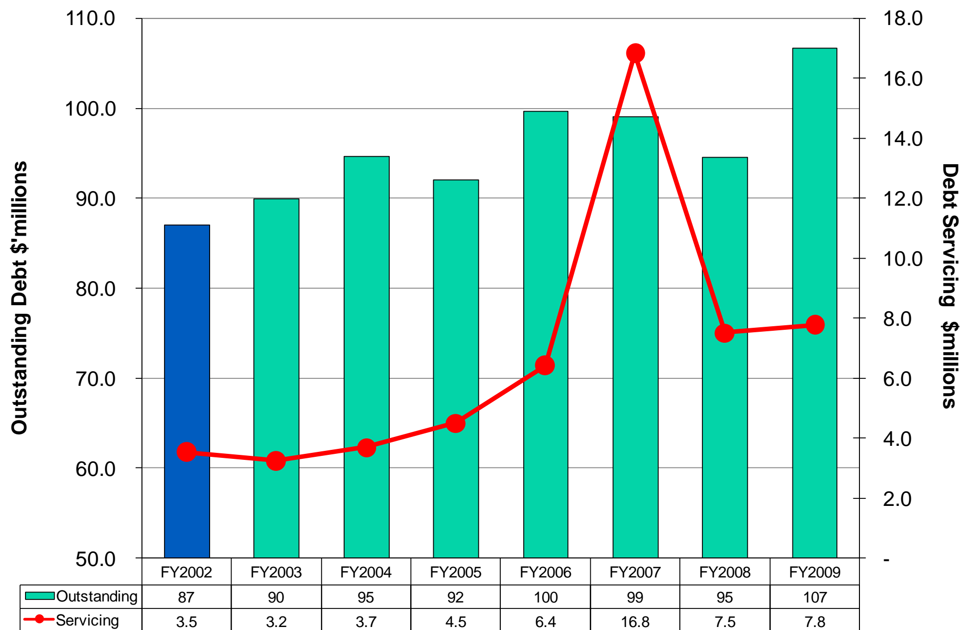
Commercial credit improves after the departure of the Bank of Hawaii, but remains constrained by a lack of bankable projects.

During Compact I the government developed a substantial portfolio of loans from the ADB. The portfolio includes loans for water supply, the social sector, fisheries, transport projects, and reform program loans. In total, the ADB has approved $76.2 million in loans, with an outstanding debt, at the end of FY2009 of $58.8 mil-

lion. All but $4 million of this outstanding amount is provided on concessional terms. In addition to direct borrowing, the government guarantees a substantial portfolio of loans for the SOEs. Government-guaranteed loans include $28.6 million for the NTA, $16.5 million for the MEC, and $2.3 million for the MIDB, in total an amount of $47.4 million

External debt increases significantly since 2002 as result of SOE borrowing. Debt service also grows as ADB loan grace periods expire.

Fig. 7 shows the substantial size of the RMI's external debt and the burden of the debt servicing since FY2002. In FY2002, the level of outstanding debt was $87 million, which equated to 71% of GDP. Since this time external debt has risen to $107 million in FY2009, but in relation to GDP fell slightly to 69%. Debt service, on the other hand, has risen from $3.5 million or 10% of general fund revenues in FY2002, to $7.8 million or 23% of general fund revenues in FY2009. In FY2007, the sharp upward movement in debt service represented transactions relating to the MEC crisis, which were consolidated through a $12 million loan from the Bank of Guam, and brought the level of outstanding debt down to trend levels in FY2008. While much of the RMI external debt is on concessional terms to the ADB, there has been a substantial increase in debt service as prior loans have now passed expiration of their grace periods. Since external debt servicing is funded out of the government's discretionary resources, or General Fund, there are



	FY2002	FY2003	FY2004	FY2005	FY2006	FY2007	FY2008	FY2009
Outstanding	87	90	95	92	100	99	95	107
Servicing	3.5	3.2	3.7	4.5	6.4	16.8	7.5	7.8

Figure 7 External Debt and Debt Servicing, FY2002-FY2009

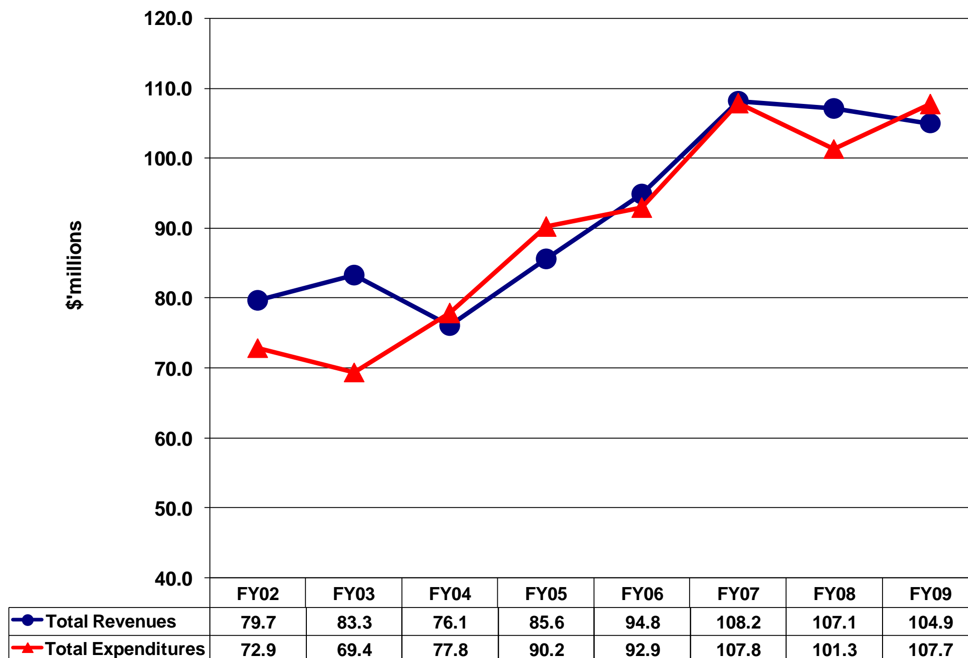
significant implications for fiscal policy.

Towards the end of Compact I the RMI underwent a difficult period of fiscal adjustment when the nation was forced to compress expenditures and lay-off significant numbers of civil servants. In FY1999, the RMI formally recognized the ROC and was to benefit from substantial contributions, both to the general fund and for capital projects. In FY2002 and FY2003, the nation entered the "bump-up" period of Compact I and received significant but temporary increases in grants. As part of the amended Compact negotiations, the RMI agreed to contribute $30 million of the additional funds to the Compact Trust Fund (CTF). In FY2002, the RMI set aside $17.5 million and a further $16 million in FY2003, which were later transferred to the CTF. Fig. 8 indicates the impact of these forces as revenues rose above expenditures and the nation ran a significant fiscal surplus.

The RMI runs a fiscal surplus FY02-FY03 to contribute to Compact Trust Fund

In FY2004-FY2009, as the amended Compact took effect, the fiscal account shows a more normal trajectory, with revenues and expenditures more closely aligned. Expenditures moved strongly upward boosted by the higher levels of funding available under the amended Compact and, in later years, by the increasing capacity utilization of the infrastructure sector grant. In FY2004, revenues were mostly in line with expenditures and the fiscal account

Strong growth in expenditures during initial years of amended Compact as capacity utilization constraints are alleviated.



	FY02	FY03	FY04	FY05	FY06	FY07	FY08	FY09
Total Revenues	79.7	83.3	76.1	85.6	94.8	108.2	107.1	104.9
Total Expenditures	72.9	69.4	77.8	90.2	92.9	107.8	101.3	107.7

Figure 8 Consolidated Revenues and Expenditures, FY97-FY08

records a small deficit of $1.8 million, or 1.3% of GDP. In FY2005, with the upward momentum in expenditures remaining in full swing, a larger deficit of 3.4% of GDP was recorded. In FY2006 and FY2007, the fiscal situation continued to tighten, but the fiscal account recorded small surpluses of 1.3% and 0.2% of GDP, respectively.

Relatively favourable fiscal outturn during the first five years of the amended Compact masks underlying fiscal pressure and instability.

By FY2008, the period of fiscal expansion had run its course, and total expenditures dropped by $7.8 million, reflecting lower transfer payments and a large drop-off in capital expenditures. Revenues were also weak, dropping by 1.1% percent, failing to exhibit the growth of earlier years. In FY2009, with continuing upward pressure on expenditures, large increases in transfers and subsidies to the SOE sector, and a weakened revenue position, the fiscal outturn again turned negative and a deficit of $2.8 million or 1.8% of GDP was recorded. The apparently close proximity of revenues and expenditures and relatively low levels of fiscal deficit in relation to GDP provide a misleading impression of the fiscal situation in the RMI. The emerging crisis in FY2008 with the onset of the world recession and higher fuel prices precipitated a financial crisis at the MEC, which in turn threatened the fiscal stability of the nation. The limited ability of the government to borrow to finance a deficit, the fine balance between revenues and expenditures, and the high risk of insolvency in the SOE sector, all placed the nation in a very precarious position.

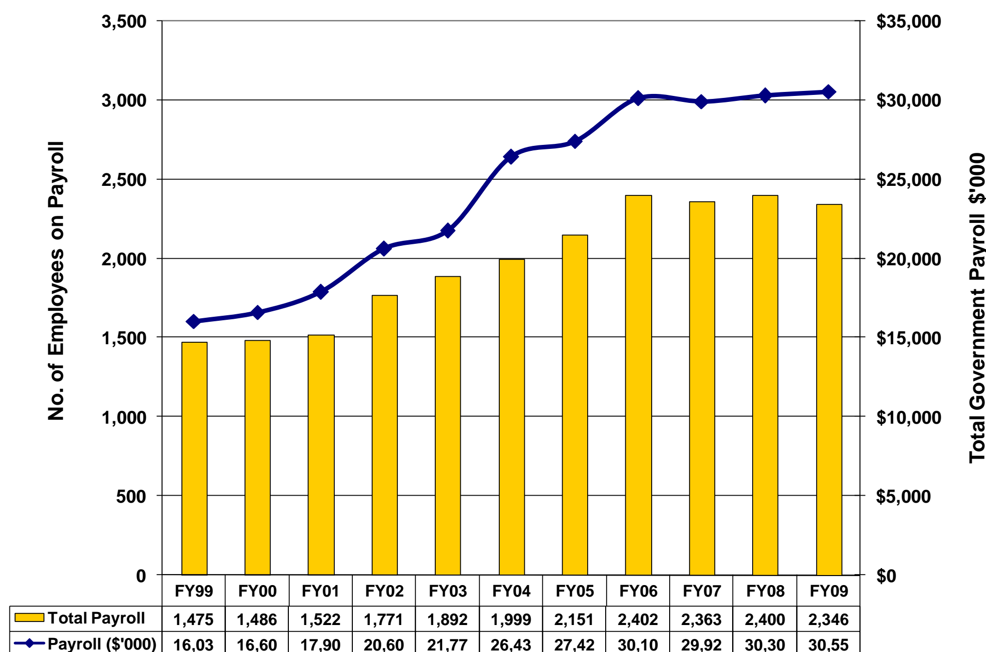
II. POLICY DEVELOPMENTS, PROSPECTS AND ISSUES

Rapid increase in government payroll puts pressure on fiscal situation.

Since the completion of the RIF program in 1999, the government payroll has grown considerably. The sizeable reductions in public service from the RIF were followed by the transitional bump-up years, which enabled expansion in payroll. The trend since FY1999 has been a rapid increase in public servants (Fig. 9). Employee numbers on the payroll fell to 1,475 in FY1999, but increased to 2,346 by the end of FY2009, a 59% increase, while payroll costs have increased by 91%. As part of the Compact renegotiations, the RMI became ineligible for the US Federal Program Head Start. However, compensatory funding was provided through the Supplemental Education Grant (or SEG) and the 200 or so former Head Start employees were transferred to the Education Department in FY2006. In FY2001 and 2002, both Majuro and Ebeye elementary school teachers were brought back under the MoE, adding approximately 100 employees and 50 employees to the payroll, respectively. Fig. 9 thus overstates the increase in government payroll. After making suitable adjustments for the change, government employment increased by 521 employees, or 35%, over the ten-year period.

Government employment increases by 521 employees or 35 percent since end of RIF.

While expansion in government payroll came to an end in FY2006, there is limited oversight and control of the recruitment process,



	FY99	FY00	FY01	FY02	FY03	FY04	FY05	FY06	FY07	FY08	FY09
Total Payroll	1,475	1,486	1,522	1,771	1,892	1,999	2,151	2,402	2,363	2,400	2,346
Payroll ($'000)	16,03	16,60	17,90	20,60	21,77	26,43	27,42	30,10	29,92	30,30	30,55

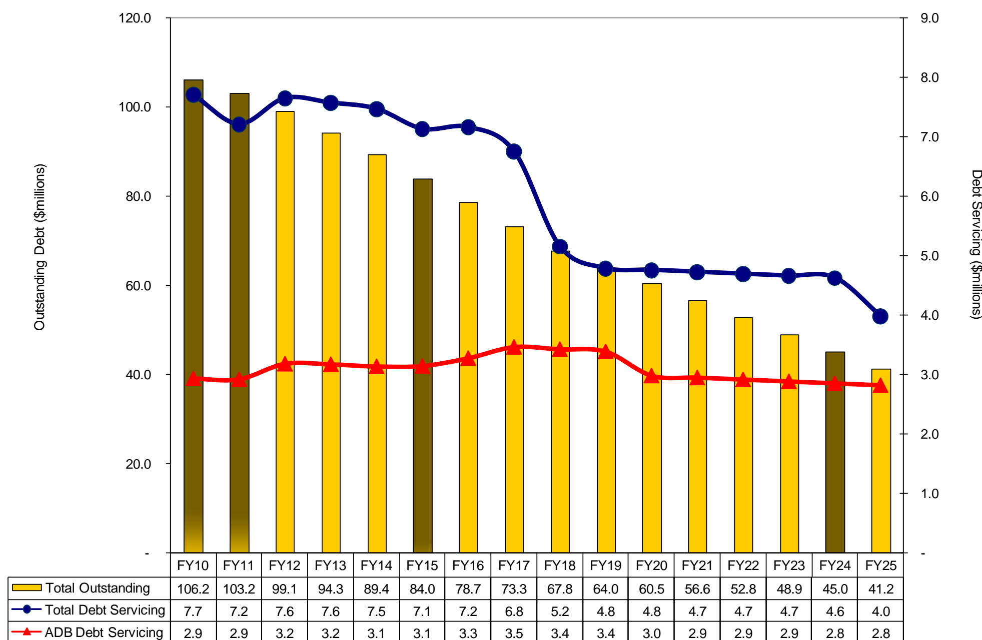
Figure 9 Government Payroll and Employees, FY1999 – FY2009.

Weak control over public service recruitment has unseen fiscal implications.

despite recent moves to performance-based budgeting. The Public Service Commission and, more importantly, the Cabinet, are the main coordinating mechanisms for managing overall payroll. While recruitment is placing increased pressure on the fiscal position, the Budget Committee needs an expanded role in managing recruitment within the overall fiscal framework.

External debt service on ADB loans exerts significant pressure and poses a major challenge to fiscal management.

Although the sizeable bond issues used to finance development projects in the 1990s are now part of the RMI's fiscal history, external debt management in the medium term presents a major challenge. There are two major components of debt service: (1) government debt on concessional terms to the ADB, and (2) government guaranteed debt incurred by the SOE sector. Fig. 10 indicates the projected trend in outstanding debt and debt service for the two types, based on amortization schedules. For total debt, there are two phases: an existing high rate of debt service of about $8 million, to be repaid over the next eight years, then a much reduced rate of about $5 million. For its debt to the ADB, the government will be required to set aside about $3 million from the general fund for the next 20 years. As a proportion of general fund revenues of $30 million, this represents about 10%. In previous years, nearly all of the RMI debt was in the grace-period era, and debt service obligations were not significant. However, in the last four years,



	FY10	FY11	FY12	FY13	FY14	FY15	FY16	FY17	FY18	FY19	FY20	FY21	FY22	FY23	FY24	FY25
Total Outstanding	106.2	103.2	99.1	94.3	89.4	84.0	78.7	73.3	67.8	64.0	60.5	56.6	52.8	48.9	45.0	41.2
Total Debt Servicing	7.7	7.2	7.6	7.6	7.5	7.1	7.2	6.8	5.2	4.8	4.8	4.7	4.7	4.7	4.6	4.0
ADB Debt Servicing	2.9	2.9	3.2	3.2	3.1	3.1	3.3	3.5	3.4	3.4	3.0	2.9	2.9	2.9	2.8	2.8

Figure 10 External Debt, Total Debt and ADB Debt Servicing, $M's

principal repayments for many of the loans have fallen due, and debt service has contributed to significant fiscal pressure. In FY2006, the government experienced its first problems in servicing ADB debt and defaulted on several loans. In FY2007, it remained in arrears, as service obligations rose to $2.2 million. By FY2008, the government placed ADB debt service higher on its payment priority schedule, made good on past delinquencies, and the RMI is now current with respect to its ADB debts.

The difference between the two curves in Fig. 10 indicates the debt service obligations of the SOE sector. External debt of the SOEs is at higher interest rates and shorter terms, and thus incurs a proportionately higher service commitment. Current debt service levels of the NTA, MIDB, and MEC are $2.1 million, $0.6 million, and $4.3 million, respectively. Given the current financial problems of the MEC, its existing debt service has presented a substantial financial risk for the government. However, as indicated below, moves are afoot to refinance this debt to make MEC liabilities more stable and less costly. The ADB debt service crisis has brought home the impact of a poorly managed external debt strategy. A well articulated debt management strategy is needed to assist the RMI in determining the type of projects for which external loan finance is appropriate and identifying cases where there is potential for projects to cover service costs.

RMI requires a coherent external debt strategy to avoid past excesses.

MEC debt poses significant risk.

The operations, profitability, and subsidies to the State Owned Enterprise (SOE) sector have become a major and pervasive problem for the RMI. During FY1999-FY2001 the average level of subsidy and capital transfer was $4.5 million. During the FY2007-FY2009 period this level had risen to $10.3 million and represented 30% of general fund revenues. Once merely an important financial issue, the RMI government's level of subsidy to the SOEs has now reached a critical level, indicative of the need for reform. The RMI government, aware of this growing problem, requested the ADB to undertake a review of the SOE sector and recommend options for reform.

State owned enterprise required an average subsidy of $10.3 million in FY2007-FY2008 or 30% of general fund revenues.

Based on the ADB study, Fig. 11 provides an overview of the SOE sector by each of the major enterprises and indicates the change in level of net operating profits from the averages of FY1999-FY2001 to FY2006-FY2008. The largest group of loss-making SOEs has been the utilities, comprising both the MEC and KAJUR, which now average an annual loss of $6 million. Additional information on MEC is described below, but the level of loss at KAJUR falls not far behind. The next group of entities comprises SOEs that provide social obligations to the outer atolls: AMI (air-

SOE management now requires urgent attention to improve fiscal stability.

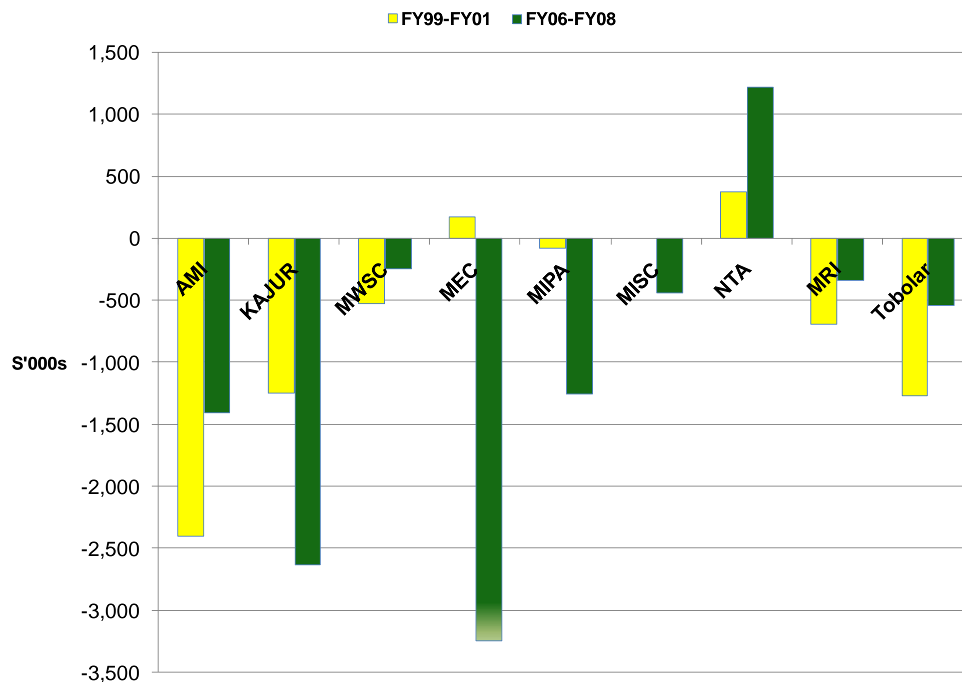


Figure 11 State Owned Enterprises, net operating profit

line), MISC (shipping company) and Tobolor (responsible for coconut oil production), have collectively incurred losses averaging $2.2 million in the last three years. A third group comprising the MIR (hotel) and MIPA (port authority) record annual losses but receive no subsidy. In effect, this group is making a return insufficient to provide for the depreciation of capital. Among RMI SOEs, only NTA (telecom) makes a positive return.

MEC's initially favourable conditions turn sour after a series of adverse developments threatening fiscal stability of the government

Established at the beginning of the Compact as a wholly-owned Government corporation, MEC was long considered one of the better-run electric utilities in the Pacific. MEC's success capitalized on the RMI's large fuel bunkering capacity, which allowed direct shipment of lower unit-cost and larger volumes. RMI's consignment-based fuel supply arrangements with Mobil, Majuro's proximity to productive fishing grounds, and its ideal port conditions established it as an attractive refueling and transshipment hub in the central Pacific. High gross profit margins on fuel sales allowed MEC to cross-subsidize and suppress electricity tariffs. This model worked quite well for over a decade.

A series of events from 2004 to 2007 radically altered this favorable position:

- loss of the Compact I energy grant;
- steadily increasing global fuel prices;
- the inability of MEC to pass on higher fuel costs through its tariffs;
- the outbreak of a major legal dispute between MEC and its fuel supplier MOBIL;
- the imposition of new import and gross revenue taxes on MEC's fuel imports and sales; and
- the entry of lower-cost high-seas refueling vessels in the central Pacific, which significantly eroded MEC's market share.

What had once been a lucrative and well-run utility had very quickly turned into a major liability and risk to the fiscal system and overall economy. To redress the situation, the MEC board pushed through a comprehensive set of financial, operational and corporate governance reforms aimed at improving the fundamental solvency and sustainability of the utility. The major policies include:

MEC pushes through a comprehensive set of reforms aimed to achieve a return to profitability

- Adoption of a new tariff template which will, once company inefficiencies have been rectified, provide for full cost recovery;
- Strengthening of accounts receivable, and installation of pre-paid meters for all residential customers;
- Reduction of power system losses both technical and financial;
- Negotiation of community service obligation contracts to compensate MEC for loss-making operations in outer island atolls;
- Renegotiation and deferment of loan repayments with the Rural Utilities Service, and restructuring of the Bank of Guam loan.

Should these reforms be implemented on schedule, it is estimated that the MEC could return to an operating profit by 2011. The reform process will take several years and is currently the centerpiece of a public sector program loan under negotiation with the ADB. If implemented, this will remove one of the most serious risks to financial instability facing not only the MEC, but also the RMI government.

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 RMI was a major feature of the amended Compact. The Trust Fund was created "to contribute to the long-term budgetary self-reliance of the RMI… [and] to provide the Government of the RMI with an ongoing source of revenue after FY2023." The design features of the Trust Fund related to distributions to the RMI 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.

Notwithstanding this 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 negative, and if the "C" account, established as a buffer, is empty, the RMI 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 RMI 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 investment policy of the buffer account.

With the actual level of sustainable Trust Fund distributions not being guaranteed, it is also imperative that the RMI Government continues to monitor the progress of the Trust Fund to assess 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 RMI. 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 US and RMI Gov-

ernment should also be aware that the current rules specified in the Trust Fund Agreement fail to protect the real value of the Trust Fund. One can only presume that a drafting error led to the specification which in fact only protects the nominal value of the Trust Fund from the outset of FY2024 forward. This is a serious flaw that should be corrected.

Trust Fund currently below track—needs to grow at the achievable annual rate of 9.24% to meet the "terminal condition."

The current value of the RMI Trust Fund is 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 $737 million 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 $133.4 million; however the actual value of the RMI Trust Fund at that date was $101.4 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 9.24% (Fig 12). This "catch-up" rate of return remains achievable, though by no means assured. To achieve such a return given the current investment policy established by the RMI Trust Fund Committee would require market returns in excess of

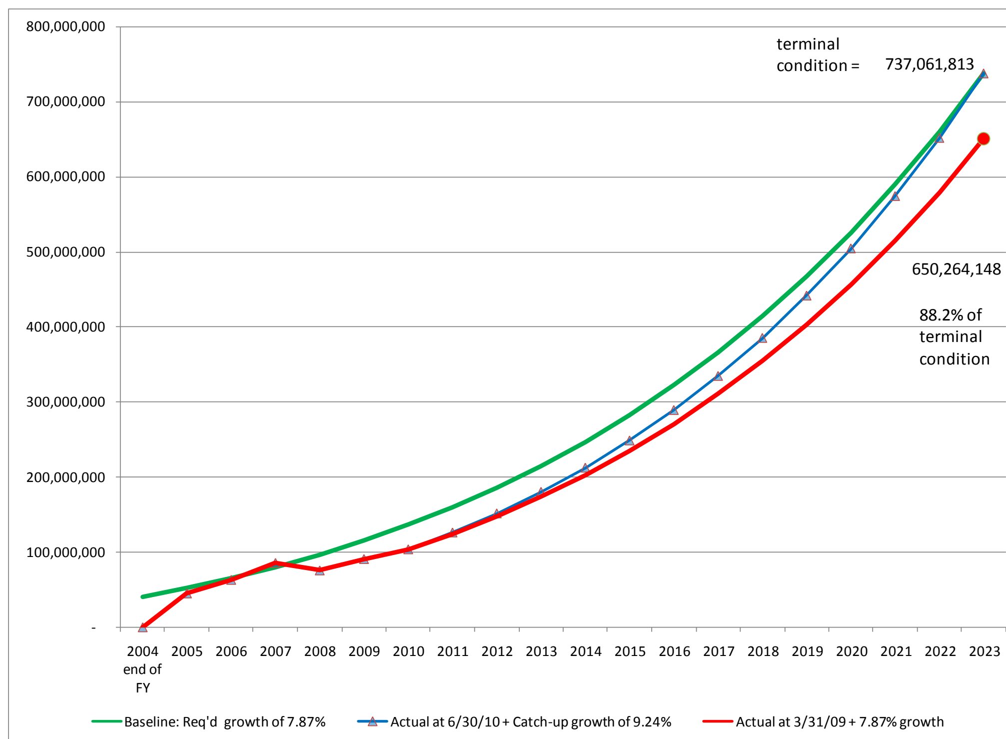


Figure 12 Compact Trust Fund Sufficiency, FY2004 – FY2024, $'millions

asset class-weighted historical returns.

Apparent fiscal balance masks underlying fragile and vulnerable fiscal position.

Recent fiscal performance (Fig. 8) indicates a tight fiscal position but does not reveal the large or growing deficits frequently associated with an unsustainable fiscal position. This begs the question of whether the fiscal outturn requires adjustment. An economy such as the RMI cannot easily run a large deficit, since there is no central bank or access to external capital markets. Deficits can be supported only through such measures as aging payments to vendors, default on debt, or failure to pay monthly tax and social security allotments on behalf of employees. Thus, to accurately assess actual fiscal pressure, it is necessary to identify non-conventional signals of weakness. The following indicators have been evident during the amended Compact:

- A ruling in July 2005 by the U.S. Inspector General that Compact funds should be quarantined to avoid the use of Compact resources to fund general government operations;
- Use of the Compact Trust Fund "D" account ($3.5 million) to meet the RMI capital contributions to the "A" account in FY2005 and FY2006;
- Difficulty in meeting the general fund payroll in FY2006, and delays in the payment of allotments and MISSA contributions from the salaries of government employees in FY2006;
- A very finely balanced fiscal outturn, existence of a priority list of recipients, and weekly cash flow management;
- Inability to service ADB debt in FY2007;
- The increasing use of the ROC project fund ($6 million in FY2009) for advances to the SOE sector and general fund purposes; and
- Low unreserved working balances of the general fund and a negative unreserved fund balance (-$3.0 million in FY2009).

There is no doubt from the above observations that the daily operation of the RMI government budget is stressed. While the situation has improved from that in FY2008 when debt service, payroll and allotments were in arrears, the government's cash flow position remains tenuous. Over the period of the annual cycle the budget has been approximately in balance, but the timing of receipts and payments may be such that there is a cash shortfall during particu-

lar weeks or days. Clearly, this is an undesirable result and begs the question of what is suitable fiscal policy for the RMI. There would appear to be four different considerations in the design of fiscal policy:

Outline of principles of fiscal management in the RMI.

- ***Cash flow management***: maintenance of a sufficient fiscal balance and reserves to enable smooth operations of government and payment of expenditures.
- ***Cyclical downturn***: The nation also needs to be prepared for cyclical developments usually in the medium-term that arise from adverse world economic conditions. This may arise from changes in the external terms of trade, such as fuel price shocks, food prices increases, or primary commodity price reductions (coconut oil, fish prices).
- ***Structural imbalances***: while the RMI fiscal position is tenuously in balance in the immediate short-term, the medium and longer-term outlook is in deficit. This will arise due to the decline in grants from the U.S. due to the annual decrement. Although nominal grants are likely to remain constant due to the fact that the decrement is off-set by the 2/3rds inflation adjustment, the real value of the Compact grants will decline.
- ***Insufficiency of the CTF***: During the recent IMF Article IV consultations the IMF defined the concept of fiscal balance in relation to the generation of sufficient saving to make up for the anticipated shortfall in the CTF in 2024. Based on their calculations the RMI needs to increase fiscal savings to 5% of GDP within 5 years and to maintain it at that level through 2024.

JEMFAC request decrement management plan.

During the annual Compact meetings of the JEMFAC in September 2009 resolution JEMFAC 2009-1 Sustainability of Sector Budgets was unanimously passed:

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

While the JEMFAC resolution relates to the sustainability of the sector grants it clearly recognizes that this cannot be undertaken in isolation and requires a holistic approach to budget formulation. Decisions on maintenance of the sector grants in a declining envi-

ronment interact with the use of general fund resources and other priorities of government. It is thus clear that there is a need for the development of a long-term fiscal framework to balance the needs of government taking into account the objectives of fiscal policy outlined above and the JEMFAC resolution. A three part process might be envisaged:

Outline of long-term budget and decrement management.

Establishment of Long-Term Fiscal Framework (LTFF). This would include an economic modeling framework based on the structural characteristics of the RMI economy with a planning horizon through 2024. A policy package could then be developed meeting the long-term objectives of the government of the RMI and sector grant considerations.

Sector grant usage. This would include 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 might also be included.

Review of recommendations by leaders at a conference. Organization of a participatory meeting to review the long-term fiscal framework, sector grant usage and delivery of general public services will be necessary. The outcome of the conference would be the preparation of a public sector plan for endorsement by government to guide future budgetary allocations.

Government initiates a series of internally conceived reform initiatives.

In response to the emerging world economic crisis in 2008, rising fuel and food prices, onset of global recession, and most importantly the imminent financial collapse of the MEC, the Cabinet created two groups and commissions tasked with fiscal reform initiatives. In April 2009, an RMI CAP Advisory Group was created to develop an internally conceived and designed Comprehensive Adjustment Program. The second group created by Cabinet was the Revenue and Tax Reform and Modernization Commission. Arising out of these internally generated reform initiatives the ADB was requested to provide support through a Public Sector Program (PSP) aimed at consolidating the reform process and in particular the provision of resources to refinance MEC debt on concessional terms.

The Minister of Finance, with the endorsement of Cabinet, created the CAP Advisory Group on April 22, 2009. Two broad goals were identified for the program: (i) provide the Government with a well-defined series of actionable measures to recover from the recent deterioration in the fiscal position and, following a period of fiscal restraint, to put the Government on a path toward long-term fiscal

sustainability, and (ii) to provide the Government with an internally designed program that can better guide its relations with the external donor community. Although the CAP Advisory Group outlined the general principals of reform, the measures specified were almost entirely related to expenditure reduction, and followed a detailed examination of the major areas of expense. The two major areas of cost saving identified were payroll and subsidies to the SOE sector.

Cabinet creates a Comprehensive Adjustment Program Advisory Group.

Group recommends a RIF and cost savings of between $7 and $8 million.

In the RMI the civil service represents nearly 50% of the cost of current operations. The Advisory Group recommended the implementation of a Reduction-In-Force (RIF) with possible cost savings ranging from $0.7 to $5.6 million. The group proposed a reduction of 300 positions equivalent to about one third of the public service employed under the general fund. The Advisory Group did not directly make any recommendations regarding the savings that could be generated from reduction in subsidies and transfers to the SOEs and other government agencies, as this would be a long-term process requiring development of broad-based plan. However, an immediate cost saving of between $0.6 and $1.8 million was felt possible. Overall the CAP group recommended a reduction in expenditures of $7 to $8 million over the next 1-3 years to address the structural deficit position. This corresponds to a similar level recommended in a recent IMF Article IV consultation.

Complementing the creation of the CAP Advisory Committee cabinet created the Tax and Revenue Reform and Modernization Commission (TRAM) in July 11, 2008. While the CAP was created to investigate ways to save cost in the operations of government, the TRAM was created to: (i) prepare a proposal for reform of the tax system and structure, (ii) strengthen the capabilities and effectiveness of the revenue collecting administration, and (iii) to ensure effective implementation. In order to support the recommendations of the TRAM a request was made to PFTAC for technical assistance for the development and design of the tax reform package. The essence of the reforms proposed by PFTAC was the introduction of a modern tax system which was equitable, efficient and simple, while raising sufficient revenue to meet future fiscal challenges. The package of reforms would broaden the tax base, while attempting to keep rates low. The major elements of the system included the following:

Cabinet creates a Tax and Revenue Reform and Modernization Commission (TRAM)

PFTAC outlines tax reform initiative including introduction of a VAT and net profits tax.

- replacing the GRT, hotel and resorts tax, local sales taxes, and standard import duties with a broad based consumption tax;

- replacing the special import duties and local government taxes on alcohol, tobacco, motor vehicles and fuel with similar excises;
- introducing a net profits tax for large businesses;
- retaining the GRT for businesses with turnover less than $100,000; and
- modifying the wages and salaries tax by broadening the tax base to include items currently exempt, modifying and expanding the current tax-free threshold, and introducing a higher tax rate for high income earners.

TRAM rejects the VAT in favour of a sales tax at "first point of sale".

PFTAC indicates a series of issues with the proposed sales tax and suggests revisiting the selection of a VAT.

The PFTAC tax reform proposal was generally well received by the TRAM Commission, and barring one major exception, was recommended to the Government without significant modification. The major exception was the introduction of the VAT, which in effect was the centerpiece of the PFTAC tax reform initiative. The Commission recommended the replacement of the VAT with a sales tax to be levied at the "first point of sale". In a subsequent PFTAC report a variety of potential problems with the proposed sales tax were indicated, asserting that the concept of a sales tax levied at the first point of sale had been insufficiently developed for implementation. PFTAC also indicated that technical assistance would only be provided if these issues could be satisfactorily resolved, and recommended that the issue of the choice between a VAT and the sales tax be revisited.

The RMI government negotiates with the ADB for a Public Sector Program

Based on the recent internally-designed reform initiatives developed by the CAP Advisory Group, the TRAM Commission and SOE report endorsed by Cabinet, the ADB engaged with the Government in negotiations to develop a Public Sector Program (PSP) loan. The total value of the loan will be $9.5 million of which $8.4 million will be devoted to refinancing of the existing MEC debt to the Bank of Guam. The PSP is designed to support the government in the achievement of its reform initiatives through the delivery of 5 outputs:

- Improved medium term fiscal outlook,
- Restraint of recurrent expenditure,
- Increased tax revenue,
- Improved SOE performance, and
- Increased stakeholder participation.

The design of output 1 is based on the IMF recommendation that the RMI generate sufficient savings (fiscal surplus) to make up for the projected short-fall in the CTF. The viability of the CTF is clearly a key objective but this is a shared responsibility between the parties of the Compact and their mutually agreed goals. While the objective to generate a fiscal surplus is clearly desirable, the RMI may not be well-advised to lock up the resulting funds in the CTF in perpetuity when there remain other important objectives of fiscal policy. Outputs 2 and 3 are to be achieved through implementation of the CAP and TRAM reports, but the specification of the targets is general in nature and lacks definition. Output 4 calls for the SOE sector to attain profitability by 2012, a clearly impossible target, although the refinancing of MEC debt will considerably improve the Corporation's financial viability. The last output begs the question of political will, which is the all-important requirement for successful implementation of the PSP.

ADB loan requirements may not be appropriate, are weakly defined, and include impossible targets in the case of a return to SOE profitability.

There is no doubt that the RMI economy benefited from the additional fiscal stimulus during the initial years of the amended Compact. Economic growth averaged 2.6% per annum during the FY2003-FY2007 period. However with the onset of the world recession and the lack of further fiscal stimulus, the economy has faltered and experienced negative growth in the last two years. Employment data indicates that the economy has managed to generate significant additional jobs over the period. Both the private and public sectors have grown significantly, although this has been offset by declines at the Kwajalein military base. However, the generation of additional jobs has been insufficient to provide gainful employment opportunities for those seeking work, and outward migration remains substantial and averaged 1.7% annually.

Economic growth averaged 2.6% in the first half of the 2000s, but with the onset of the world recession in 2008 growth and employment opportunities falter. Out migration averages 1.9%.

This review indicates that the positive trend in economic growth has peaked and is unlikely to continue. In fact, if anything, the FSM experience of a negative economic growth of 1.0% during the amended Compact period is more likely for the RMI, unless proactive decisions are made to confront the issues facing the nation. The review has indicated that the fiscal situation, while not deteriorating, is very tight—and fragile. A costly public service, external debt service, and the financial situation of the state owned enterprises threaten the nation's financial viability. The financial conditions of the amended Compact—decrement and lack of full indexation—will involve declining real resource inflows. Unless the private sector is able to take center stage and become the engine of growth, sustained economic growth is unlikely.

Continued economic growth is unlikely unless private sector becomes engine of economic growth.

Government initiates a series of economic reform initiatives together with an ADB public sector program.

However, political will to implement the reforms needs to be proven.

In a realization of the economic and financial circumstances facing the nation the RMI leadership initiated a series of reforms in FY2008. The Comprehensive Adjustment Program (CAP) Advisory Group and Tax and Revenue Reform and Modernization Commission (TRAM) were created, and the reports of both of these groups were endorsed by the Cabinet. A report on the SOE sector was initiated and the MEC adopted a comprehensive recovery program. The ADB will support these reform efforts through a Public Sector Program including loan finance to refinance the external debt of the MEC. However, all of these initiatives now require the political will to implement the reforms that have been endorsed. Reduction in the size of an oversized public service and introduction of a modern tax regime are not be popular measures, especially with elections looming. While the current focus on the public sector is appropriate, attention will need to switch in the longer-term to engendering an environment inductive to private sector initiative, if the economy is to generate an increasing level of living standards for its citizens.