Republic of the Marshall Islands

Fiscal Year 2010 Economic Review

SUMMARY DOCUMENT

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Office of Insular Affairs

Graduate School USA
PACIFIC ISLANDS TRAINING INITIATIVE
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Currency Equivalents

Currency Unit	—	United States Dollar (US$)

Abbreviations

ADB	—	Asian Development Bank
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.

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FOREWORD

This Summary presents the major findings and conclusions of the FY2010 RMI Economic Review. The purpose of the Review is to assist the governments of the Republic of the Marshall Islands (RMI) and the United States of America (U.S.) in fulfilling 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 with funding assistance from the U.S. Department of the Interior, Office of Insular Affairs, and administered by the Graduate School USA. It is not intended to directly fulfill the reporting requirements of the two governments, but rather to assess RMI's economic performance and 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://econ.pitiviti.org.

Mark Sturton

EXECUTIVE SUMMARY

Earlier economic reports have indicated that the initial period of the amended Compact FY2003-FY2007 had been a period of sustained fiscal expansion and public sector led growth, with overall GDP growing by an annual average of 2.6%. However, revisions to the national accounts and the derivation of GDP by industry now show that growth faltered in the early part of the Compact, and only averaged 1.9% during that period. In FY2008-FY2009, growth turned negative—as it did in many countries during this period—with the onset of the international recession. However, FY2010 has turned out to be a particularly favorable year for the RMI, with strong growth of 5.2% resulting from low inflation and expansion in the fisheries sector. Further, this trend is set to continue in the next 3 years, as investment in fisheries enterprise and airport improvements continue. Employment data indicates that the economy has managed to generate a number of additional jobs amounting to 0.9% during the amended Compact. Both the private and public sectors have grown, despite 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, averaging 1.7% annually during the amended Compact period.

After a period of fiscal stagnation at the end of Compact I, the RMI went through a period of rapid public sector expansion at the start of the amended Compact through FY2007. Public expenditures grew by an annual average rate of 12% between FY2003 and FY2007, and employment in the public sector expanded by 507 jobs or at an annual average rate of 6% over the same period. The various forces that had permitted the rapid expansion came to a halt in FY2007, and the government was left in a stressed fiscal position suffering a tight cash flow. Total public expenditures have been held in check since that time, but the government went through periods of default on debt service, delays in vendor payments, payroll and negative unreserved general fund balance. The fiscal position is now less stressed but huge challenges remain. Debt service now represents 8% of general fund revenues, annual subsidies to the troubled State-Owned Enterprise sector represent 17% of the general fund, and general transfers, including subsidies, are as high as 37%. At the same the annual decrement in Compact funding is declining in real terms, requiring an increasing proportion of general fund revenues to support essential services in education and health.

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. It is thus imperative that the RMI Government makes every effort to assess the Trust Fund's 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 RMI. The terminal condition for sufficiency of the Trust Fund is projected to be $748 million at the outset of FY2024. Comparing actual performance to a smooth trend line signifying "on-track" performance, the Trust Fund would have reached $157.3 million as of June 30, 2011; however, the actual value was just $141.9 million. The projected growth rate required to "catch-up" is projected at 8.6 percent. This rate of return remains achievable, though by no means assured. It is recommended that policy makers mobilize additional contributions—from domestic and external sources—to the Trust Fund to more reliably support the RMI's long-term fiscal stability and sustainability.

Realizing the economic and financial circumstances facing the nation, the RMI leadership initiated a series of reforms. The Comprehensive Adjustment Program (CAP) Advisory Group, and the 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 is supporting these reform efforts through a Public Sector Program which includes a loan to refinance the external debt of the MEC. However, as the review of the current status of the PSP indicates, while some reforms, such as energy and tax reform, are on track, others, such as expenditure compression and the generation of sustained fiscal surplus, are not.

As part of the FY2010 review, a medium term economic framework has been prepared based on standard macroeconomic accounts, providing projections through FY2014. The framework compares a baseline forecast, which assumes no change in economic policy, to a Reform Scenario, which assumes implementation of CAP reforms. The baseline scenario projects strong GDP growth in FY2011 and FY2012, due primarily to growth in the fisheries sector and planned FAA projects. However, this initial growth is followed by declines in GDP in FY2013 and FY2014. While implementation of the Reform Scenario will have a positive impact on government savings and cash flow, the loss of jobs will have a further negative impact on GDP.

Although the RMI has committed to reforms, it remains unclear whether the government has the resolve necessary to implement these commitments. The donor community indicated their support at the Development Partners Meeting last December, but creditability will undoubtedly be lost if no further progress is made once a new government is formed following elections later this year.

I. ECONOMIC PERFORMANCE

The Economy

The RMI economy has experienced periods of boom and bust since the late 1990s (see Fig. 1.) The late 1990s were marked by an extended period of 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 1990s. 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 was the major component of the reforms intended to reduce the cost of government. There were further objectives: to improve tax administration, reform public enterprises, and improve the environment for the private sector. While the PSRP of the late 1990s is now more than 10 years behind, it remains especially relevant to the current circumstances facing the RMI.

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

By the start of FY2000 circumstances began to improve. In 1999, the RMI recognized the Republic of China (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

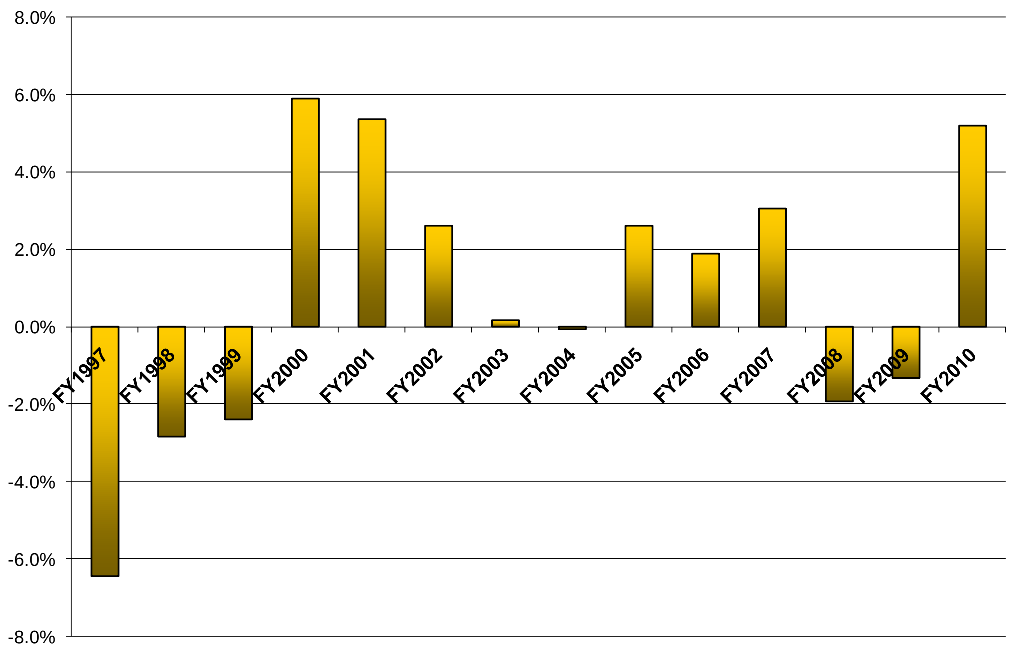


Figure 1 RMI Real GDP Growth

RMI economy undergoes periods of boom and bust in the FY2000-FY2007 period.

complete; Compact funds that had in prior years been absorbed in debt repayment were now available. FY2002 and FY2003 represented the "bump-up" years of Compact I, which saw infusion of additional Compact resources from the U.S. However, the RMI had committed and contributed $25 million to a Compact Trust Fund at the start of FY2004; this effectively sterilized the majority of what otherwise would have been a very sizeable infusion of resources. FY2004 marked the start of the amended Compact, and the RMI negotiated a favorable assistance package that resulted in an increase in funding of $10 million above the pre-bump-up levels. However, the economy stagnated overall, primarily resulting from the closure of the fish loining plant and capacity constraints in utilizing the additional fiscal resources.

By FY2005, the substantial increase in Compact resources over the FY1999-FY2004 period had reached a peak. Greater capacity utilization of the available resources enabled the economy to expand. The private sector maintained economic activity, with additional investment demand arising from the Compact infrastructure grant, renovation of the Majuro airport, the ROC-funded convention center, and reconstruction of the Majuro fish loining plant under new ownership.

Recession hits the RMI in 2008 as further fiscal expansion is no longer possible and rapid inflation erodes the value of incomes.

By FY2008 the economy had peaked, and GDP fell by 1.9%. The initial wave of Compact infrastructure construction projects had come to fruition, and further expansion in government was no longer possible as expenditures hit their 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%, eroding domestic real incomes and reducing demand for local business. Compounding these problems, the Marshalls Energy Company (MEC) underwent a severe cash flow crisis as fuel prices reached record levels, requiring substantial cash infusions from government. These forces prompted the RMI leadership to declare a first-ever "state of economic emergency" in late FY2008. In FY2009, while inflation eased back to 0.7%, reducing the erosion in household incomes, the same general economic forces exerted themselves, and GDP fell by a further 1.3%.

Economy experiences strong growth in FY2010 driven by expansion in fisheries.

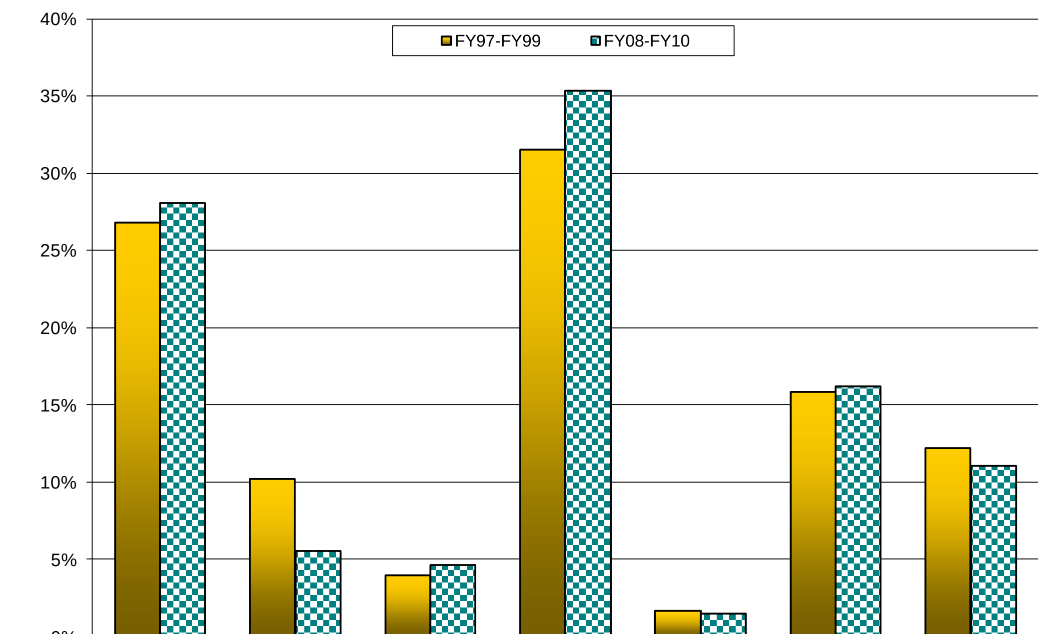
In FY2010, the RMI economy grew by 5.2%—a surprise, given world economic conditions. The main driving force was expansion in the fisheries sector, which contributed half of the overall growth with increased output from the reopened loining plant and the addition of new purse seiners to the fishing fleet. Education and health services also continued to expand throughout FY2010, producing a positive result with spillover to other sectors. Improved tax collections also contributed to growth although this was offset by increased subsidies to the SOE sector.

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 government sector fell by 5%, reflecting a large increase in subsidies. As a result of the deteriorated position of the SOEs, the share of the public sector (including both government and SOEs) has fallen from 42% to 41%. The private sector has increased its contribution, but the small increase reflects an inability to break away from its dependency on government to assume a more dynamic role as an engine of economic growth. The share of indirect taxes has been reduced reflecting discretionary reductions in tax rates, and weak collections. The finance sector shows some increase, while the share of households and NGOs remain largely unchanged.

Share of government increases significantly over 10 year period

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

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



	Private Enterprise	Public Enterprise	Finance (Banks)	Government	NGOs	Households	Indirect taxes
FY97-FY99	26.8%	10.2%	4.0%	31.5%	1.7%	15.8%	12.2%
FY08-FY10	28.1%	5.5%	4.7%	35.4%	1.5%	16.2%	11.0%

Figure 2 Structure of the RMI Economy by Institutional Sector.

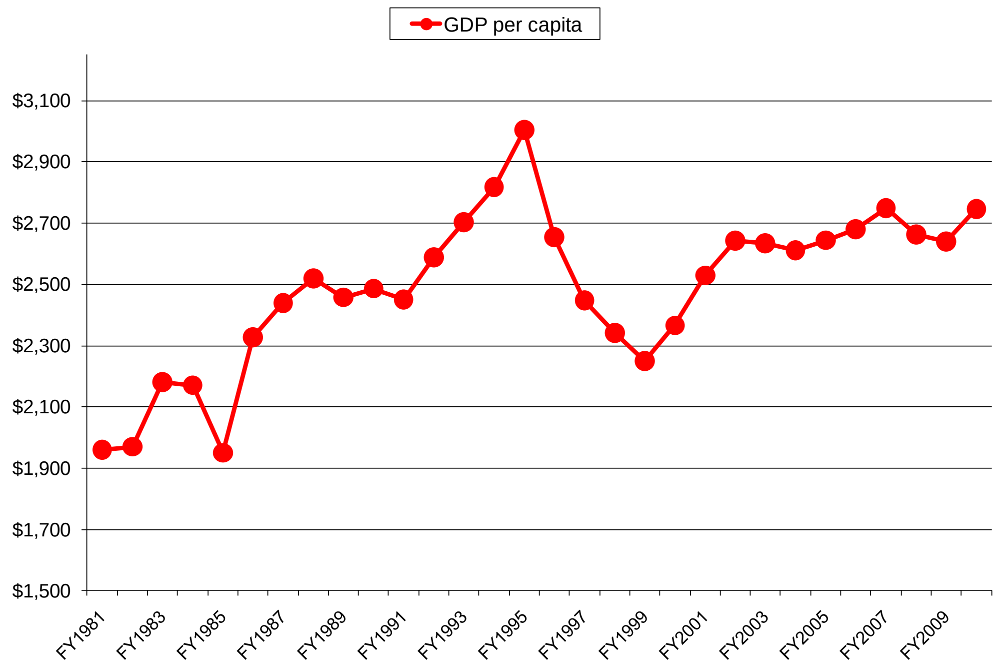


Figure 3 Constant GDP per capita, 2000 prices

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 improve during the initial part of the 2000s.

In FY2010 ground lost in FY2008 and FY2009 due to the onset of the world recession is regained.

In FY2000, matters improved, as fiscal stability was restored with new donor assistance, repayment of debt, and a favorable financial outcome of the amended Compact negotiations. Between FY2000 and FY2007, GDP per capita expanded by $382, or at an average annual rate of 2.2%. However, it failed to regain the level achieved in the mid-1990s. In FY2008 and FY2009 GDP per capita faltered and took a downward turn as the economy went into recession, but regained the lost ground with the strong economic growth in FY2010.

Population, Migration and Employment

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.

Strong job growth in the early 2000s in both public and private sectors,

Employment grow slows since FY04, but has remained positive despite peaking in the public sector and reductions in the Kwajalein base.

From a declining level of employment in the late 1990s, public sector employment expanded strongly between FY1999 and FY2007, growing by 28% or at an annual average rate of 3% (Fig. 4). In FY2008 through FY2011, while government employment remained constant, employment in the two local governments and agencies has fluctuated, resulting in minor changes in the overall level of 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 and had created an additional 948 jobs by FY2011, compensating for

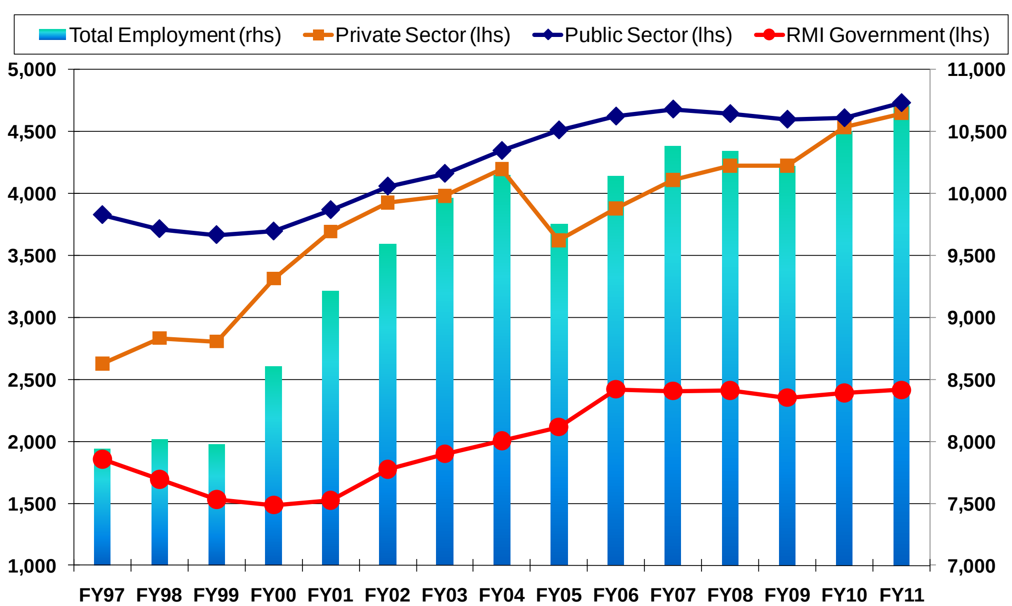


Figure 4 Employment by Sector FY1997-FY2010

the reduction in construction activity, and employment reductions in the Kwajalein military base. 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 3.7%. Between FY2004 and FY2011 an additional 560 jobs have been created and employment creation has averaged 0.8% per annum.

Inflation

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

Fig. 5 indicates changes in the CPI for selected commodity groups since the first quarter of CY2004. After relatively modest rates of inflation through the end of CY2007, consumer prices increased at alarming rates in CY2008. 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 the third quarter of CY2008. 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

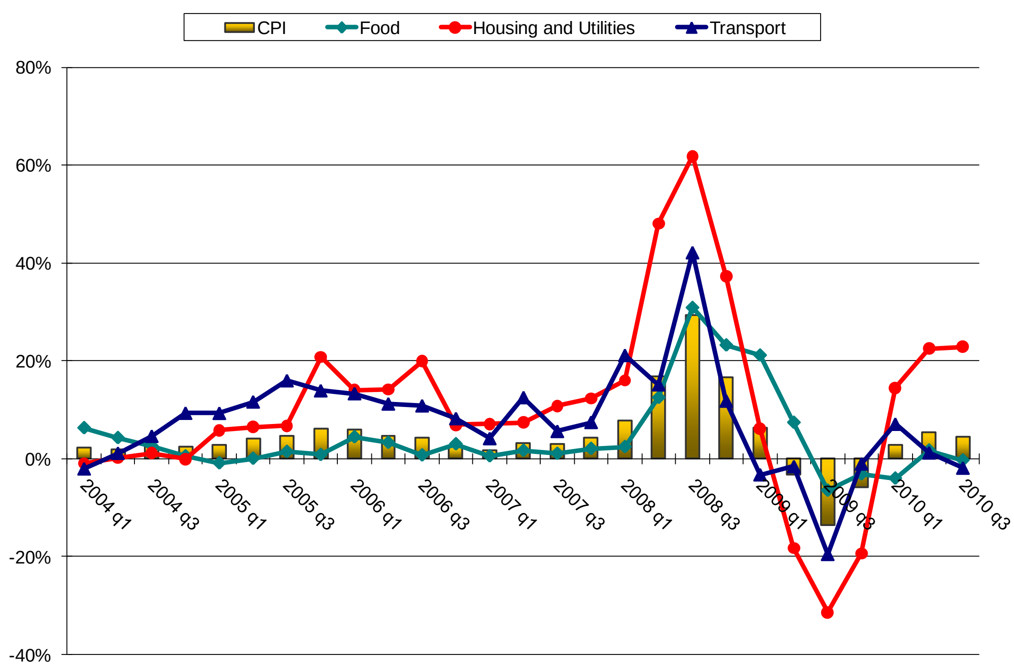


Figure 5 Change in CPI and selected commodity groups, FY2004-FY2010

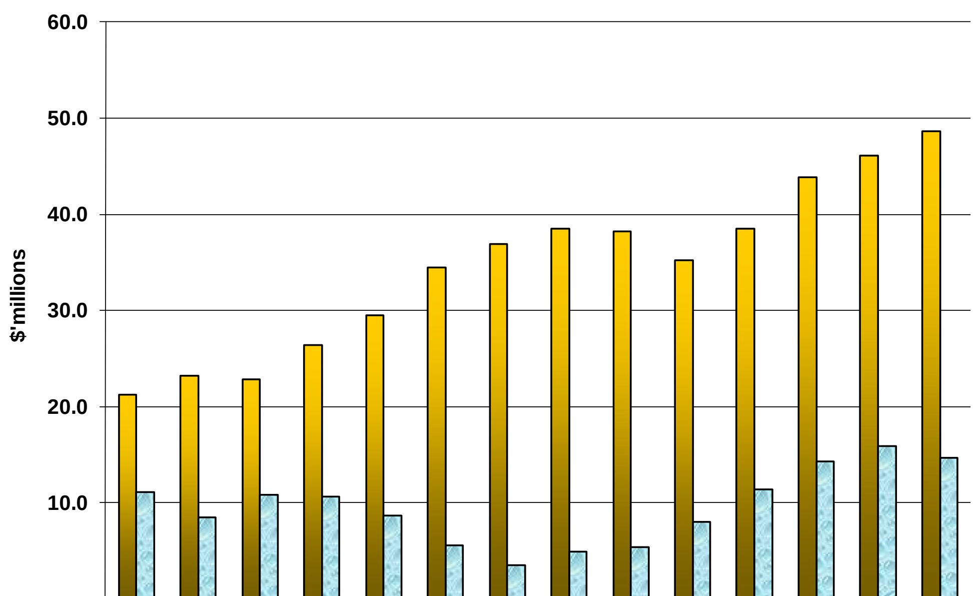
by 15%, rates not experienced since the mid-90s. In CY2009 food and fuel prices moderated significantly to levels below the CY2008 levels. In the third quarter of CY2009 fuel prices had fallen by 31% and food prices by 20%. During CY2010 price changes were generally less erratic with food prices continuing to decline and transport prices rising modestly at 1%. However, the housing and utility sections again returned to rates of inflation which prevailed in CY2009 and registered a 23% rise by the end of the year. Overall the rate of inflation recorded 4.4% in the third quarter of CY2010 compared to the same quarter in the previous year.

The Banking Sector

Consumer credit expands rapidly, incurring high levels of household indebtedness.

Commercial lending to the private sector has been lackluster reflecting lack of collateral, poor business management, and the many impediments to lending.

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 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 FY2010, consumer credit grew by an annual average of 6.6% and consumer lending stood at 47% of total employee compensation. This indicates a high level of household



	CY1997	CY1998	CY1999	CY2000	FY2001	FY2002	FY2003	FY2004	FY2005	FY2006	FY2007	FY2008	FY2009	FY2010
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	48.6
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	14.7

Figure 6 Commercial Bank Credit by Sector

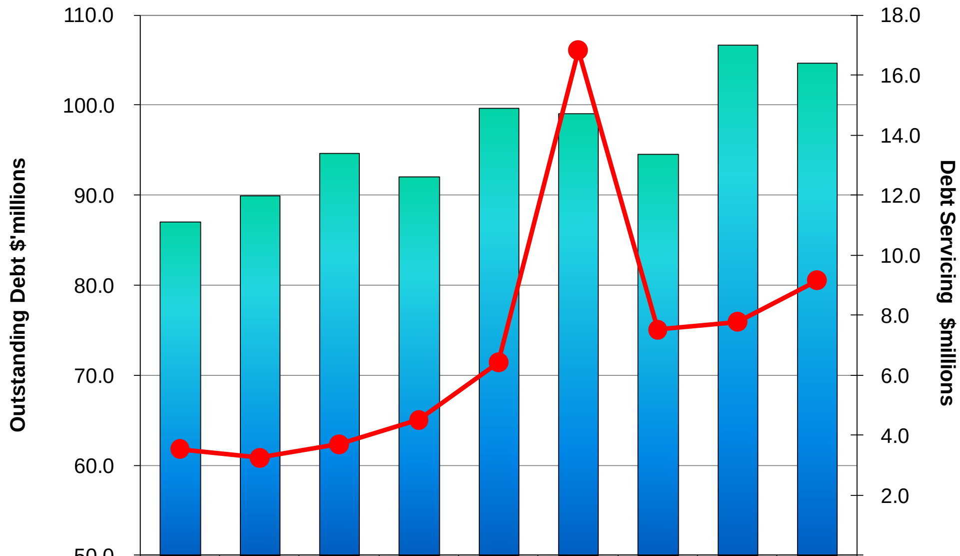
indebtedness, which will not only place stress on household finances, but also pose a threat to the banking system. For the commercial sector, lending collapsed after 2000, with the departure of the Bank of Hawaii. Since FY2003, commercial lending to the private sector has improved, but performance has been lackluster and reflects lack of collateral, poor business management, and the many impediments to lending. With the enactment of the "secure transactions" law in 2007, it is hoped that this segment of the market, which is of critical importance to private sector development, will show signs of expansion.

External Debt

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

During Compact I the government developed a substantial portfolio of loans from the Asian Development Bank (ADB). The portfolio includes loans for water supply, the social sector, fisheries, transport projects, and a reform program. In total, the ADB has approved $85.7 million in loans, with an outstanding debt, at the end of FY2010, of $56.7 million. 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 $30.1 million for the National Telecommunications Authority (NTA), $14.8 million for the MEC, and $1.8 million for the Marshall Islands Development Bank (MIDB), in total an amount of $48.0 million.

Fig. 7 shows the substantial size of the RMI's external debt and the burden of debt servicing since FY2002. In FY2002, the level of outstanding debt was $87 million, or 70% of GDP. Since this time external debt has risen to $105 million in FY2010, but in relation to GDP fell slightly to 64%. Of more serious concern is debt service, which has risen from $3.5 million or 10% of general fund revenues in FY2002, to $9.2 million or 26% of general fund revenues in FY2010. 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 significant implications for fiscal policy.



	FY2002	FY2003	FY2004	FY2005	FY2006	FY2007	FY2008	FY2009	FY2010
Outstanding	87.1	90.0	94.7	92.1	99.7	99.1	94.6	106.8	104.7
Servicing	3.5	3.2	3.7	4.5	6.4	16.8	7.5	7.8	9.2

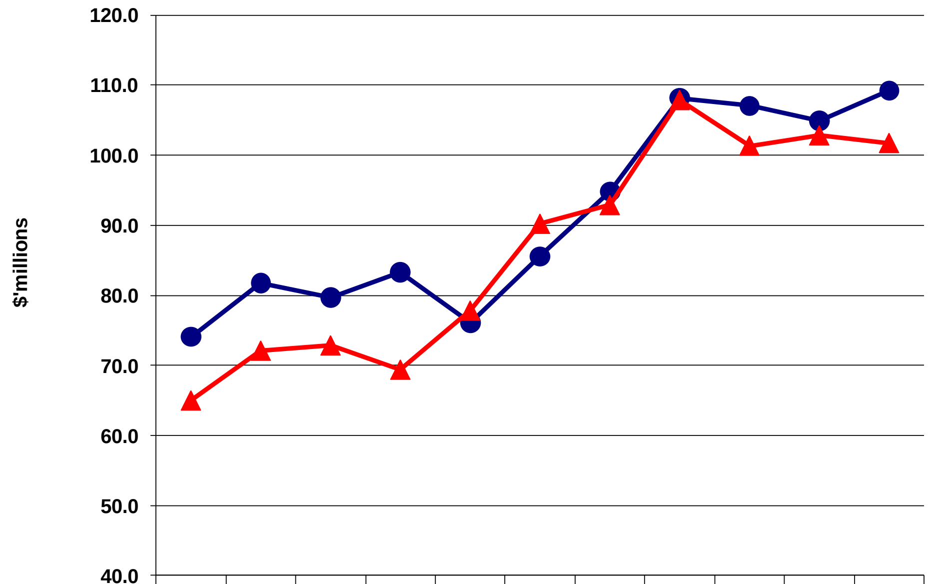
Figure 7 External Debt and Debt Servicing, FY2002-FY2010

The Fiscal Situation

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-FY2010, as the amended Compact took effect, the fiscal account shows a more normal trajectory, with revenues and expenditures more closely aligned. Expenditures grew strongly as a result of higher levels of funding made available under the amended Compact and as a result of increased capacity utilization of the sector grants—the infrastructure grant, in particular. In FY2004,



	FY00	FY01	FY02	FY03	FY04	FY05	FY06	FY07	FY08	FY09	FY10
Total Revenues	74.1	81.7	79.7	83.3	76.1	85.6	94.8	108.2	107.1	104.9	109.2
Total Expenditures	65.1	72.1	72.9	69.4	77.8	90.2	92.9	107.8	101.3	102.8	101.7

Figure 8 Consolidated Revenues and Expenditures, FY2000-FY2010

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

revenues were mostly in line with expenditures and the fiscal account recorded 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 1.4% and 0.2% of GDP, respectively.

Relatively favourable fiscal outturn during the last 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 contracted by $7.8 million, reflecting lower transfer payments and a large drop-off in capital expenditures. Revenues were also weak, dropping by 1.1% as a reflection of the contracting economy and a failure to exhibit the growth of earlier years. However, an overall surplus of 3.8% of GDP was attained. In FY2009, revenues continued to weaken and expenditures firmed as outlays on goods and services and subsidies to SOEs expanded. However, overall the government continued to maintain fiscal balance and ran a small surplus. In FY2010 the economy grew strongly and all categories of revenues expanded: taxes, non tax revenue and grants. Meanwhile the level of expenditures contracted overall and a large fiscal surplus was attained of 4.6% of GDP.

The apparently close proximity of revenues and expenditures and ability to maintain a fiscal surplus averaging 2.3% of GDP in the last five years provides 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 existence of a priority list of creditors, difficulties in maintaining debt service obligations to the ADB, use of the ROC project grant to fund operational expenditures, and daily cash flow problems all indicate a stressed fiscal position. 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 indicate that the RMI remains in a precarious fiscal position.

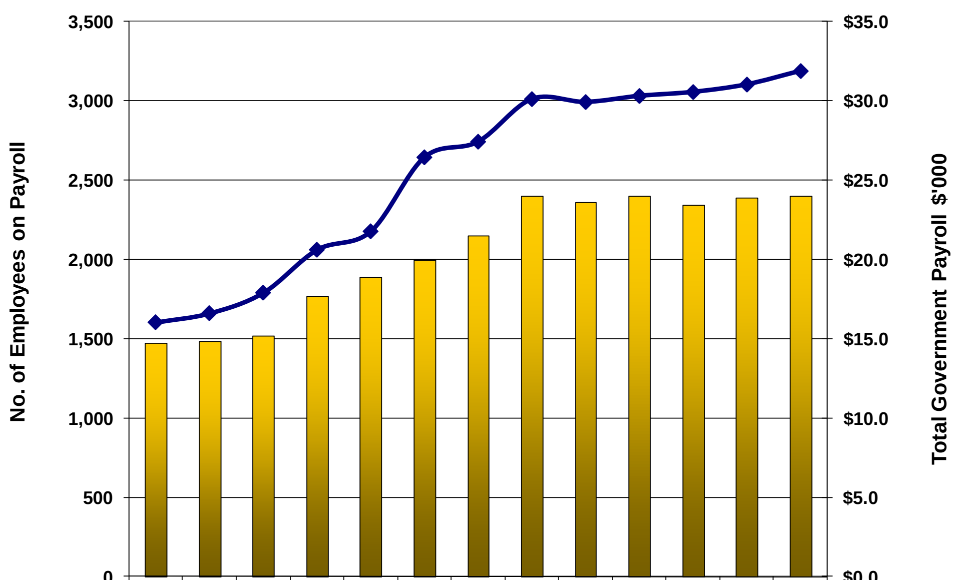
II. Policy Developments, Prospects and Issues

Government Payroll

Rapid increase in government payroll puts pressure on fiscal situation.

Government employment increases by 577 employees or 39 percent since end of RIF.

Since the completion of the RIF program in 1999, RMI 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 2,401 by the end of FY2011, a 30% increase, while payroll costs have doubled. As part of the Compact re-negotiations, the RMI became ineligible for the US Federal Program Head Start. However, compensatory funding was provided through the Supplemental Education Grant (SEG) and the 200 or so former Head Start employees were transferred to the Education Department in FY2006. In addition, FY2001 and FY2002 marked the return of Majuro and Ebeye elementary school teachers 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 577 employees, or 39%, over the ten-year period.



	FY99	FY00	FY01	FY02	FY03	FY04	FY05	FY06	FY07	FY08	FY09	FY10	FY11
Public servants	1,475	1,486	1,522	1,771	1,892	1,999	2,151	2,402	2,363	2,400	2,346	2,388	2,401
Payroll cost	$16.0	$16.6	$17.9	$20.6	$21.8	$26.4	$27.4	$30.1	$29.9	$30.3	$30.6	$31.0	$31.9

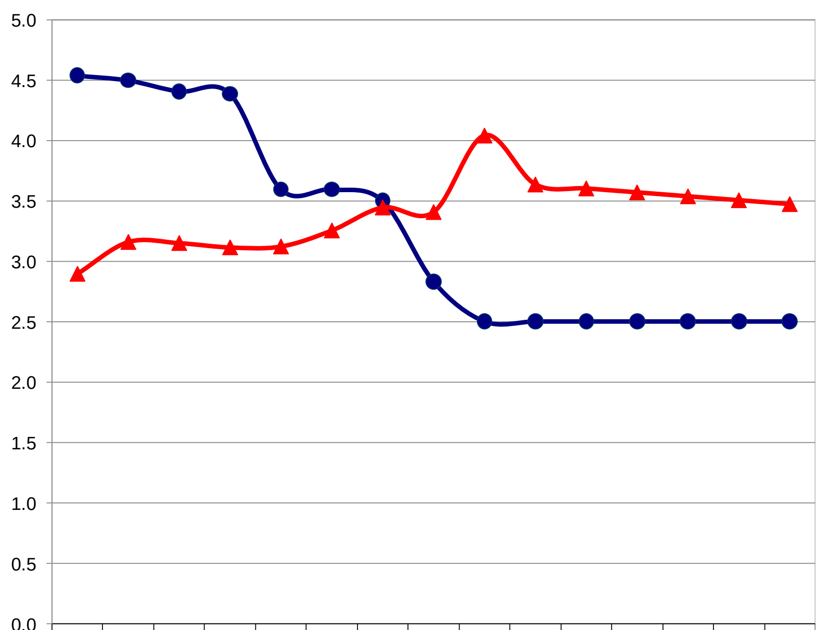
Figure 9 Government Payroll and Employees, FY1999 – FY2011.

While expansion in government payroll came to a halt in FY2006, total government payroll costs have continued to expand, reflecting increases in wages. A policy of freezing payroll costs has been in place, but in fact a hidden 1% annual wage drift has occurred. Although there now appears to be control over the recruitment process, the size of the expansion in government since FY1999 suggests significant overstaffing. While not large, this pattern has been adding to the overall cost of government in an environment with limited fiscal space. Moderate annual increases in wage rates may be a wise policy to attract and maintain a qualified work force. A more critical issue is that of ‘right’ sizing to a level that adequately maintains government services. The level of public service that existed at the start of the decade appears to provide a reasonable benchmark (see Fig. 9).

Need for resizing of government payroll to levels existing in FY2000.

External Debt Management and Policy

External debt management in the medium term presents a major challenge. There are two major components of debt service: government debt on concessional terms to the ADB, and government guaranteed debt incurred by the SOE sector. Fig. 10 indicates the projected trend in debt service for the two types. For government guaranteed debt there is a projected decline from the current ser-



	FY11	FY12	FY13	FY14	FY15	FY16	FY17	FY18	FY19	FY20	FY21	FY22	FY23	FY24	FY25
Gov guaranteed debt service	4.5	4.5	4.4	4.4	3.6	3.6	3.5	2.8	2.5	2.5	2.5	2.5	2.5	2.5	2.5
ADB debt service	2.9	3.2	3.2	3.1	3.1	3.3	3.4	3.4	4.0	3.6	3.6	3.6	3.5	3.5	3.5

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

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

vice level of $4.5 million to $2.5 million by FY2019 when the debt service schedule stabilizes. However, the external debt of the SOEs occurs at higher interest rates and shorter terms, thus incurring a proportionately higher service commitment. Current debt service levels of the NTA, MIDB, and MEC are $2.5 million, $0.6 million, and $1.1 million, respectively. The recent ADB Public Sector Program loan enabled the MEC to refinance a high-interest loan from the Bank of Guam with concessionary finance. As a result, its debt service level of $3.1 million in FY2010 has now dropped to a more manageable level of $1.1 million. There are also moves afoot to restructure the remaining finance from the Federal Financing Bank to a more favorable basis.

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

MEC debt poses significant risk.

In order to make debt payments to the ADB, the government will be required to set aside between $3 and $3.5 million annually over the next 15 years—roughly 10% of its $36 million general fund. In previous years, nearly all of the RMI debt was in an initial grace-period, which made debt service obligations insignificant. However, in the last four years, 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, defaulting on several loans. Although the RMI is now current with those loans, the ADB debt service crisis underscored 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 some potential for projects to cover service costs.

State Owned Enterprise Reform

State owned enterprise required an average subsidy of $10.1 million in FY2008-FY2010 or 28% of general fund revenues.

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 FY2008-FY2010 period this level had risen to $10.1 million, representing 28% 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. In 2010 the RMI government, aware of this growing problem, requested the ADB to undertake a review of the SOE sector and recommend options for reform.

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 FY2008-FY2010.

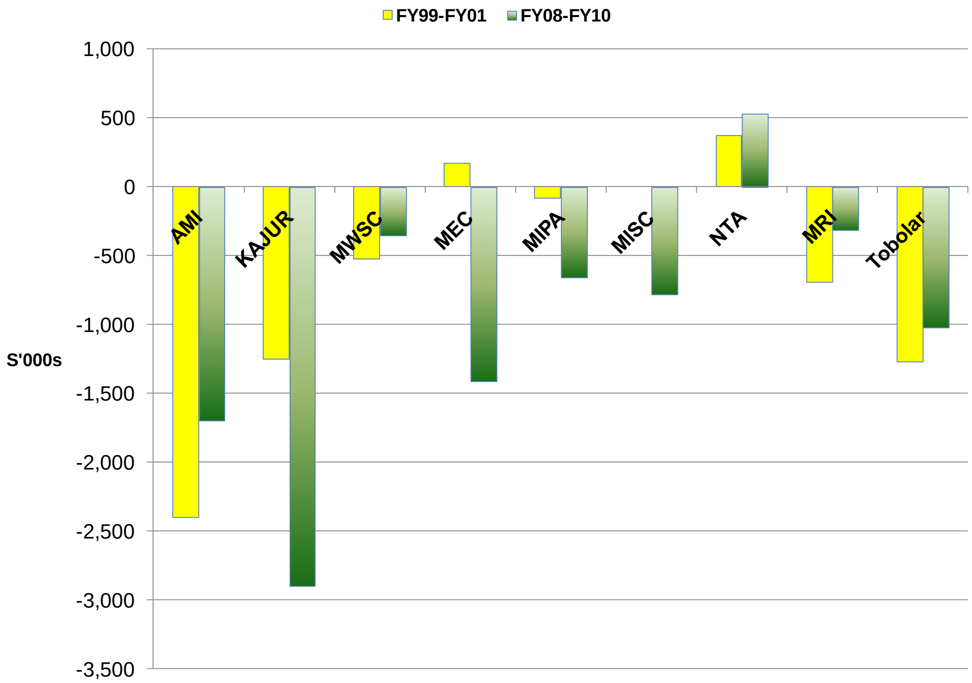


Figure 11 State Owned Enterprises, net operating profit

The largest group of loss-making SOEs has been the utilities, comprising both the MEC and KAJUR, which now average an annual loss of $4.3 million. The next group of entities comprises SOEs that provide social obligations to the outer atolls: Air Marshall Islands (AMI), the Marshall Islands Shipping Corporation (MISC) and Tobolor (responsible for coconut oil production), have collectively incurred losses averaging $3.5 million in the last three years. A third group comprising the Marshall Islands Resort (MIR) and Marshall Islands Port Authority (MIPA) record annual losses but receive no subsidy. In effect, this last group is making a return insufficient to provide for the depreciation of capital. Even NTA, which operates as a telecommunications monopoly, recorded a loss in FY2010—a first since 1999 (although the three year average remains positive).

Nevertheless, the government has pledged and sought development partner support for reforms to SOEs. SOE reform constitutes a major component of the ongoing ADB-supported Public Sector Program (PSP). To signal its intention to strengthen governance of SOEs, in 2010 the RMI Cabinet passed a set of good practice principles which state that:

RMI Cabinet passed a set of good practice principles.

- SOEs are to prepare business plans that disclose the strategic direction and performance targets and, after Cabinet has approved them, they are to be publicly released;
- The activities undertaken by SOEs are to be categorized as either essential or nonessential and the non-essential should then be sold or wound down;
- The government will ensure that SOE boards have independence in operation and that they comprise members who are suitably qualified and experienced;
- The government will also ensure that the senior management within the SOEs have suitable qualifications and experience;
- SOEs will be required to align their prices and charges with the total cost of service delivery, except where they are being funded by community service obligation (CSO) arrangements;
- SOEs will be required to operate in accordance with sound financial management principles;
- An SOE policy and SOE Act established by the RMI government will provide mechanisms for the sound application of good practice principles.

ADB study indicates good practice principles short on detail.

And only few principles have been implemented.

In 2011 a further ADB regional report stated that, "While the foregoing are helpful and if implemented will provide useful guidance, the principles are too short on detail to be sufficient on their own. The government should adopt a more detailed SOE policy that could then be used to guide the development of an SOE Act." Moreover, it appears that despite the official adoption of these principles, not all of them have been implemented. For instance, as of mid-2011, the majority of SOEs have yet to develop and publicize business plans. Also, alignment of prices and charges with total cost of service delivery remains an area for improvement. Nonetheless, with ongoing technical assistance support from ADB, a new SOE Policy will be drafted and adopted by Cabinet in late 2011, paving the way for a new SOE Act to be introduced some time in 2012.

Compact Trust Fund

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.

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. 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 RMI 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 RMI 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.

With the actual level of sustainable Trust Fund distributions not being guaranteed, it is also imperative that the RMI 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 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.

Trust Fund currently below track—needs to grow at the achievable annual rate of 8.6% to meet the "terminal condition."

The value of the RMI 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 $748 million 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 $157.3 million; however the actual value of the RMI Trust Fund at that date was $141.9 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 8.6 percent (Fig. 12). This "catch-up" rate of return remains achievable, though by no means assured. It is recommended that policy makers mobilize additional contributions—from domestic and external sources—to the Trust Fund to more reliably support the RMI's long-term fiscal stability and sustainability.

The Medium Term Budget and Investment Framework and Decrement Management

At the onset of the amended Compact, the RMI adopted a medium-term framework to guide the preparation of the annual budget and

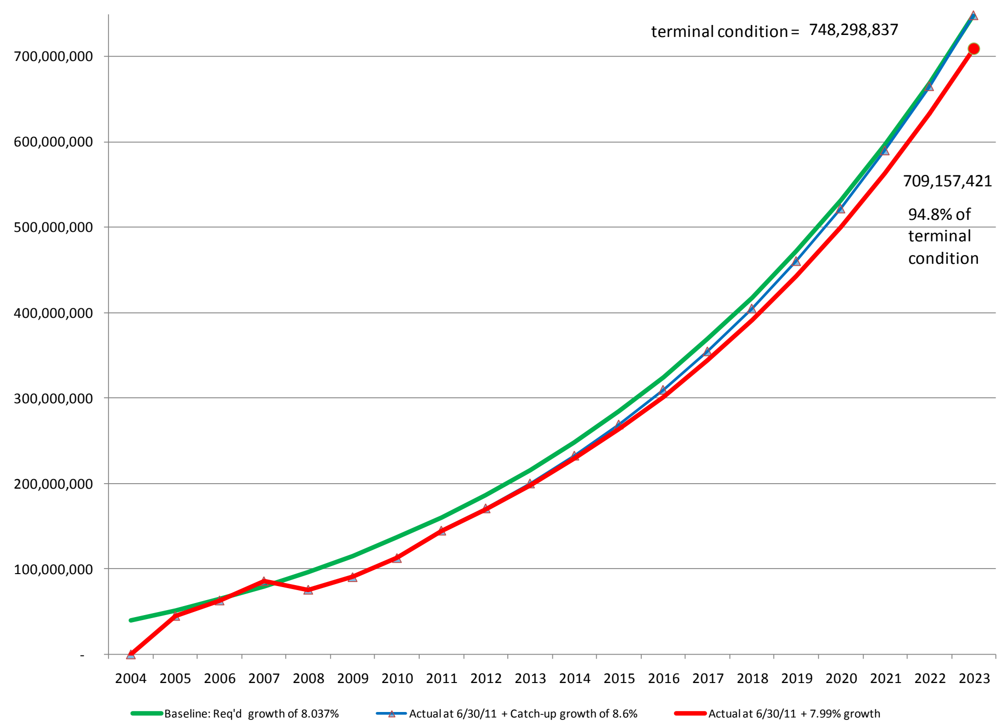


Figure 12 Compact Trust Fund Sufficiency, FY2004 – FY2024, $'millions

requests for Compact sector grant funding. The framework is known as the Medium-Term Budget and Investment Framework (MTBIF). The MTBIF was written into the language of the Compact in the following requirement:

MTBIF adopted as the medium term framework for the annual request for Compact funding.

> *The Government of the Republic of the Marshall Islands shall prepare and maintain an official medium-term budget and investment framework. The framework shall be strategic in nature, shall be continuously reviewed and updated through the annual budget process, and shall make projections on a multi-year rolling basis.*

The MTBIF is described in government planning documents as a five-year, medium-term budgeting framework. It contains two past review years, the current fiscal year and two future trend years, and is to be updated twice annually. However, the MTBIF approach has not been adopted as a meaningful budget planning tool or an active component of fiscal and macroeconomic planning.

It is clear that there has been a lack of institutional capacity to build and maintain the MTBIF within the Economic Policy, Planning, and Statistics (EPPSO) office. The MTBIF has been prepared by non-resident consultants and there have been no local staff capable of managing, updating, or communicating the results of the MTBIF to policy makers in time to affect budget preparations. In addition, there has been a lack of up-to-date fiscal information on which to base the framework. While audit statements are produced annually, they only become available at the end of June, when budget development is already in its advanced stages. As a result, annual budget development is based entirely on modifications to a prior-year budget, rather than any analysis of actual annual expenditures within a given year. Finally, a historical lack of macroeconomic data has constrained the development of a macroeconomic framework, which would typically comprise the national accounts, a statement of government operations, a balance of payments, and a survey of depository corporations. Only with the statistical update undertaken through the preparation of this year's economic report has sufficient macroeconomic data become available to develop such a robust framework.

MTBIF fails to provide a meaningful process for annual budget preparation.

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

JEMFAC request decrement management plan.

> *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.*

RMI submits MTBIF for decrement management to preserve education and health services while scaling back delivery of other government activities.

In response to the U.S. request the RMI issued an update to the the MTBIF and submitted a report entitled "Decrement Strategy & MTBIF Policy Framework Paper, FY11-14" in March 2011. The approach adopted by the MTBIF was a simple one: implement recent reform efforts to reduce expenditures (CAP see below), and adopt a modern tax regime (TRAM see below). The subsequent improved fiscal position would enable education and health expenditures—adopted as priority by the RMI government—to be maintained in real terms over the medium term, while scaling back the remainder of government expenditures. The RMI decrement strategy presents a financially viable process and is based on previously endorsed documents. However, the RMI government has yet to demonstrate its commitment to the strategy by enacting reforms in its current budget. With an election coming up in November this will present a real challenge to the government's resolve to enact politically tough measures.

Longer term planning process required to address decrement management and CTF issues through end of the amended Compact.

While the MTBIF presents a medium-term solution, there remains a need to develop a long-term framework to address the annual decrement and required fiscal adjustment through the end of the amended Compact in 2023. This need is even more pronounced in recognition of the likely insufficiency of the Compact Trust Fund. Decrement management over the medium term will require continual reprogramming as real Compact flows decrease. While preserving current expenditure levels in education and health may be possible in the medium term at the expense of all other expenditures, this is not viable in the longer-term as the rest of the government falls below critical levels. There is thus a need for the design of a Long-Term Fiscal Framework or LTFF, which would not only address the decrement issue, but would also identify appropriate levels of all government services in light of the CTF.

The Comprehensive Adjustment Program (CAP)

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 Comprehensive Adjustment Program (CAP) Advisory Group was created to develop an internally conceived and designed program. The second group created by Cabinet was the Revenue and Tax Reform and Modernization Commission (TRAM). Following the development of these internally generated reform initiatives, the ADB was asked 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 savings 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 savings of between $0.6 and $1.8 million was deemed 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.

More than two years following the development of the CAP, none of the recommendations have been implemented. In the FY2010 budget an across-the-board cut of 5% was implemented, which is clearly not an efficient means of expenditure reduction. In FY2011 a further 5.5% cut was imposed to allow for increased allocations to investments, which does not indicate any reduction in total outlays. During March of 2011 a resolution was introduced to reduce the working day by one hour per day or one day biweekly. A public meeting to discuss the proposed cuts attracted a large turnout

While none of the specific adjustments proposed by the CAP have yet been implemented, across the board reductions in line Ministries has been adopted in each of the last 3 budgets.

and the proposal was shelved. At the time of the preparation of the current FY2012 budget it is again intended that there will be a further 5.5% across the board cut. The non-specific reductions that have prevailed in the last three budgets are exactly the type of approach to revenue loss that the request for a decrement management plan was intended to avoid. Decrement management was intended to be an approach to maintaining output delivery through efficiency gains, prioritization of key services, and reduction in non-essential services.

Tax and Revenue Reform and Modernization Commission (TRAM)

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.

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 costs 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:

- 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.

The PFTAC tax reform proposal was well received by the TRAM Commission and, barring one major exception, was largely recommended to the Government without modification. The major exception was the introduction of the VAT, which has been a long-standing issue of sensitivity in the RMI, going back to the time of the PSRP, when it was initially proposed and rejected. However, after a set of public awareness meetings, these objections have been overcome and the Minister of Finance has agreed to include the VAT in the tax reform initiative. Laws have now been drafted for an Income Tax Act, a Marshall Islands Consumption Tax, and a Revenue Administration Act. The intention is to submit the bills to the August 2011 session of the Nitijela, prior to the November 2011 elections. Implementation would then be phased over a two-year period.

TRAM initially objections to the VAT have now been overcome.

Tax reform laws have been drafted ready for consideration by the Nitijela for implementation over a 2 year period.

The Public Sector Program (ADB Loan)

Based on the recent internally-designed reform initiatives developed by the CAP Advisory Group, the TRAM Commission and SOE report endorsed by Cabinet, the Government requested the ADB to assist the RMI with a Public Sector Program (PSP) loan. The total initial value of the loan was $9.5 million of which $8.4 million was devoted to refinancing of the existing MEC debt to the Bank of Guam. A second tranche is planned conditioned on progress with attainment of the loan covenants. The loan became effective in September 2010 with a planned review for second tranche release in February 2012. The PSP is designed to support the government in the achievement of its reform initiatives through the delivery of 5 outputs:

The RMI government requests ADB for a Public Sector Program loan to consolidate reform initiatives.

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

Implementation of PSP has been slow to get off the ground and success will be hard to achieve.

With elections due in November, review of 2nd tranche release in Feb 2012 is premature and should be delayed.

The PSP loan has now been effective for nearly a year with less than six months remaining before the review for second tranche release. A detailed discussion of various targets is presented in the main report. In brief, a detailed set of covenants in the loan would require the program policy matrix to be placed at the forefront of the government's budget and economic policy formulation. It is not apparent that this is the case. Progress in meeting loan covenants has been slow, with some conditions not yet considered, others, such as the attainment of a fiscal surplus of 3% of GDP in FY2011 and FY2012, appearing impossible. The RMI government is in violation of a condition requiring a freeze on non-concessional borrowing, while still other conditions, such as the tax reform initiative, are actively supported by Government. With an election coming up in November the February 2012 review is clearly unrealistic and should be delayed. After the election, the government will need to renegotiate conditions with the ADB, and place a high priority commitment on their achievement if the RMI is to succeed with second tranche release.

RMI government hosts Development Partner Meeting in December 2010 to present the nation's fiscal and economic adjustment programs.

In December 2010 the RMI hosted a Development Partners Meeting (DPM). The meeting engaged governmental participants from within the Marshall Islands, as well as the RMI's primary international development partners. The primary purpose of the DPM was to allow the RMI government to present an overview of the nation's fiscal and economic adjustment programs, including the Comprehensive Adjustment Program (CAP), the Tax & Revenue Reform and Modernization (TRAM) program, and reform plans for the energy sector and state-owned enterprises. In general, the Development Partners noted the comprehensive nature of the RMI's reform efforts, and commended the government for its commitment to reform. However, the Development Partners also noted the need for discipline in following through on these commitments. The question remains as to whether the resolve exists to implement these commitments. Without significant progress in implementing the reforms, the government will not only face mounting fiscal challenges, but will also face credibility problems across the Development Partner community.

III. THE MEDIUM TERM ECONOMIC FRAMEWORK

As part of the FY2010 review, a medium term economic framework has been prepared based on standard macroeconomic accounts: GDP by industry, the fiscal account, balance of payments and the banking survey. The framework is interconnected; variables in one part of the system are interrelated to variables in another. The goal of the framework is to provide projections for the year in progress (in this case, FY2011) as well as three additional years (FY2012 through FY2014). Two different projections are made. The first is a baseline forecast, which assumes no change in economic policies. The second projects a reform scenario, which essentially examines the medium-term impact of selected CAP reforms, if they were to be implemented. Since the framework is "under development" the results must be considered preliminary.

FY2010 economic review incorporates medium term economic framework.

The Baseline

The baseline projection is shown in Fig. 13. Without changes to policy, GDP is set to grow strongly in FY2011 and FY2012 by 9.0% and 8.4%, respectively, and then to drop back to 3% and -2.8% in the following two years. The high rates of growth in the initial years are due to two factors: (i) growth in the fisheries sector in commissioning additional purse seiners and (ii) the impact of the

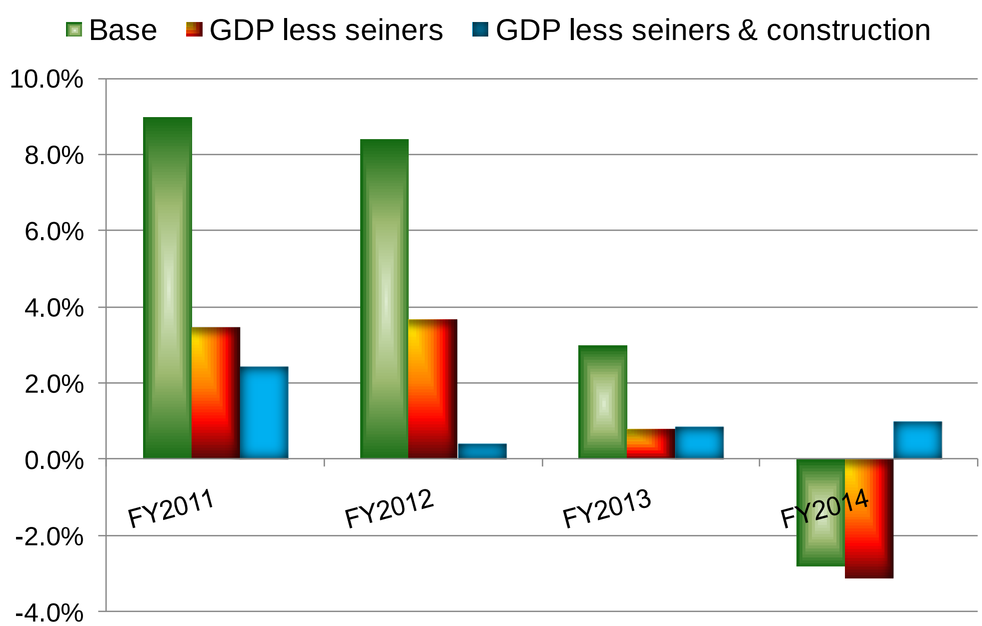


Figure 13 Baseline projections with impact of fishing and construction

$18 million FAA road realignment project at the airport.

Two additional purse seiners were commissioned in August 2010, which will impact growth in FY2011. An additional two boats are anticipated in FY2012, and a third in FY2013. In addition, implementation of the FAA road project is scheduled to begin in FY2011 with a modest expenditure of $2 million, with expenditures increasing to $8 million in each of the following two years. The combined impact of these large new activities is significant. Without them, economic growth would be much more modest, averaging 0.7% during the FY2012-FY2014. While these additional investments are obviously welcome, the impact on economic growth is not sustained in the longer-term. In the case of fisheries, the new seiners will generate strong economic growth in the years that the new boats come into service, but GDP will then stabilize at the higher level. Likewise, the FAA project will generate growth during implementation, but economic activity will fall back once the project is complete. The impact of these activities notwithstanding, the underlying rate of economic growth based on the prospects of the other activities in the economy remains modest. For the RMI economy to experience sustained growth, additional private sector activity will need to be generated.

Forecasts indicate rapid economic growth in FY2011 and FY2012.

Underlying growth, however, remains weak.

Fig. 14 describes the fiscal position of the RMI economy over the medium term. The fiscal deficit represents the sum of revenues less expenses and acquisition of nonfinancial assets. It does not include repayment of principal on government debt. In the RMI, the cash position of government is the sum of the fiscal deficit less debt repayments plus incurrence of new debt. This cash position is equivalent to the change in Fund balances recorded in the annual audits.

Fig. 14 indicates a fiscal surplus during FY2008 through FY2010, on average, 3% of GDP. This is a favorable result and reflects accumulation of unspent resources in activities falling outside the general fund. The general fund itself, however, was depleted during this period. In FY2011 it has been assumed that both the fiscal surplus and cash position will deteriorate as use is made of the unspent resources left over from the prior year. In the projection period the fiscal outturn is forecast to run small surpluses averaging 2.3% of GDP, while the cash position averages zero. Government will have sufficient resources to meet its debt obligations but its cash flow position will remain tight.

Medium term forecasts indicate modest surpluses, but continuing tight fiscal situation with overall cash balances zeroing out.

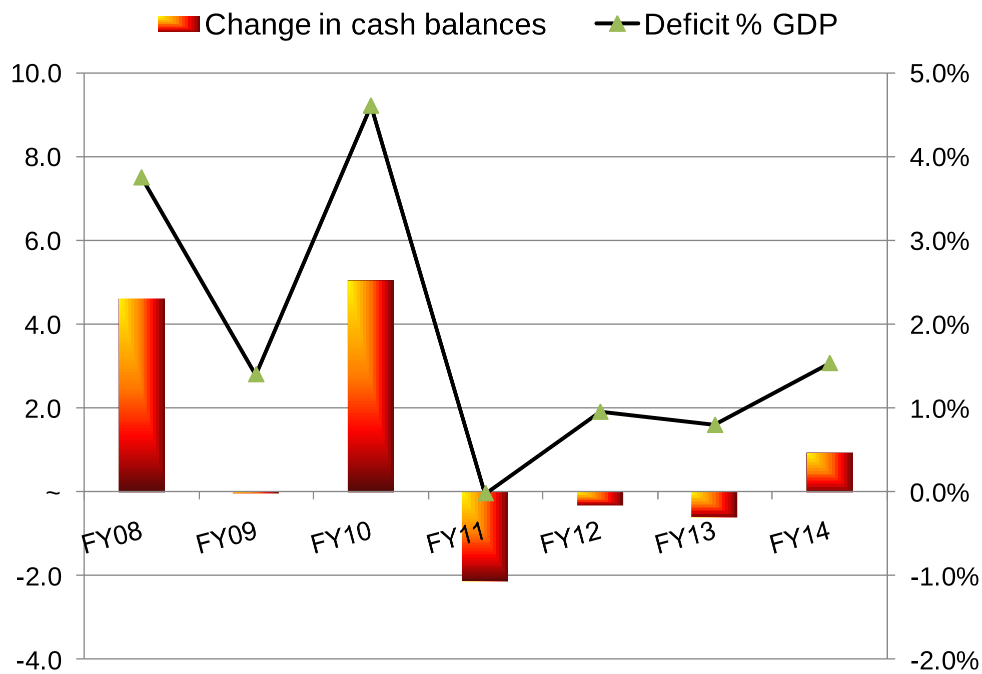


Figure 14 Fiscal position and deficit percent of GDP, FY2008 – FY2014.

The Reform Scenario

While there has been a general consensus in the RMI that reform is necessary, the question of commitment remains. In the reform scenario it is assumed that some of the CAP recommendations are implemented. In particular, it is assumed that the level of administrative services is cut by 10% in both FY2012 and FY2013, which is equivalent to a loss of 150 jobs. This amounts to a cost savings of $1.1 million in FY2012 and $2.5 million in FY2013. It is also assumed that savings of $1.5 and $3.0 million are realized through the use of goods and services, such as electricity allowances, utility bills, transfers, etc.

Reform scenario assumes implementation of CAP proposals.

Savings of 2% of GDP generated

The results of these savings on government's cash flow position are indicated in Fig. 15. The Reform Scenario projects a savings of nearly $2 million in FY2012, and $4.0 million in FY2013. There is a compensating lose in tax revenues resulting from the reductions in wage payments and demand for local services. The macroeconomic framework indicates that about 30% of the total original cost savings are likely to be lost due to reductions in taxes and social security receipts. It should be cautioned that the framework is under development, and although the compensating loss in tax revenues may appear high, this reflects the interlinkages in the system.

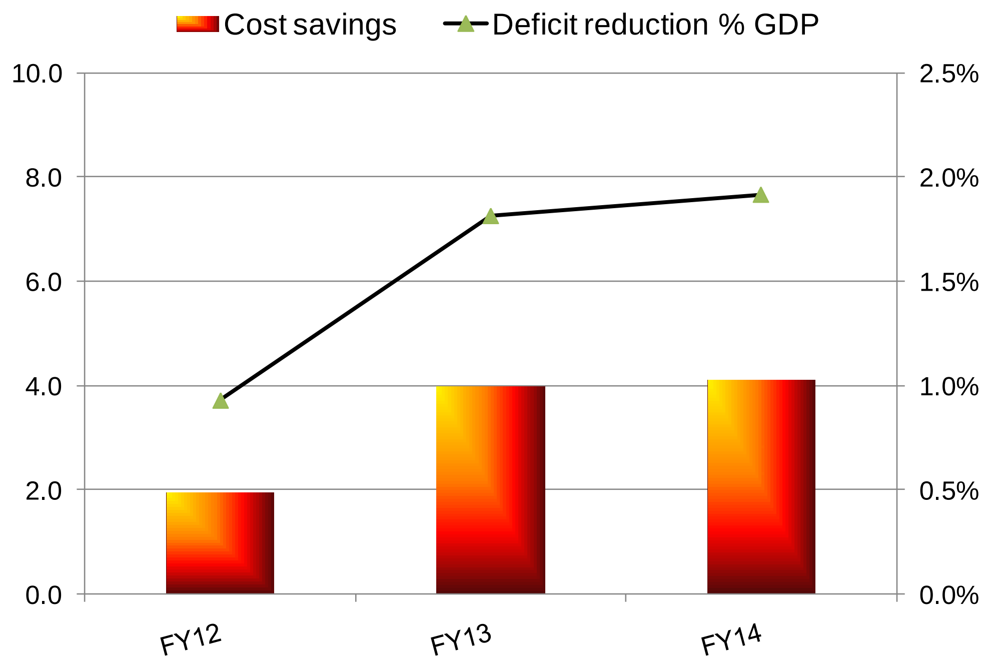


Figure 15 Change in fiscal position: base and reform scenario.

Reforms imply significant loss in welfare and GDP.

While the argument for reform is made in many parts of this report, the impact of the reforms on GDP and loss in welfare requires specification. Fig. 16 indicates a comparison of the impact of the baseline status quo and the Reform Scenario on GDP. In FY2012, implementation of the Reform Scenario would result in a loss of 1.2% of GDP in comparison to the baseline, and in FY2013 the loss amounts to 1.4% of GDP.

Policy Implications

As figure 16 indicates, implementing the Reform Scenario will have a negative impact on GDP. So, why reform? In its report to Cabinet, the members of the Comprehensive Adjustment Program stated that the RMI government needed to "restore fiscal flexibility and to enable the Government to respond to emerging needs without being forced to operate in a persistent state of crisis management and cash-flow shortages." In the absence of reform, the framework projects a baseline of exactly this scenario: the RMI government will be able to pay its debts, but will not have achieved any fiscal flexibility, and will not be able to respond to any external shocks.

Moreover, even the most optimistic market scenarios project a shortfall in the Compact Trust Fund's ability to replace operational

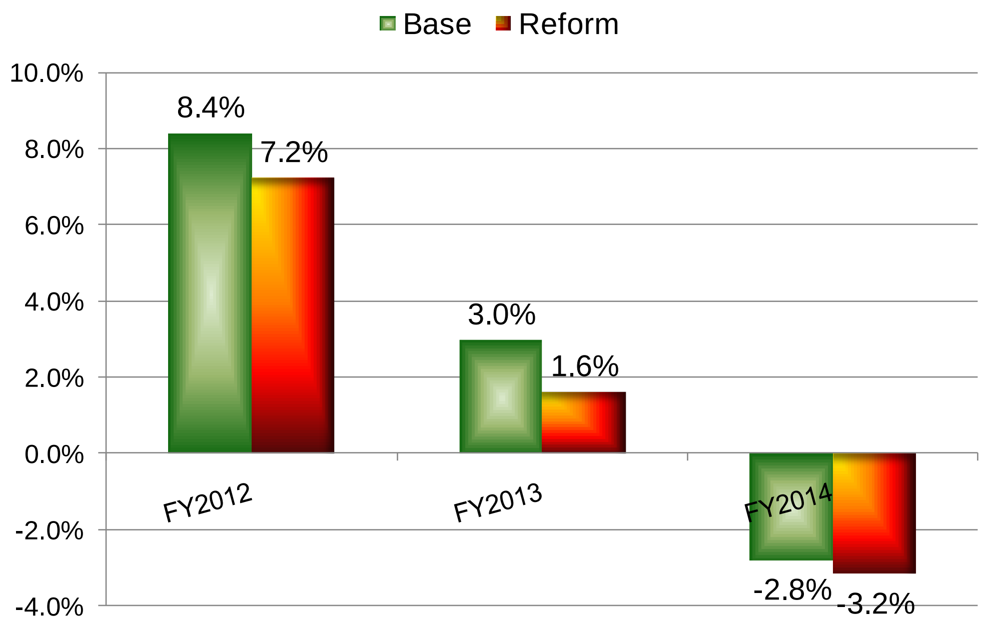


Figure 16 GDP growth with and without reform

expenses in 2023. The sooner the RMI government begins working proactively to generate savings that can be used to augment the CTF, the easier their adjustment will be in 2023.

Attaining fiscal surplus and making additional contributions to the CTF have been repeated findings of the IMF. The ADB has also supported such reforms, requiring the RMI government to deposit 1.5% of GDP into the Compact Trust Fund in FY2011 and FY2012, in order to access the second tranche of funding for the PSP. Whether through the CAP, the DPM, or ADB loan covenants, the RMI government has committed to a reform path, even as elections loom in late 2011. Without significant progress in implementing reforms, the government will not only face mounting fiscal challenges, but will also face credibility problems across the Development Partner community.