Economic Impact of the Compact and Renewal for the Federated States of Micronesia

April, 2023

ASIAN DEVELOPMENT BANK

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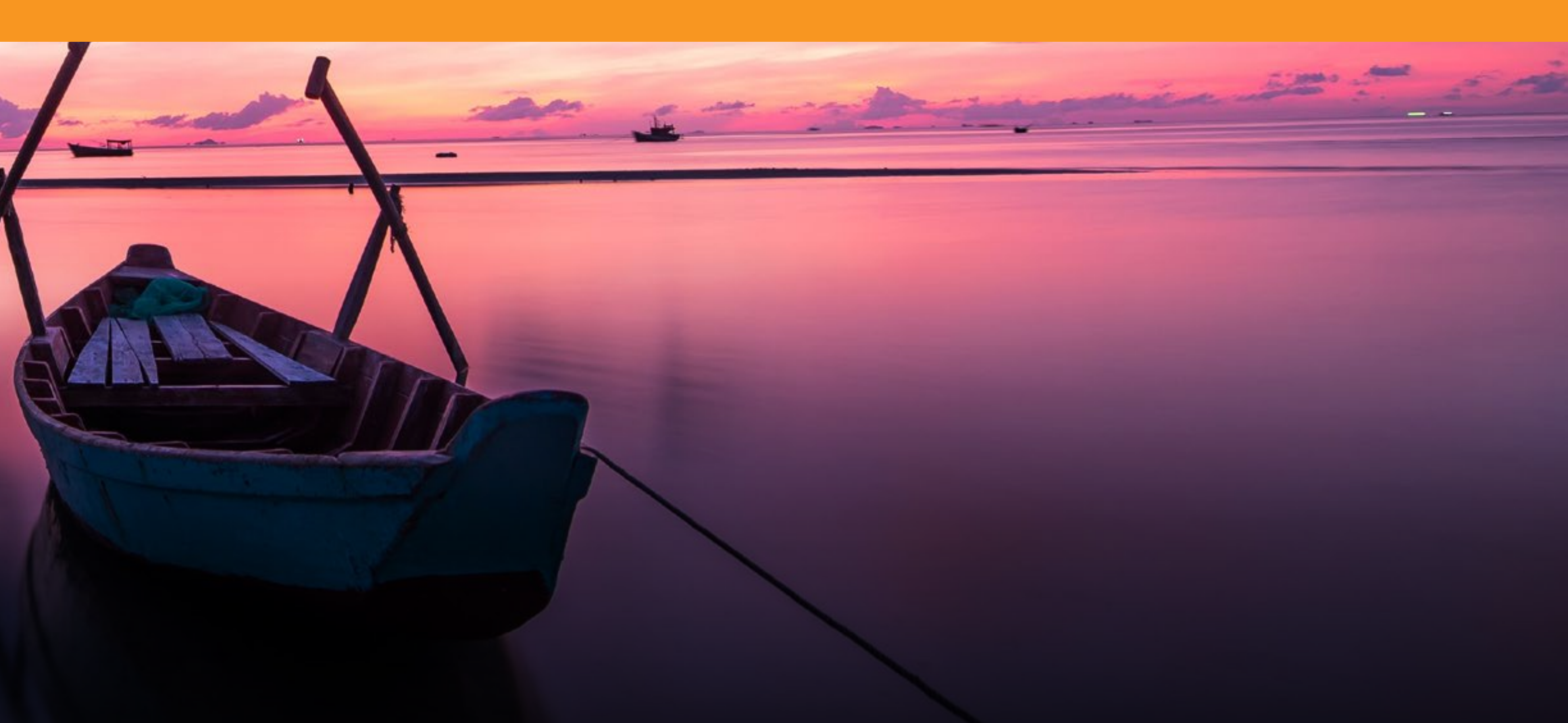
ABBREVIATIONS

ADB	—	Asian Development Bank
CARES	—	Coronavirus Aid, Relief, and Economic Security Act (US)
CDC	—	Centers for Disease Control (US)
COFA	—	Compact of Free Association
COM	—	College of Micronesia
COVID	—	Coronavirus disease
CPRO	—	Coronavirus Pandemic Response Option
CTF	—	Compact Trust Fund
DAEF	—	Disaster Assistance Emergency Fund
DOE	—	Department of Education (US)
DOI	—	Department of the Interior (US)
DRP	—	Disaster Resilience Program
DSA	—	Debt Sustainability Analysis
EconMAP	—	Economic Monitoring and Analysis Program (GSUSA)
ERA	—	Enhanced Reporting and Accountability
FAA	—	Federal Aviation Administration (US)
FAS	—	Freely Associated States
FDIC	—	Federal Deposit Insurance Corporation (US)
FPA	—	Fiscal Procedures Agreement
FPUC	—	Federal Pandemic Unemployment Compensation (US)
FSM	—	Federated States of Micronesia
FSMCTF	—	Federated States of Micronesia Compact Trust Fund
FSMTF	—	Federated States of Micronesia Trust Fund
FTE	—	Full-Time Equivalent (jobs)
GAO	—	Government Accountability Office (US)
GDP	—	Gross Domestic Product
GNP	—	Gross National Product
GSUSA	—	Graduate School USA
HEALS	—	Health and Livelihoods Support Program
IAG	—	Inter-Agency Group (US executive)
ICOR	—	Incremental Capital Output Ratio
ICT	—	Information and Communication Technology
IMF	—	International Monetary Fund
JCRP	—	Joint Committee on Compact Review and Planning (FSM)
JEMCO	—	Joint Economic Management Committee (FSM-US)
NORMA	—	National Oceanic Resources Management Authority (FSM)
OIA	—	Office of Insular Affairs (DOI-US)
PACTAM	—	Pacific Technical Assistance Mechanism (Australia)



Palau	—	Republic of Palau
PFM	—	Public Financial Management
PNA	—	Parties to the Nauru Agreement
PUA	—	Pandemic Unemployment Assistance (US)
RMI	—	Republic of the Marshall Islands
RMICTF	—	Republic of the Marshall Islands Compact Trust Fund
SAFER	—	Sustainability Adjustment for Enhanced Reliability (GSUSA)
SEG	—	Supplemental Education Grant (US)
SOE	—	State-Owned Enterprise
TA	—	Technical Assistance
TSMRF	—	Tourism Sector Mitigation Relief Fund
TT	—	Trust Territory
UN	—	United Nations
UNDP	—	United Nations Development Program
US	—	United States
VDS	—	Vessel Day Scheme

NOTE:

FSM governments' fiscal year (FY) ends on September 30.

Currency unit: United States dollar (US$).

Figures may not add in this report due to rounding.

TABLE OF CONTENTS

Abbreviations iv

List of Figures and Tables viii

FOREWORD x

EXECUTIVE SUMMARY xii

FSM Compact Structural Features, Trends, and Preparedness. xii

FSM Economic and Fiscal Structure and Performance xiii

The Impact of COVID-19 on the FSM Economy and Outlook xiii

Modeling the Impact of Non-Renewal of Compact Economic Assistance xiv

Modeling the Impact of Compact Economic Assistance Renewal xiv

1. FSM COMPACT 101: STRUCTURAL FEATURES, TRENDS, AND PREPAREDNESS. 1

Compact Structural Features 2

FSM Compact Trends 7

Preparedness for the End of Compact Funding . . . 7

2. FSM ECONOMIC AND FISCAL STRUCTURE AND PERFORMANCE 11

Economic Structure. 12

Economic Performance 12

State Performance and Income Disparities 14

Fiscal Structure 15

Fiscal Performance 16

3. THE IMPACT OF COVID-19 ON THE FSM ECONOMY THROUGH THE END OF THE AMENDED COMPACT PERIOD 19

Economic Impact 21

Impact on Employment and Household Income 22

Fiscal Impact 23

Conclusion 24

4. MODELING THE IMPACT OF NON-RENEWAL OF FSM COMPACT ECONOMIC ASSISTANCE 25

Non-Renewal Scenario. 26

Independence Illustration 29

Conclusion 32

5. MODELING THE IMPACT OF FSM COMPACT ECONOMIC ASSISTANCE RENEWAL. 33

Compact Renewal Scenario 34

Better Results Scenario 36

Compact Trust Fund Issues and Cost of Renewal 38

Reforms and Donor Support. 40

CONCLUDING OBSERVATIONS 43

APPENDIX: WHAT'S WRONG WITH THE COFA TRUST FUND RULES? 45

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ADB

LIST OF FIGURES AND TABLES

1. FSM COMPACT 101: STRUCTURAL FEATURES, TRENDS, AND PREPAREDNESS . . . 1

Figure 1: Comparison of FSM Compact Features (Initial and Amended Compact Periods) . . . 4

Figure 2: FSM Compact Timeline . . . 6

2. FSM ECONOMIC AND FISCAL STRUCTURE AND PERFORMANCE . . . 11

Figure 3: Economic Structure: Economy-wide and Private Sector, FY17-FY19 Average . . . 13

Figure 4: GDP Growth and Level, FY04 Prices . . . 13

Figure 5: Contribution to GDP Growth by Industry, FY03-FY19, FY04 prices . . . 14

Figure 6: GDP per Capita (FY04 prices) in Chuuk, Kosrae, Pohnpei, and Yap . . . 14

Figure 7: National and State Governments' Revenue by Source, FY17-FY19 Average . . . 15

Figure 8: National and State Governments' Expenditures by Function, FY17-FY19 Average . . . 15

Figure 9: National and State Governments' Share of Expenditures, FY04-FY06 & FY17-FY19 . . . 16

Figure 10: Per Capita State Government Expenditures, Average FY17-FY19 . . . 17

Figure 11: Fiscal Balance: State and National Governments, Percent GDP . . . 17

Figure 12: National Government Revenue and Expenditures, as a Percent of GDP . . . 17

3. THE IMPACT OF COVID-19 ON THE FSM ECONOMY THROUGH THE END OF THE AMENDED COMPACT PERIOD . . . 19

Figure 13: GDP Growth and Level, FY04 Prices . . . 21

Figure 14: Major Industries Affected by the Pandemic (Value Added, FY04 prices) . . . 22

Figure 15: Private and Public Sector Growth, FY04 Prices . . . 22

Figure 16: Employment Level and Growth . . . 23

Figure 17: Household Income (FY04 prices): With and Without Mitigation . . . 24

Figure 18: Projected State and National Government Fiscal Deficit . . . 24

4. MODELING THE IMPACT OF NON-RENEWAL OF FSM COMPACT ECONOMIC ASSISTANCE . . . 25

Figure 19: FSM Downward Adjustment Scenarios . . . 27

Fig. 20-23: FSM Non-Renewal Scenario: GDP, Household Income, Employment, and Migration . . . 28

Fig. 24-27: FSM Independence Illustration: GDP, Household Income, Employment, and Migration . . . 30

Figure 28: Impact on GDP of the Independence Illustration by State (Index: FY19=100) . . . 31

Figure 29: Impact on Household Income of the Independence Illustration by State (FY04 prices) 31

Figure 30: Impact on Employment of the Independence Illustration by State 31

Figure 31: Impact on Cumulative Migration Since FY18 of the Independence Illustration by State 31

Figure 32: Impact of Migration on Population of the Independence Illustration by State (FY24) 32

5. MODELING THE IMPACT OF FSM COMPACT ECONOMIC ASSISTANCE RENEWAL 33

Figure 33: FSM Compact Renewal Scenario 35

Fig. 34-37: FSM Renewal Scenario: GDP, Household Income, Employment, and Migration 36

Fig. 38-41: FSM Better Results Scenario: GDP, Household Income, Employment, and Migration 38

Figure 42: Impact on GDP of the Better Results Scenario by State (Index: FY19=100) 39

Figure 43: Impact on Household Income of the Better Results Scenario by State (FY04 prices) 39

Figure 44: Impact on Employment of the Better Results Scenario by State 39

Figure 45: Impact on Cumulative Migration Since FY2018 of the Better Results Scenario by State 39

Table 1: FSM Compact Trust Fund Performance Under the Existing Arrangement and Compact Renewal 40

Table 2: Cost to the US of a 20-Year Compact Funding Extension (As Modeled) 40

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ECONOMIC IMPACT OF THE COMPACT AND RENEWAL FOR THE FEDERATED STATES OF MICRONESIA

Foreword

The Asian Development Bank (ADB) commissioned a study to benefit its three North Pacific member countries and their development partners. This study provides information and analysis about the Freely Associated States (FAS) as they approach an important milestone in their respective Compact relationships with the United States (US). At the time of conceiving this study, in late 2018, the range of possible outcomes at the end of each specified Compact funding period for the FAS was quite broad. Consequently, ADB believed that the affected parties and their development partners would benefit from a professional study that estimated the range of potential fiscal adjustments and modeled the associated economic outcomes.

US announces intention to negotiate extension of Compact economic assistance. This study was commissioned in May 2019, before the United States (US) government officially announced its intention to negotiate an extension of Compact funding with each FAS, including the Federated States of Micronesia (FSM). The US shared an undisclosed offer of assistance with each FAS, including the FSM, in late 2020 as the end of the term of the prior US administration approached. In March 2022, the US named a Special Presidential Envoy for Compact Negotiations and reinitiated formal negotiations with the FSM. ADB decided to continue this study along the initially conceived lines: with downward adjustment and Compact funding renewal scenarios. The downward adjustment case is noted as nearly identical to the outcome that would result even from a delay in a fully funded period of renewal with the FSM. The renewal case, optimistically, provides the welcome challenge of ensuring that additional resources have the greatest sustained benefit to the FSM.

COVID-19 pandemic impacts demand a reassessment of the economic outlook for each FAS. Since the draft findings of the original three-country study were shared with all affected parties in January 2020, the world suffered from the Coronavirus Disease-19 (COVID) pandemic, with varying degrees of impact on each FAS. This FSM country-focused study serves two purposes: (i) it includes more FSM-specific detail; and (ii) it updates all the underlying model assumptions to take into account the estimated impacts of the COVID-19 pandemic on the FSM. This report is based on economic data available as of May 2022.

ADB trusts that the provision of information and analyses herein will prove beneficial to all interested parties. This study builds upon the ongoing work of the Economic Monitoring and Analysis Program (EconMAP), administered by the Graduate School USA (GSUSA) with funding support from the US Department of the Interior's (DOI) Office of Insular Affairs (OIA).

Importantly, this study makes no recommendations to the directly affected parties. ADB looks forward to working with the FSM and its development partners to address needs as they arise. In the event of unlikely but conceivable severe fiscal outcomes, such work might entail a greater focus on mitigating the effects of fiscal adjustments. More optimistically, following a commitment by the US to extend the financial terms of each Compact, ADB could focus more directly on policy reform and in-country economic management

needs to support the achievement of enhanced private sector-led economic growth.

ADB looks forward to a dialogue on this country-focused report in the FSM and welcomes feedback from all parties.

EXECUTIVE SUMMARY

FSM Compact Structural Features, Trends, and Preparedness

Compact structural features. The Compact between the US and the FSM delivered sovereignty and self-governance, included economic development assistance, and provided the right of FSM citizens to move to the US. After two periods of US economic assistance the FSM and the US are now conducting negotiations for a third round. The FSM Compact entered into force in 1986 with the initial economic assistance provided for fiscal year (FY) 1987 through FY03. During this period, most funding was provided as budgetary support for current operations and capital improvement projects. Near the end of the period, the US and FSM negotiated an amended Compact agreement. The amended Compact provided for economic assistance for FY04-FY23 and included several changes: a Compact Trust Fund (CTF) was established for the FSM, with US annual contributions rising over the 20-year period; and a US-FSM committee was established to provide more accountability over annual grants to targeted sectors such as education, health, and infrastructure. Also, the US established a Supplemental Education Grant (SEG) for FY05-FY23 that cashed out several existing US federal programs. Under the terms of the FSM amended Compact, annual grants terminate at the end of FY23; thereafter, the FSM receives annual distributions from the trust fund. In addition, the SEG ends at the end of FY23.

Compact trends. The FSM experienced economic growth and reduced reliance on Compact transfers as they fell over time. FSM achieved moderate but positive real economic growth from FY87 to FY18 that is expected to continue through FY23. This growth occurred while the FSM received declining real transfers through the Compact. The reliance of the FSM on Compact transfers declined from very high levels during the initial Compact period to a projected level of 23 percent of gross domestic product (GDP) in FY23. Over time, under terms of the Compact, citizens of the FSM have migrated to the US, increasing their cumulative number at the end of FY23 to 45,633 (not including children born to FSM Compact migrants in the US). The FSM population is estimated to be about 105,198 at the end of FY23..

Preparedness. The FSM established the Joint Committee on Compact Review and Planning (JCRP) and designated a Chief Negotiator to represent them as they engaged with the US regarding further assistance. The US has a standing mechanism to monitor and implement its policies toward the FSM—an Inter-Agency Group (IAG) led by the White House National Security Council. The IAG has scaled up FAS engagement due to US desire to offset China's growing influence in the Pacific region and the scheduled expiration of ongoing economic assistance through the three Compacts. The Presidents of the US and the three FAS nations met at the White House in May 2019 and the US identified two co-negotiators in April 2020. Several meetings were held in 2020. Following a period of minimal formal interaction, in March 2022, the US President appointed a Special Presidential Envoy for Compact Negotiations. Negotiations are well underway with an expressed desire to reach mutual agreement with each

FAS as early as possible. The FSM and US signed a memorandum of agreement (MOA) regarding future Compact funding levels in February 2023.

FSM Economic and Fiscal Structure and Performance

Economic structure and performance. The FSM is the least developed of the three FAS, with the private sector representing 22 percent of GDP and with the major private sector activity focused on retailing to provide goods and services to the local economy, as compared to 33 percent of GDP in RMI and 52 percent in Palau. The FSM has the largest household sector comprising subsistence and informal sector activities, representing 24 percent of GDP, and has a government sector at 25 percent. The FSM has implemented neither a public sector-led nor a private sector-led development strategy; however, the FSM's combined state and national planning efforts are aimed at promoting a multi-sector private sector-led growth strategy.

Fiscal structure and performance. In terms of fiscal structure, tax revenues reflect the degree of development in the economy. Palau with 47 percent has the highest proportion of tax revenues of total revenues, while the FSM and RMI record only 14 percent and 22 percent respectively. While all three FAS have relied on the same set of taxes inherited from Trust Territory (TT) days, the FSM score displays a particularly low level of tax effort. Sovereign rents derived from fishing fees, and in the FSM's case, also from the domicile for major Japanese corporations now represent a large share of tax revenues in the FSM and RMI, 43 percent and 28 percent, respectively, while Palau receives only a modest 8 percent of revenues from this source. Reflecting the dependent nature of the three FAS, grants remain a critical component of the landscape since independence and TT days, recording 38 percent, 48 percent and 30 percent in the FSM, RMI and Palau, respectively.

In the FSM, reflecting the nature of the Federation, there are differences in fiscal performance between national government performance and that of the four states. The national government has benefited from the recent and significant growth in sovereign rents, while the four states have not benefited directly from that increase; rather the states have continued to rely upon Compact sector grants for their major share of revenues. This has led to large fiscal surpluses at the national level, averaging 21 percent of GDP in recent years. Meanwhile the state governments' collective fiscal envelope has been constrained as each state has struggled to sustain fiscal balance as the real level of grants has declined.

The Impact of COVID-19 on the FSM Economy and Outlook

Mitigation programs. In the early months of 2020, to reduce the spread of COVID-19, global travel restrictions were implemented which led to a collapse of international travel and tourism. In response to the pandemic the FSM effectively closed its borders in March/April 2020 and as a result remained COVID-free until 2022. The FSM benefited from donor and internal programs to mitigate the health issues and economic costs of COVID-19. US health programs provided the major source of funds to mitigate the potential impact of a COVID-19 outbreak. The FSM also benefited from the US Coronavirus Aid, Relief, and Economic Security Act (CARES), Federal Pandemic Unemployment Compensation (FPUC), and Pandemic Unemployment Assistance (PUA). These benefits supported the economic livelihoods of FSM workers. The ADB has been a major contributor to the FSM, providing $29.7 million grants for COVID-19. The FSM Congress also initiated a tourism sector mitigation relief fund.

Economic Impact. In the case of the FSM, the economic impact of COVID-19 has been significant but not outside the normal volatility experienced during the economic cycle. GDP fell over the two-year FY20-FY21 period by 5.0 percent. Private sector GDP fell over the two-year FY20-FY21 period by 12.3 percent. Without the US CARES Act and ADB CPRO programs, household income would have fallen by 6.3 percent. Instead, household income rose 3.2 percent over the two years FY20-FY21. However, in FY22 household incomes are projected to fall once mitigation programs end and before the economy fully recovers

Fiscal impact. The impact of COVID-19 on the fiscal position of the FSM is expected to be minor. The mitigation grant funds received by the FSM provided for local needs without the need for significant local funding. In fact, the FSM fiscal position will show an improved fiscal surplus in FY20 and FY21, reflecting a buildup of grant funds not yet expended during the period. However, in FY22 and FY23, these funds will be drawn down and without replenishment from grant sources, existing mitigation programs will need to be funded from domestic sources.

Modeling the Impact of Non-Renewal of Compact Economic Assistance

FSM non-renewal scenario. Modeling a scenario with non-renewal of Compact assistance is built on several key assumptions. The FSM moves to the regime outlined in their Compact that has two key features. First, the FSM would transition from sector grants funded by US appropriations to annual distributions from the CTF. Second, SEG funding would cease. In the modeling, the initial level of annual distributions from the CTF is set at a sustainable (with a high degree of confidence) and subsequent distributions are adjusted for inflation.

The projected level of the Federated States of Micronesia Compact Trust Fund (FSMCTF) in FY23 is estimated to provide a sustainable draw of $31.4 million in FY24, which requires a substantial adjustment. The adjustment would result in large reduction of funds to finance government operations that is $52.1 million below the FY23 level, a resource cut equivalent in size to 12.4 percent of GDP. The loss of SEG entails a further reduction in funding, equal in size to 2.6 percent of GDP, bringing the total cut in funding equivalent in size to 15.0 percent of GDP or $63.2 million. Almost all of the fiscal adjustment would occur at the state level. The FSM economy is projected to contract by 8.6 percent of GDP under the non-renewal scenario. Most of the adjustment will be felt in the public sector GDP which contracts by 20.4 percent, while private sector GDP contracts by 5.1 percent. The resultant job losses result in a projection of almost 11,800 additional migrants to the US.

Independence Illustration. In addition to the adjustment to a sustainable level of CTF distributions and the loss of SEG outlined in the non-renewal scenario, the Independence Illustration models what the FSM would face if all US federal programs and services ceased, both Compact and non-Compact. This illustration is presented not as a likely outcome, as the relationship between the US and the FSM remains strong, but rather to illustrate the ongoing value of the US relationship to the FSM.

Under the modeled assumptions, the potential additional reduction in US funding (nearly all of the listed programs and services) totals $28.1 million annually, which is equivalent in size to 6.7 percent of projected GDP in FY23. Taken in addition to the non-renewal scenario reduction of $63.2 million, the total annual reduction in transfers would be $91.3 million annually, or the equivalent in size to 21.7 percent of projected GDP in FY23. Once that funding is withdrawn from the economy, GDP is estimated to fall by 13.2 percent. The resultant job losses are projected to induce almost 19,000 new migrants to the US, or 18 percent of the FSM population. These results illustrate the dependence of the economy on the Compact and other US grants.

Modeling the Impact of Compact Economic Assistance Renewal

Compact renewal scenario. For the FSM, Compact renewal assumes a further 20-year period at a level equivalent to the FY23 sum of the annual sector grants, SEG, audit, and CTF contributions. This “topline” level of ongoing US support would be subject to the same partial inflation adjustment rule that prevailed throughout the amended Compact period (two-thirds of the annual change in the US GDP deflator). The outcome is that FSM GDP is projected to increase by 3.4 percent in FY24 and be maintained at an average of 0.8 percent, thereafter through FY30. This is an improvement over the amended Compact period where growth stagnated for 20 years. Reflecting the additional projected growth, employment and household incomes increase and outmigration is held at bay. Compact renewal allows the FSMCFT to grow to sustainable levels.

Better Results scenario. Continuation of Compact sector grants at existing levels ushers in a new period and potential to develop a public sector development strategy. Under the new circumstances the revenue-sharing arrangements that currently exist between national and state governments would be subject to new dynamics. Arguments for recent sustained growth of sovereign rents to remain within the national government would no longer be relevant. For the FSM, the Compact renewal scenario envisages the large national government structural surplus would be transferred to the state governments in a planned and increasing way, allowing for absorptive capacity constraints to be overcome. Further, an annual sustainable drawdown from the Federated States of Micronesia Trust Fund (FSMTF), after setting aside a reserve for climate events and resilience, would provide additional resources to pursue the public sector growth strategy.

1

FSM COMPACT 101: STRUCTURAL FEATURES, TRENDS, AND PREPAREDNESS

ADB

1 FSM COMPACT 101: STRUCTURAL FEATURES, TRENDS, AND PREPAREDNESS

This chapter describes the structure and timing of the initial and subsequent Compact economic assistance periods for the FSM, followed by a timeline of key trends during the Compact periods.

The Compact of Free Association status represented the choice each FAS made in order to terminate its status as a territory under the United Nations (UN) Security Council mandate for the Trust Territory of the Pacific Islands. For the FSM, like the Republic of the Marshall Islands (RMI) and the Republic of Palau (Palau), the Compact relationship delivered sovereignty and self-governance. Each FAS governs according to its own Constitutional provisions. Each has demonstrated an abiding commitment to free and fair democratic elections. The Compacts also included economic assistance provisions to support the ultimate achievement of self-reliance. The FSM and RMI Compact provisions are similar as they were negotiated in a similar timeframe and passed into US law together. The Palau Compact negotiations followed a different track. Even though the Palau Compact was passed into US law less than a year after the passage for the FSM and RMI, it only came into effect 8 years after the FSM and RMI Compacts.

Compact Structural Features

FSM Initial Compact Period (FY87 to FY03, "Compact I")

The FSM Compact of Free Association entered into force on 3 November 1986, early in FY87. The Compact had been mutually approved on 1 October 1982. In the FSM, the Compact was approved by the Government as an international treaty and in a plebiscite observed by the UN on 21 June 1983, a sovereign act of self-determination. In the US, the Compacts with the FSM and the RMI were approved by Public Law 99-239 on 14 January 1986.

The Compact and its subsidiary agreements were approved as an "Executive Agreement of the United States containing international obligations." Within the US government the Compact is treated as a treaty obligation that required passage of a public law by both houses of the United States Congress. Pursuant to the Compact, 3 November 1986, marked self-governance of the FSM with the right to conduct foreign affairs in its own name. On 17 September 1991, UN Resolution 46/2 granted FSM membership in the UN. As of October 2022, the FSM had diplomatic relations with 94 countries. The FSM has typically been within the top three countries in the UN with respect to coincidence of votes with the US.

Title II of the FSM Compact describes US economic assistance for the 15-year period from FY87 to FY01. A 2-year extension period was called for under section 231 and "the initial Compact period" now describes the 17-year period from FY87-FY03.

Funds provided through the initial Compact were backed by a "full faith and credit" commitment of the US government. In the US law approving the Compact, Congress authorized and appropriated funds to cover Compact commitments for the full period. Therefore, Compact funds were not subject to annual appropriations processes.

During this initial period, most funding was provided under section 211 as unrestricted budgetary support. Of this total, 60 percent was alloted to current operations, while 40 percent was reserved for capital improvement projects. The level of support to the FSM was designated as $60 million annually for the first five years, $51 million annually for the second five years, and $40 million annually for the third five years. The two reductions in funding after the 5th and 10th years of the initial Compact period are referred to as "step-downs." The second step-down was extraordinarily disruptive and required structural reforms, including civil service retrenchment across all five governments of the FSM (national and four states).

Annual transfers totalling $15.1 million were provided for energy, communications, marine surveillance, health and medical programs, scholarships, and education/health block grants. One-time payments totaling $8.1 million were also provided in FY87 for the US Coast Guard facility in Yap, communications hardware, and maritime surveillance support. Finally, the legislation implementing the Compact provided $20 million in initial financing for the FSM Investment Development Fund in FY87 to support private-sector lending. This $20 million partially compensated the FSM for the loss of tax and trade incentives that the US Congress removed from the negotiated Compact.

An inflation factor equal to two-thirds of US inflation was applied to most Compact funding. The supplemental years under the initial Compact—FY02 and FY03—were funded at the average level that prevailed during the initial 15 years. However, the FSM contributed most of the incremental increase in funding for those two years—$30 million—to the FSM Compact Trust Fund (FSMCTF) created under the amended Compact.

Most of the specified annual transfer provided during the initial Compact economic assistance period were adjusted for inflation by a formula that provided two-thirds of the annual change in the US Gross National Product (GNP) Implicit Price Deflator, with a capped maximum annual adjustment of 7 percent. (The 7 percent cap never limited the annual adjustments.) An initial adjustment of 22 percent was applied to the affected initial year distributions, reflecting two-thirds of the inflation from the mutually agreed Compact negotiated terms at the outset of FY81 until the start of FY87. By the final year of the initial Compact period in FY03, the cumulative annual adjustments applied to the affected base grants was 58 percent.

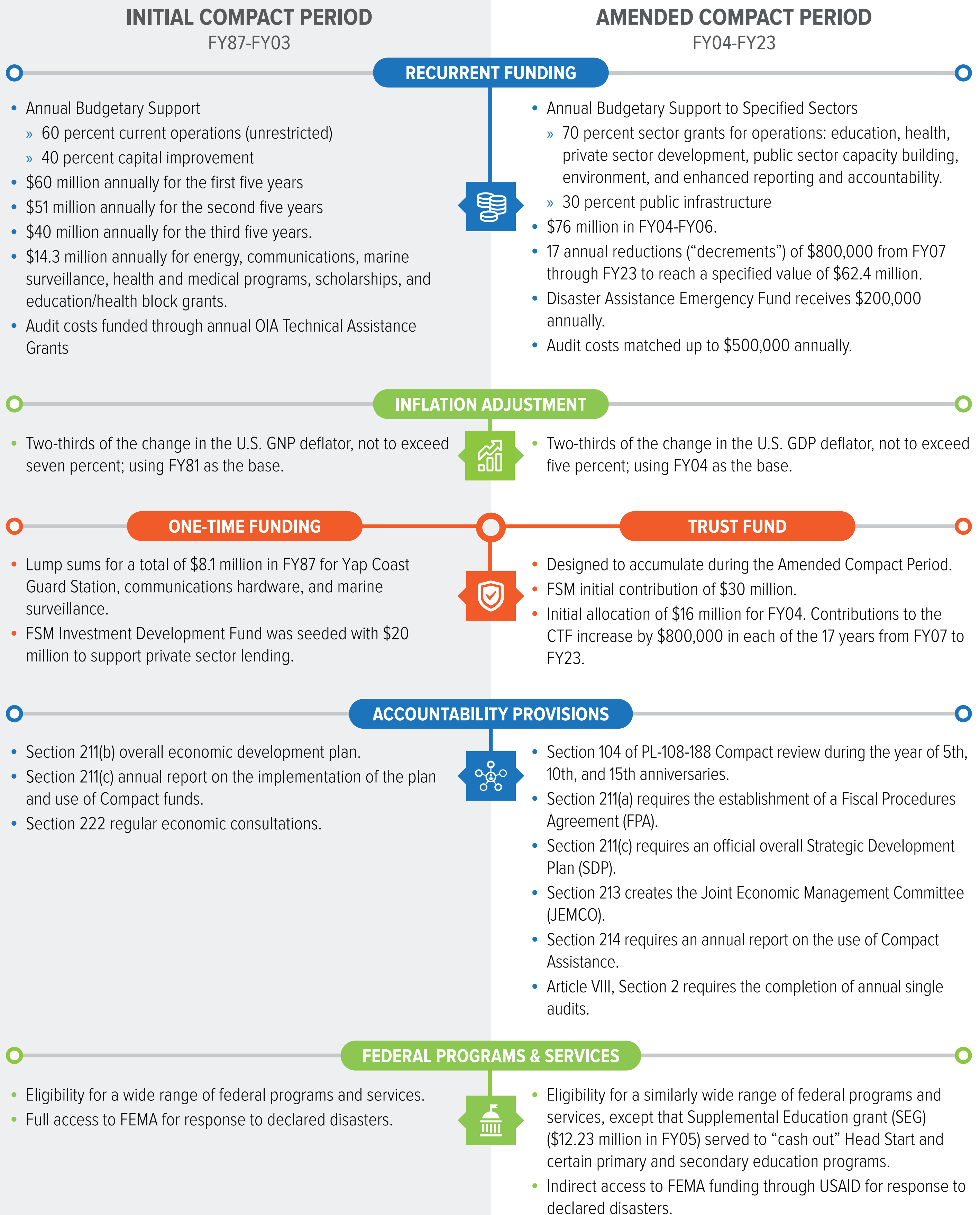
Figure 1 provides a summary comparison of the features of the initial FSM Compact period described above and the amended Compact period described below.

FSM Amended Compact Period (FY04-FY23, "Compact II")

At the outset of FY01, the FSM entered into negotiations with the US to extend economic assistance pursuant to section 231 of the Compact. Four key outcomes from the negotiations include:

- **Compact Trust Fund**. The parties agreed to the creation of a Compact Trust Fund (FSMCTF) that would accumulate during the amended Compact period. After that period, the fund would replace terminating sector grants. While explicitly not guaranteeing the level the FSMCTF or its distributions would reach, the intent was to provide a smooth transition and a perpetual FSM support fund to end the need for annual US budgetary support. The FSMCTF was anticipated to be established on 1 October 2003; however, the amended Compact did not go into effect until 25 June 2004, and the FSMCTF was incorporated as a nonprofit corporation on 17 August 2004. Initial deposits of $30 million from the FSM and $16 million from the US were anticipated to be available on 1 October 2003. But the FSM deposited $30.3 million exactly one year late, on 1 October 2004, and the US chose to await the FSM contribution, thereby delaying its initial deposit of $16 million until 5 October 2004. The allocation of funds to the asset classes identified in the FSMCTF Investment Policy Statement did not occur until 10 August 2006—34 months into the amended Compact period. This delay was ill-timed, as the markets performed well during that period. The cumulative impact of the delay is estimated to be $51 million at the end of FY23, or approximately 5 percent of the projected value of the FSMCTF at that time.
- **Accountability provisions**. The US insisted on significant changes to the accountability provisions attached to transfers during the amended Compact period. The amended Compact revised the "Fiscal Procedures Agreement" (FPA), basing it heavily on the "Common Rule" that applies to federal grants to US states, territories, and local governments. The parties also agreed to create a Joint Economic Management Committee (JEMCO), to have oversight duties specified in the FPA.

Figure 1: Comparison of FSM Compact Features (Initial and Amended Compact Periods)



- **Sector grants**. The transfers—now treated as grants from the US government—were required under section 211 to be awarded to six initially specified sectors: education, health, private sector development, public sector capacity building, environment, and public infrastructure. A seventh sector was created by mutual agreement pursuant to section 211 to allow sector grants to cover the costs of enhanced reporting and accountability (ERA). Such ERA expenditures are limited to 2 percent of total annual grants. By action of the JEMCO, and consistent with the "sense of the Congress" expressed in the amended Compact act, 30 percent of section 211 sector grant funding has been dedicated to public infrastructure.
- **Supplemental Education Grant**. The FSM agreed to a "cash-out" provision for several US federal programs that had supported Head Start (pre-K), primary, and secondary education in the FSM. The reason US officials provided at the time was that the programs were not well-suited to circumstances in the FSM and the cost of those programs, converted to annual grants, would provide more flexibility and improved outcomes. The amount authorized for this Supplemental Education Grant (SEG) was $12.23 million in FY05 (allowing for a one-year transition under previously authorized federal education programs for FY04), with the authorization partially adjusted for inflation for the period FY05-FY23. The amount was provided as an authorization for the US Department of Education (DOE) to request annual budget allocations and inflation adjustments in the appropriation process. Had the designated amount been both authorized and appropriated, the nominal value would have grown from $12.23 million in FY05 to an estimated $15.7 million in FY23. However, US DOE did not request authorized annual partial inflation adjustments, and with two cuts that resulted from US government-wide periods of sequestration, the FY23 level of the SEG was projected to be $11.1 million. However, the recent FY23 Congressional appropriation provided $13.104 million for FY23.

The FSM and US signed the amended Compact on 15 May 2003. The amended Compact was approved by the US Congress on 30 November 2003 and signed into law as US PL 108-188 on 17 December 2003, during the first quarter of FY04. The FSM Congress approved the amended Compact on 26 May 2004, following earlier ratification by the four FSM states. The US and FSM signed documents to implement the amended Compact on 25 June 2004.

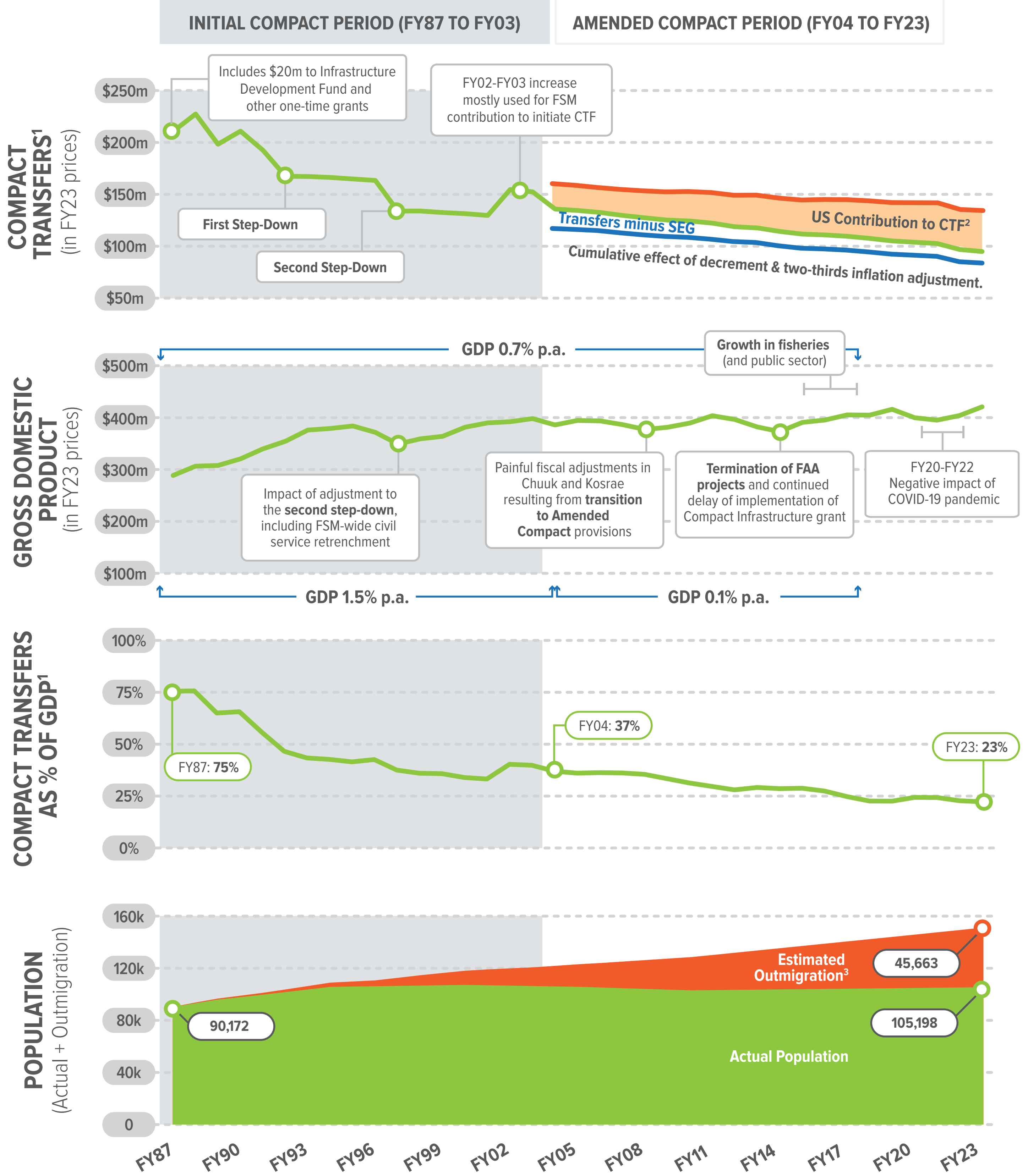
Congress authorized and appropriated funds to cover amended Compact commitments in its implementing legislation. Therefore, Compact funds were not subject to the annual appropriations process.

The structure of the amended Compact contains four funding streams for the FSM and a fifth that accumulates in the FSMCTF:

- **Sector grants**. This funding started at $76.2 million, including $0.2 million for the Disaster Assistance Emergency Fund (DAEF), in FY04 to FY06, and was followed by 17 sequential annual reductions of $800,000 each year (referred to as the "decrement") to reach a specified value of $62.6 million in FY23. Since sector grants are adjusted annually by two-thirds of the change in the US GDP deflator (now capped at 5 percent), the nominal level of the sector grants actually provided has been relatively stable. Sector grants started at $76.2 million in FY04, peaked at $81.7 million in FY13, and are projected to be $81.4 million in FY23.
- **Supplemental Education Grant**. The SEG, as described above, started at $12.23 million in FY05 and is projected to be $11.1 million in FY23.
- **Audit expenses**. The US will reimburse FSM for audit costs of up to $500,000 annually, with no inflation adjustment.
- **Disaster Assistance Emergency Fund**. Since 2004, the US and FSM have each contributed $200,000 annually to a Disaster Assistance Emergency Fund, which is intended to support disaster responses. Annual contributions (adjusted partially for inflation) are expected to reach $260,000 from each contributor in FY23.
- **The Compact Trust Fund**. The FSMCTF, created at the outset of the amended Compact period, received an initial US allocation of $16 million for FY04. The base contribution to the CTF increased annually in the 17 years after FY06 by the $800,000 value of the decrement in sector grants; additionally, the contribution increases as a result of the partial inflation adjustment. The FY23 US contribution to the CTF is projected at $38.5 million.

Under terms of the amended Compact, all five funding streams are scheduled to terminate at the end of FY23. Thereafter, the FSM would take annual distributions from the FSMCTF, pursuant to a distribution policy to be adopted by the CTF committee within a resticted set of rules. The result could be potentially severe financial impacts. For example, if the FSM were to receive FSMCTF distributions at the maximum allowed level, it would cause significant volatility in annual distributions, including a high probability of one or more years of zero distributions.

Figure 2: FSM Compact Timeline



1. Compact transfers are based on award levels, and are not precisely equal to annual expenditures and/or drawdowns, especially during the Amended Compact Period. Transfers are shown in the blue line with SEG removed to allow for comparison across Compact periods.
2. Compact Trust Fund contributions grew from $16 million nominal ($23 million in FY23 prices) in FY04 to $38.4 million in FY23.
3. FY04-FY11 FSM outmigration averaged 1.8% based on reliable US data. All other periods estimated by the authors.

FSM Compact Trends

Figure 2 provides four charts covering FSM Compact trends from FY87-FY23.

- The first chart shows the transfers the US made available to the FSM under the initial Compact period (FY87-FY03) and under the amended Compact period (FY04-FY23). All values are in FY23 prices.
- The second chart shows real GDP from FY87-FY18 and projections through FY23, also using FY23 prices. A comparison of the two charts shows that FSM has achieved moderate but positive economic growth over the FY87 to FY18 period, which is projected to continue through the FY19 to FY23 period. This real growth was achieved while the FSM received declining real transfers through the Compact.
- The third chart shows the combined impact of the declining level of transfers and the growing economy. Specifically, the FSM's reliance on Compact transfers has declined from very high levels during the initial Compact period to a projected level of 22.6 percent of GDP in FY23, which markes the end of the amended Compact period.
- The fourth chart shows the gradual—but mounting—effect of cumulative migration from the FSM to the US. FSM's population is expected to have grown from 90,172 in FY87 to 105,198 at the end of FY23. However, direct migration over the period will have totaled an estimated 45,663 by the end of FY23, not counting children born to FSM Compact migrants overseas.

Preparedness for the End of Compact Funding

FSM

The FSM has established a working body, called the Joint Committee on Compact Review and Planning (JCRP). The JCRP was created "to coordinate the country's preparation efforts towards effective and smooth ... government upon expiration of the economic provisions of the Amended Compact of Free Association with the United States [after FY23]."

JCRP has designated a Chief Negotiator, currently the Chief of Staff to the President of the FSM. JCRP also made significant efforts to prepare for either a termination of the Compact's economic provisions or for negotiations that renew economic assistance provisions. While there is no planning or fiscal strategy framework that would be applicable across all five governments of the FSM, the national government has made comprehensive efforts to: (i) maintain a structural fiscal surplus to mitigate against a moderate level of fiscal adjustment, and (ii) set aside substantial funds in the FSM Trust Fund (FSMTF), with some of those funds designated for the states.

Thus, in terms of preparation for the possible post-FY23 fiscal outcomes, the FSM national government has the means to best address a fiscal shock primarily affecting the state governments and to substantially reduce the impact of a shock of the magnitude modeled in the non-renewal of Compact assistance scenario. The states are not by their own means prepared to manage the impacts of a fiscal shock resulting from non-renewal of Compact economic assistance. Further, the FSM national government is not prepared to mitigate the greater impacts associated with any greater reduction in US support than modeled in the non-renewal scenario.

USA

The US has prioritized its partnership with the FSM within the larger context of its Free and Open Indo-Pacific Strategy. The US has a standing mechanism to monitor and implement its policies toward the three FAS—an Inter-Agency Group (IAG) that is led by the White House National Security Council and has both a small group with key agencies and a broader group meant to encompass all agencies with programs or interests in the FAS. The IAG holds meetings on an as-needed basis. The IAG has scaled up engagement due to one key policy factor and one major timing factor. The policy factor of most concern to the US is the desire to offset China's growing influence in the Pacific region and specifically in the Western Pacific. This policy concern is captured by the US government's "Free and Open Indo-Pacific Strategy," which is shared with key regional allies, including Japan, Australia, and New Zealand. This policy concern clearly raises the visibility and importance of the US relationships with the FSM, the RMI, and Palau, as well as the combined land and ocean space controlled through the three Compacts of Free Association.

The timing factor which has led to the increased frequency and urgency of IAG meetings is the one built into the respective three Compacts of Free Association. The inflection point for a change in funding arrangements happens after FY23 for the FSM and RMI and after FY24 for Palau. The IAG is considering the possibility

that a cessation of US funding could create a funding gap, which China could, in turn, leverage to increase its presence and influence in the FAS. The Presidents of the US and the three FAS nations met at the White House in May 2019 and the US identified two co-negotiators in April 2020. Several meetings were held in 2020. Following a period of minimal formal interaction, in March 2022, the US President appointed a Special Presidential Envoy for Compact Negotiations. Negotiations are well underway with an expressed desire to reach mutual agreement with each FAS as early as possible. As a step in that process, the FSM and US signed a memorandum of agreement (MOA) regarding future Compact funding levels in February 2023.

Once agreement is reached, two additional steps remain: approval by the US Congress and approval by the FSM of the agreed renewal arrangement.

Major Multilateral Donors

World Bank and ADB involvement in the North Pacific has increased markedly in recent years. The FSM has recently benefited from a large increase in funding commitments from the World Bank and an unrelated, but timely, designation that allows for grant-only assistance. The grant-only status is the result of a joint World Bank-International Monetary Fund (IMF) Debt Sustainability Analysis (DSA). The US funding risks faced by the FSM after FY23 contributed substantially to the debt stress finding. Current World Bank program plans indicate $35 million in annual support for the FSM infrastructure, sector programs and projects. The FSM also has access to a regional World Bank ICT facility. The FSM has already received more than $50 million for fiber-optic connectivity plus technical assistance in the telecommunications sector from that regional Information and Communication Technology (ICT) facility.

ADB has provided long-standing support to the FSM. ADB follows the DSA finding and thus currently provides grant-only funding to the FSM. Current program plans indicate ADB's 2023-2024 support for FSM infrastructure, sector programs, and projects is an estimated $58 million.

Since 1996, ADB has supported development partner meetings in the FSM. Periodically, ADB supported the FSM with technical support through resident economic advisory teams. A direct correlation exists between that level of intensive support with periods of effective reform and accelerated improvements in public financial management (PFM). Government commitment to policy reform and PFM improvements is a necessary condition; however, effective implementation of those commitments is also associated with extended technical support that substantially invests in local hires and advanced training.

The increased presence of multilateral donors creates an opportunity for those donors to play an increased role in development partner collaboration. Beneficial collaboration is dependent upon strong macroeconomic and sector data systems and policy analysis capacity within each FAS. There is an important role for support to fiscal and economic management in all three countries, with a focus on capacity gap-filling and, more importantly, long-term capacity-building.

Major Bilateral Donors

Japan has been a major bilateral donor to the FSM. Infrastructure projects remain the largest share of support, but Japan also provides support for sector projects, equipment purchases, and scholarships. Indirectly, Japan funds United Nations Development Program (UNDP) for support to the FAS in disaster preparation and to support operating costs under the Australia Maritime Patrol Boat Program. The Government of Japan has initiated its own "Free and Open Indo-Pacific Strategy." While its aid levels to the Pacific will increase, modalities will remain the same. Japan has no direct mechanism to provide budgetary support in the event of a major fiscal adjustment, and embassy officials in two of the three FAS embassies indicated they have received no requests related to the potential FY24/FY25 Compact adjustments. Officials indicated they are tracking the matter closely with each FAS and through dialogue with their US embassy counterparts.

China is an important development partner for the FSM. The focus of the program is large infrastructure projects. Examples include: a multi-purpose gym at the national campus of the College of Micronesia (COM), vital ships for inter-island transportation, homes at the Palikir capital for the leadership of all three branches of the FSM national government, and state capital complexes for Pohnpei and Chuuk. The FSM currently only receives grants from China and is thus not subject to any risk of debt stress. China has announced its intention to continue its program of support to the FSM through major projects, sector projects, and scholarships.

Australia provides a relatively small amount of support to the FAS. All three FAS share an annual direct and regional aid allocation of $5 million to support regional projects, scholarships, and Pacific Technical Assistance Mechanism (PACTAM) advisors for capacity-building. All three FAS also benefit from Australia's Maritime Patrol Boat Program, which in 2019 Australia renewed to include a new fleet of boats and associated surveillance equipment. Australia has no direct mechanism to provide budgetary support in the event of a major fiscal adjustment and officials from their FSM embassy that

had covered all three FAS indicated they have received no requests related to the potential FY23/FY24 Compact adjustment.

2

FSM ECONOMIC AND FISCAL STRUCTURE AND PERFORMANCE

ADB

2 FSM ECONOMIC AND FISCAL STRUCTURE AND PERFORMANCE

In order to analyze the impact of the COVID-19 pandemic and the Compact scenarios discussed in this report, we first review the structure and performance of the FSM economy. This analysis[1] provides background as to the likely response of the economy to the different scenarios.

Economic Structure

The private sector is small and underdeveloped in the FSM. Figure 3 indicates the structure of the FSM economy by institutional sector and the composition of the private sector by industry. The private sector represented an average of 22 percent of GDP during the FY17-FY19 period. The private sector is smaller than the FSM's two sister FAS, the RMI and Palau, where it represents 33 percent and 52 percent of GDP, respectively. The FSM government sector, comprising national, state, municipal and agencies, represents 25 percent of GDP, which is larger than the RMI, where the government represents 30 percent and the same as Palau at 25 percent. Despite its public sector having a smaller share of GDP, the FSM has relied on government as the major engine of growth.

The household sector is relatively large in the FSM, reflecting the slower rate of economic growth and transformation of the economy. As an indirect measure of development of the modern economy, production of the household sector in both informal and non-marketed or subsistence production in the FSM represents a large 24 percent compared with 13 percent in the RMI and 9 percent in Palau. Palau clearly has the most developed and modern economy with a relatively large private sector, whereas the FSM has a large informal sector. The RMI on the other hand has greater integration into the cash economy than the FSM but has also relied on the public sector as the major engine of growth.

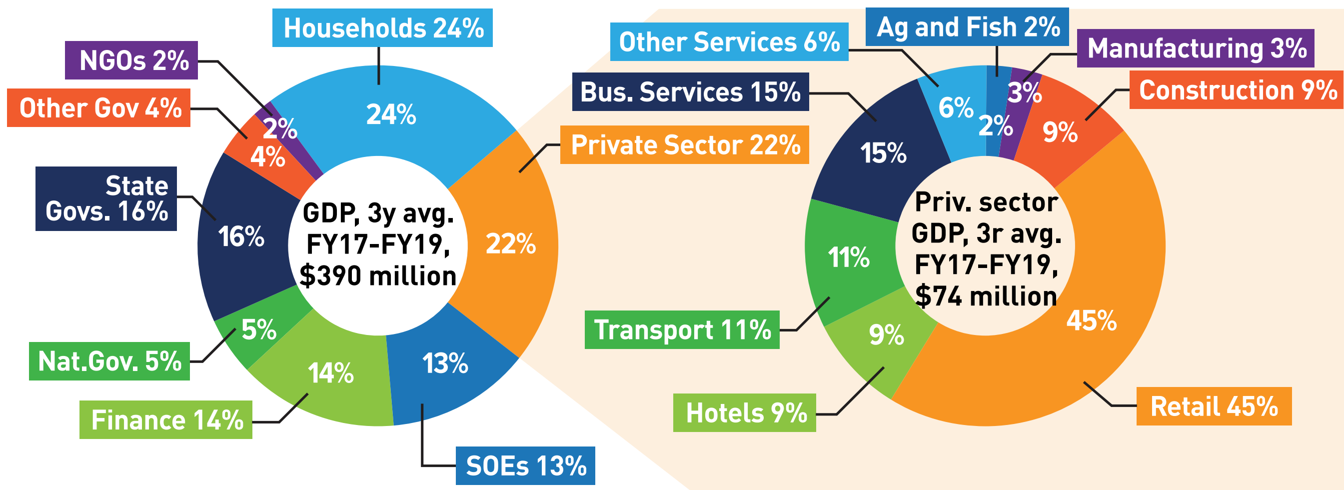
The small private sector provides services to other economic sectors and is dominated by retailing. The FSM has been unable to develop those industries in which it is presumed to have a comparative advantage: agriculture, fisheries, and tourism. See Figure 3. In contrast, fisheries represent 37 percent of RMI private sector activity, and in Palau the tourism economy is 37 percent of private sector activity. The private sector in the FSM is largely comprised of services providing support to the public sector. The largest private sector activity is retail, representing 45 percent of private sector GDP, with the next largest being business services and transport. During normal business cycles, private sector growth has typically mirrored that of the public sector, though during the COVID-19 period, private sector performance was more deeply affected.

Economic Performance

Failure to develop a competitive private sector has resulted in weak economic growth. The FSM's economic performance has been weak during the amended Compact period, with annual real growth averaging 0.3 percent from FY04 to FY19, see Figure 4.

1 See GSUSA, *FSM FY 18 Economic Review* (EconMAP Economic Review, posted March 5, 2020) for an in-depth analysis of economic structure and performance. ***https://pubs.pitiviti.org/fsm-fy18-economic-review***

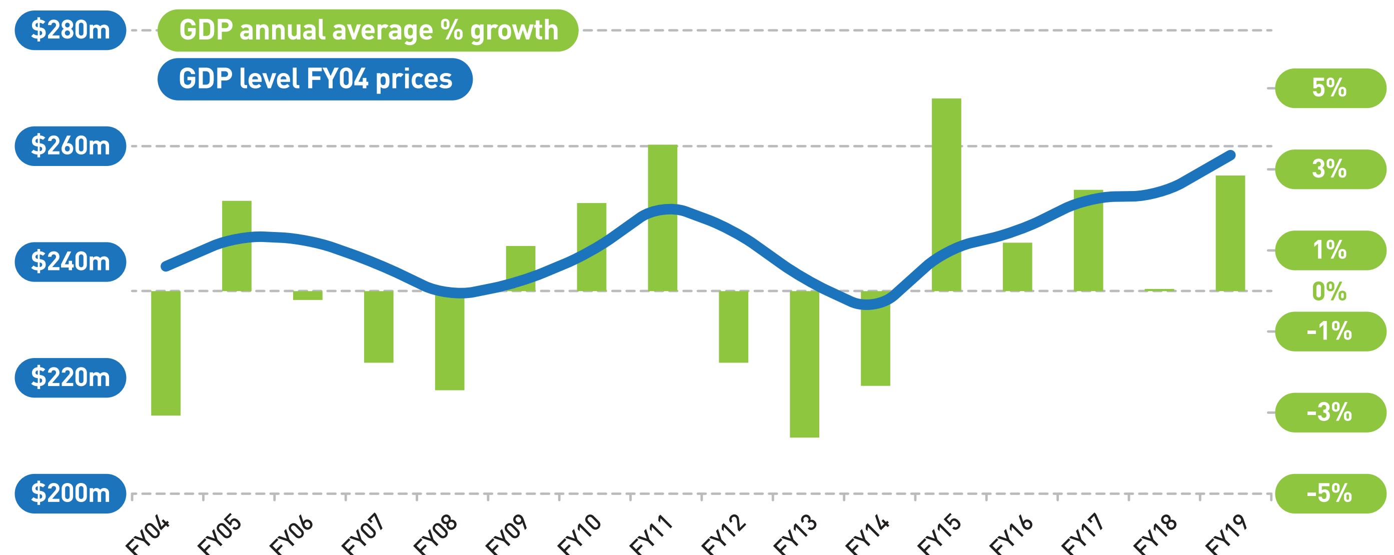
Figure 3: Economic Structure: Economy-wide and Private Sector, FY17-FY19 Average



This is below the FSM's sister FAS, the RMI, which grew by an average 1.4 percent (FY04-FY19), and Palau which grew by an average 0.5 percent (FY00-FY19). The FSM's weak performance reflects its natural disadvantages, such as its small size and remote geographical location common to the other FAS, but also results from an uncompetitive private sector policy environment and a failure of the economy to foster new industries in areas of potential comparative advantage. Economic performance has been dominated by a large public sector, supported by the economic provisions of the amended Compact. With the drag on the economy caused by the declining inflation-adjusted value of Compact sector grants due to the annual decrement and lack of full inflation indexation, the economy has been in a perpetual state of minimal growth.

While the trend in economic performance has been nearly flat, yearly results have been highly volatile. Figure 4 also indicates a high degree of volatility and periods of growth and contraction, reflecting the level of Compact and other grants received from the U.S. During the initial amended Compact period, the FSM economy

Figure 4: GDP Growth and Level, FY04 Prices
FSM economy averages 0.3 percent annual growth between FY04 and FY19



contracted sharply as the economy underwent adjustment to the last stage of Compact I and the final step-down in funding. With the reforms complete and two years of "bump-up" funding, the economy grew for a period before once again contracting as a result of adjustment to lower levels of resources from the amended Compact. During FY09-FY11, the economy benefited from greater utilization of the Compact infrastructure grant and a series of US Federal Aviation Administration (FAA) airport renewal projects. However, failure of the FSM and U.S. to agree on the full use of the Compact infrastructure grant led to delays in its use. Further, the largest FAA projects came to an end and the economy had a further sharp contraction in FY12-FY14. Growth improved over the last few years, FY15-FY19, reflecting booming sovereign rents from fishing fees, the offshore domicile fees from Japanese companies, and the increased public spending those revenues supported.

Public administration has placed a drag on growth during the amended Compact. Figure 5 indicates that finance was a main contributor to maintaining the level of economic activity, reflecting both growth of the banking sector and the offshore FSM domicile for major Japanese corporations and captives. Agriculture, mainly subsistence for home consumption, was also a large supporting sector, which reflects the stagnation in the economy and lack of modern sector development. After some initial growth in education services from additional Compact funding, education has leveled off. However, health, which is also a beneficiary of the Compact, has continued to grow. The main drag on the economy has been the adjustment of public administration to lower levels of funding under the amended Compact.

State Performance and Income Disparities

State-level economic performance and income levels significantly diverged. A critical characteristic in the development and political economy of the FSM is income growth and income differences between the four states. Figure 6 indicates real GDP per capita for all four states from FY81 to FY19. During the whole period, Pohnpei real per capita GDP grew by an average annual rate of 1.2 percent, which is comparable to the RMI and Palau. However, the other three states' per capita GDP has languished since FY81: Chuuk's fell by an average of 0.1 percent over the time period, Kosrae's grew by an average of 0.5 percent, and Yap's by 0.4 percent. GDP per capita levels are also widely divergent with Pohnpei at $3,700 in FY19, Yap at $3,100, Kosrae at $2,400, and Chuuk at $1,400. The difference puts Kosrae at 35 percent below Pohnpei, while Chuuk is 61 percent below Pohnpei.

Figure 5: Contribution to GDP Growth by Industry, FY03-FY19, FY04 prices
Agriculture, finance and health are main contributors to growth as construction and public administration contract

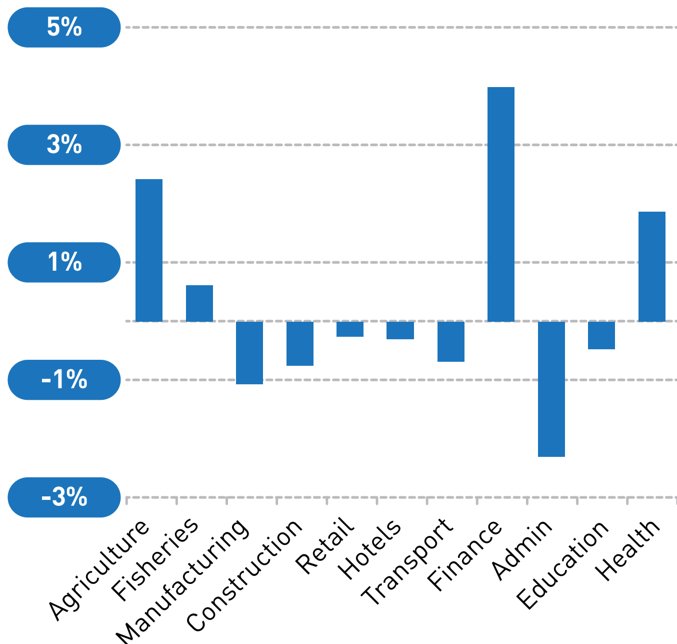
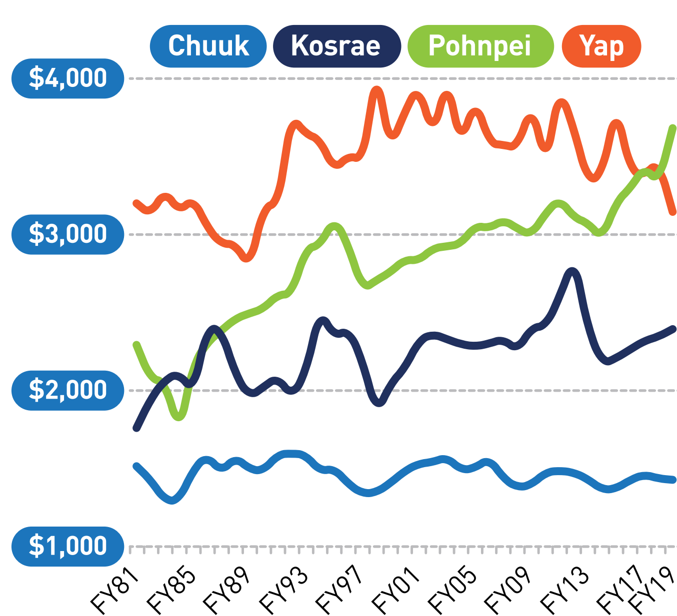


Figure 6: GDP per Capita (FY04 prices) in Chuuk, Kosrae, Pohnpei, and Yap
GDP growth averages 1.2 percent in Pohnpei but other states stagnate



Divergent state income levels have been long debated. Among the key explanations for income divergence are that the Compact distribution formula favors the smaller states (Kosrae and Yap) and the location of the national government and international agencies favors Pohnpei. Geography, cultural cohesiveness, the quality of governance, policy implementation in each state, and the near-total absence of FSM federal programs to counteract disparities cannot be ignored as potential contributing factors to the widening income gaps across the four states. The differences in economic performance and income levels create the potential for FSM domestic poverty alleviation policies and programs and/or donor-supported investments. Donor support would likely increase the success of such poverty-focused policies and programs if explicitly supported by FSM authorities.

The relatively weaker performance of the FSM economy over the recent period also reflects the prevailing policy environment, as the FSM's own policy reform commitments remain partially unfulfilled; however, it is important to recognize that the FSM, with its unique federal structure, has spent the last eight years preparing for a major post-FY23 fiscal adjustment. To the FSM's credit, substantial financial resources have been saved.

Fiscal Structure

Sovereign rents have grown rapidly and now represent close to half of all FSM revenues. Figure 7 indicates the structure of revenues by type. In more developed countries, tax revenues represent the vast majority of government revenues, but in the FSM taxes represent only 14 percent of total revenues. The tax regime is based on an outmoded regime inherited from Trust Territory days that lacks buoyancy and is ripe for reform. The most important sources of revenue are grants, at 38 percent of the total, but they are either fixed in nominal terms as it reflects the lack of full indexation of Compact grants or declining due to the decrement. The economy remains highly dependent on foreign assistance from its donor partners: U.S. Compact grants and federal programs, multilateral, and other bilateral grants.

Taking grants and certain taxes together, over half of revenues are inelastic with respect to GDP. The major buoyant source of revenues, which has grown very rapidly in the last few years, is sovereign rents: fishing fees derived from Parties to the Nauru Agreement (PNA) and implementation of the Vessel Day Scheme (24 percent of revenues), and the FSM domicile for Japanese corporations (19 percent of revenues).

The structure of government expenditures is evenly balanced between the normal functions of government. Figure 8 provides a broad picture of government expenditures by function, averaged over the FY17-FY19 period. Public services are relatively evenly spread across the normal functions of government. Two sectors, education and health, are predominantly funded through the Compact and delivered at the state level; they represent 19 percent and 16 percent of expenditures, respectively, but remain relatively small despite the focus of the amended

Figure 7: National and State Governments' Revenue by Source, FY17-FY19 Average
Major revenue sources comprise Compact grants and sovereign rents, while taxes are minor

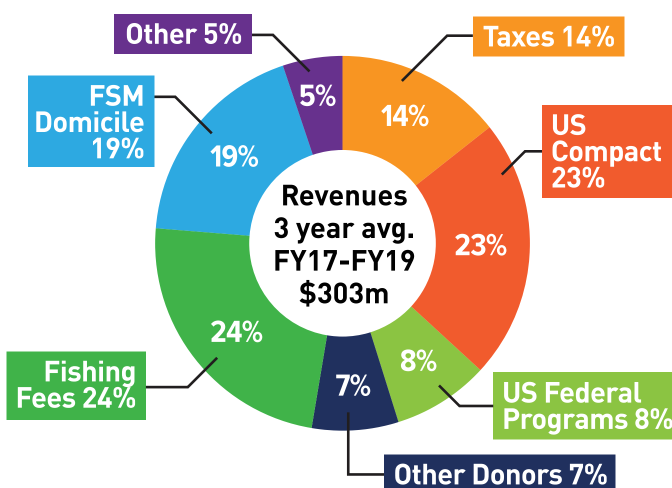
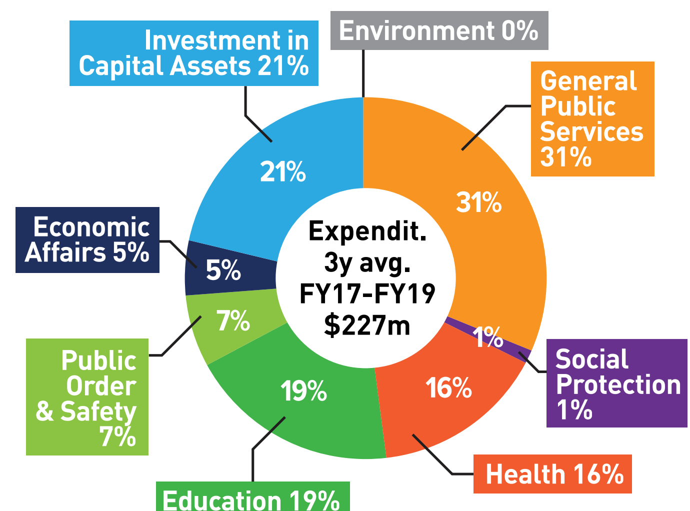


Figure 8: National and State Governments' Expenditures by Function, FY17-FY19 Average
Allocation of expenditures to capital assets is high given the low performance of the economy



Released in April, 2023

Compact. Public administration, at 31 percent, has the largest share of government spending. Economic affairs has a small share at 5 percent, but investment in capital projects is high, at 21 percent. The high proportion of investment in capital assets, despite the collapse in the use of the infrastructure grant, largely reflects recent spending on public projects from national government funds, although World Bank ICT projects and FAA airport improvements are included. The implied incremental capital to output ratio (ICOR), given the weak performance in the economy, indicates a low level of efficiency and productivity of investment.

Public expenditures at the national and state government levels have diverged as revenues accruing to the national government have grown rapidly while state revenues have languished. Figure 9 provides a broad picture of government expenses by function averaged over the FY17-FY19 period. The average level of expenditure for FY04-FY06 was $151 million, with the national government responsible for 33 percent and the remainder being spread over the four states. Since that time, the proportions have changed greatly; the national government now accounts for about half of all expenditures. During the same period, state government expenditures in total have grown by 5 percent in nominal terms while national government expenditures have grown by 145 percent in nominal terms. Given that service delivery predominantly takes place at the state level, the implications for service delivery are profound.

Significant differences in per capita expenditures by state provides a partial explanation for the income disparities between states. Figure 10 indicates the level of public expenditures per capita between the state governments. Clearly, the smaller states have a higher level of per capita expenditures, reflecting the distribution formula between the FSM's five governments for Compact resources. There is a high degree of correlation between these figures and the per capita state GDP figures displayed in Figure 6. Pohnpei is the seat of the national government and once the additional spending in Pohnpei due to the national government is taken into account, it is not surprising that Pohnpei has achieved the largest per capita income level, especially after the recent boom in national government revenues and spending. Chuuk state has by far the lowest expenditures per capita, which is clearly an important reason for the low per capita income in the state.

Fiscal Performance

The four state governments have maintained fiscal balance over the last decade; however, service delivery has been severely constrained at the state government level: The FSM government comprises four state governments and a national government. Much of the responsibility for public service provision—including education, health, and public safety—is held primarily by the state governments. With the declining

Figure 9: National and State Governments' Share of Expenditures, FY04-FY06 & FY17-FY19
National government expenditure dominance grows over time

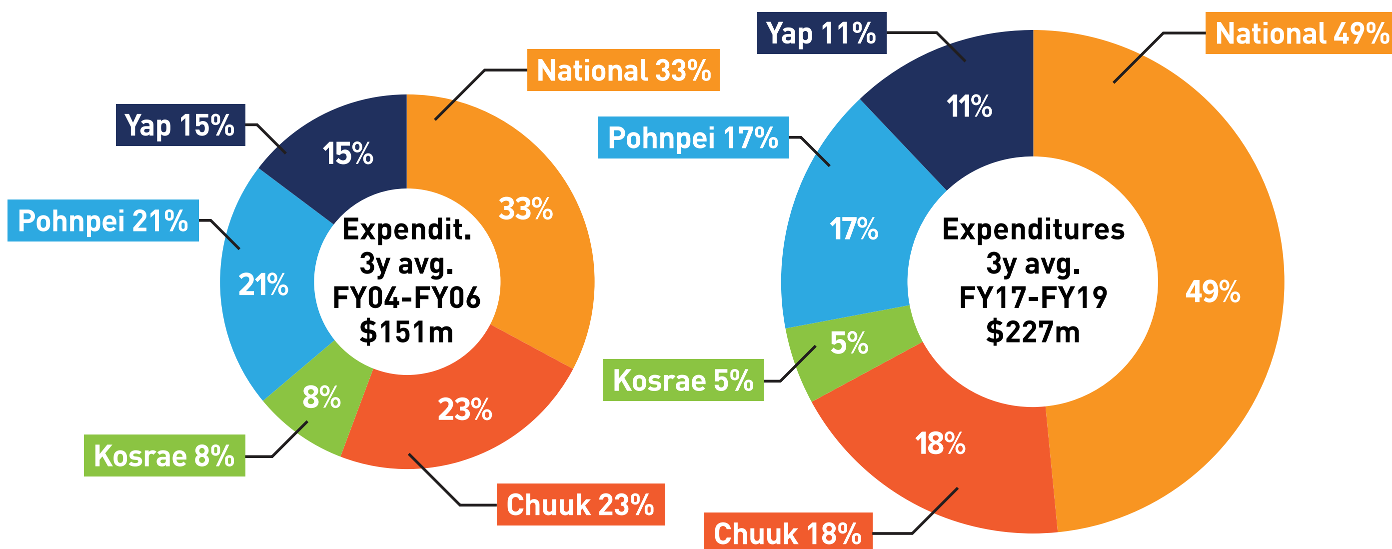
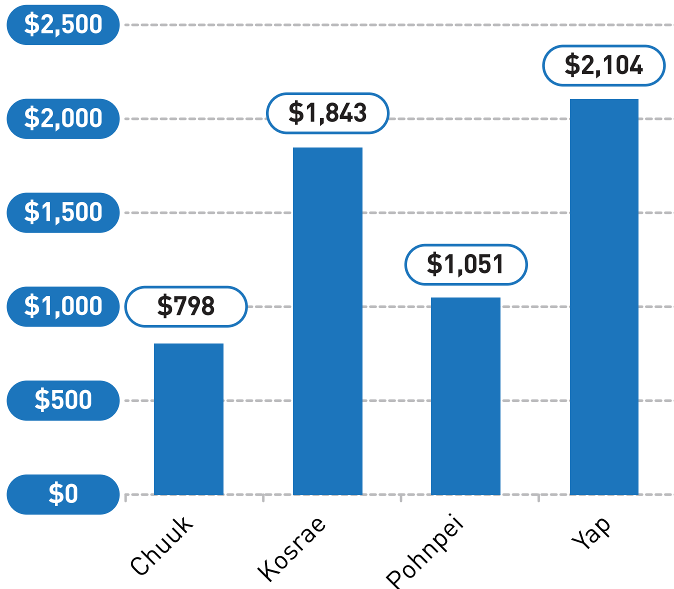


Figure 10: Per Capita State Government Expenditures, Average FY17-FY19
Smaller states have higher per capita expenditures



real value of Compact sector grants and little or no growth in domestic revenues at the state level, service delivery and public expenditures have been severely constrained. Despite these challenges, the state governments have adopted a prudent approach to fiscal policy and have maintained fiscal balance since FY09, see Figure 11.

The national government runs large fiscal surpluses: At the national government level, fiscal conditions are markedly different, see Figure 12. In addition to tax revenues shared with the state governments, the national government benefits from sovereign rents from fishing royalties under the Parties to the Nauru Agreement (PNA) and implemented through the Vessel Day Scheme (VDS). Fishing royalties have grown steadily from 5 percent of GDP at the start of the amended Compact, to an average of 21 percent of GDP - FY15-FY19, with minimal volatility. In FY19, receipts from fishing licenses were $73 million. The national government has also established an FSM tax domicile, primarily for Japanese captive insurance and major corporations. While this normally represents less than 2 percent of GDP, its value to the national revenue base spikes periodically. In FY18 and FY19, for example, it averaged 24 percent of GDP due to receipt of large tax declarations (capital gains) by major corporations. The combination of fisheries revenues and the tax domicile revenues has resulted in large fiscal surpluses for the FSM national government.

The large fiscal surplus has supported rapid growth in the nation's FSM Trust Fund. The large increase in resources has been utilized in two major ways. Firstly, and most importantly, the FSM has created a national trust fund (FSMTF) and increased its holdings of uncommitted funds. About two-thirds of the additional resources have been allocated to the fund or remain unspent. At the end of February 2022, the FSMTF is estimated to be close to $378 million, a significant—and

Figure 11: Fiscal Balance: State and National Governments, Percent GDP
State governments maintain fiscal balance while national runs large surpluses

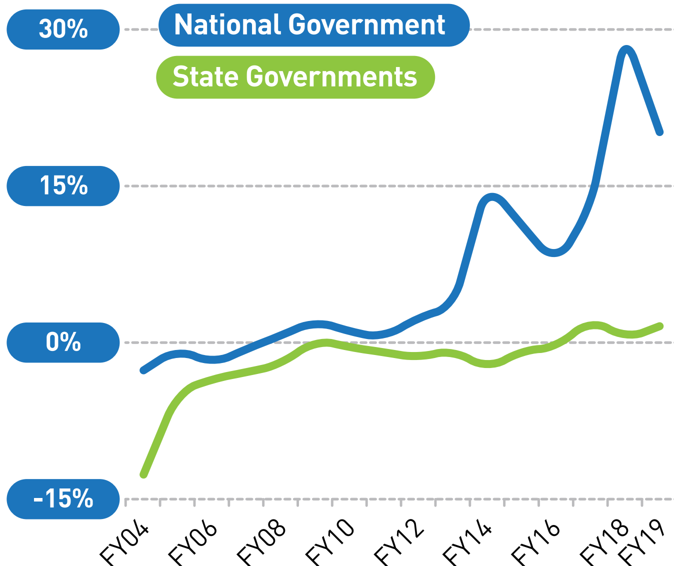
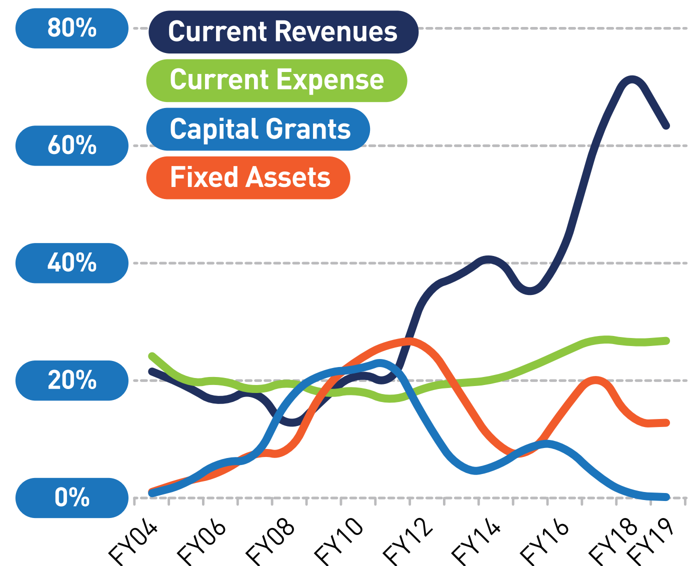


Figure 12: National Government Revenue and Expenditures, as a Percent of GDP
Revenue growth outpaces increased expenses



impressive—achievement. The national government is committed under a series of public laws to adding about $24 million annually to the fund; however, during the COVID-19 pandemic period, a portion of these funds has been diverted into the economic stimulus package and tourism sector mitigation relief fund.

The fiscal surplus has enabled large growth in congressionally based projects and increases in the use of goods and services. The second major use of the increase in resources has been a significant growth of congressionally specified projects and increased national government expenditures on goods and services. Since these expenditures are non-recurring, the true level of discretionary fiscal space and structural surplus is considerably larger than the amount listed as the annual surplus in the fiscal statistics. It could be argued that the increase in the FSM's resources has represented a lost opportunity for better service delivery at the state level. But the national government has purposefully avoided a destabilizing rise in state-level recurrent expenditures, which would surely be unsustainable after FY23 in the unlikely event of an unfavorable outcome of the ongoing Compact renewal negotiations.

3

THE IMPACT OF COVID-19 ON THE FSM ECONOMY THROUGH THE END OF THE AMENDED COMPACT PERIOD

ADB

3 THE IMPACT OF COVID-19 ON THE FSM ECONOMY THROUGH THE END OF THE AMENDED COMPACT PERIOD

Projections are based on the core assumption that travel limitations will remain in force through much of the first half of 2022. In the previous section, we discussed recent economic and fiscal performance and important structural considerations. We indicated that the structure of the FSM economy is heavily dependent on the public sector but also on fisheries activity and sovereign rent receipts. In this section, we review and estimate the likely impact of the COVID-19 pandemic on key sectors of the economy through the remaining years of the amended Compact period to FY23[1]. The core assumption is that travel restrictions will not be lifted until the latter part of the first half of FY22 and therefore the force of the COVID-19 pandemic will be felt throughout FY22. These projections have assumed that in FY22 production levels of the affected sectors recover by one-half of their normal levels and are fully recovered by FY23. This reflects the actual roll-out of the vaccination program and cautious nature of the FSM to reopening its population and its economy to the outside world. The economy relies very little on tourism and visitor arrivals; nevertheless, the projected economic consequences of the COVID-19 pandemic are significant. Further details of the economic impact of COVID-19 on the FSM economy can be found in a recent Economic Issues Paper prepared by the Graduate School[2].

1 While a full set of statistical information is not yet available for FY20, some data sources are available, and these have been used. The estimates for FY20 thus are based on a hybrid of actual data and projections.

2 GSUSA, *Impact of the COVID-19 Pandemic on the Federated States of Micronesia: Economic Outcomes and Policy Review. August 2021* (EconMAP Economic Issue Paper, posted Sept. 13, 2021). ***https://pubs.pitiviti.org/fsm-covid-impact-update***

Mitigation Programs

At the onset of the pandemic, the FSM initiated a Tourism Sector Mitigation Relief Fund. In April 2020, shortly after the onset of the pandemic, the FSM President initiated an economic stimulus package, and the FSM Congress initiated a Tourism Sector Mitigation Relief Fund (TSMRF). The TSMRF was initially credited with a $1 million congressional appropriation to support tourism operations that were adversely affected by the pandemic. In addition, approximately $9 million normally earmarked for the FSM Trust Fund as of April 2020 through the remainder of FY20 was diverted to the TSMRF. Further, the TSMRF also received $0.5 million from the FSM National Oceanic Resources Management Authority (NORMA) project development fund and $3 million (out of $6 million) from the ADB's Pacific Disaster Resilience Program (DRP). In total, the FSM secured almost $15 million for the TSRMF.

FSM benefited from a large donor response to develop a health response framework: At the onset of the crisis, the national government initiated an FSM COVID-19 Response Framework to prepare the nation with a series of steps to mitigate the impact should the FSM become subject to the community spread of the virus. Donor support for the program was immediate and strong, with the US providing the majority of health-related grants: $7.7 million under an OIA Technical Assistance (TA) from the US CARES Act, $7 million of unspent Compact sector grants, plus a series of other, smaller federal program grants from the Centers for Disease Control (CDC) and other US agencies, totaling about $29 million. Further health-related funding of $2.5

million was available from the World Bank and $2.88 million from the ADB.

US CARES Act unemployment benefits generated significant benefits to affected FSM workers: As with the other Freely Associated States, FSM citizens were made eligible for unemployment support from the US government under the US CARES Act.

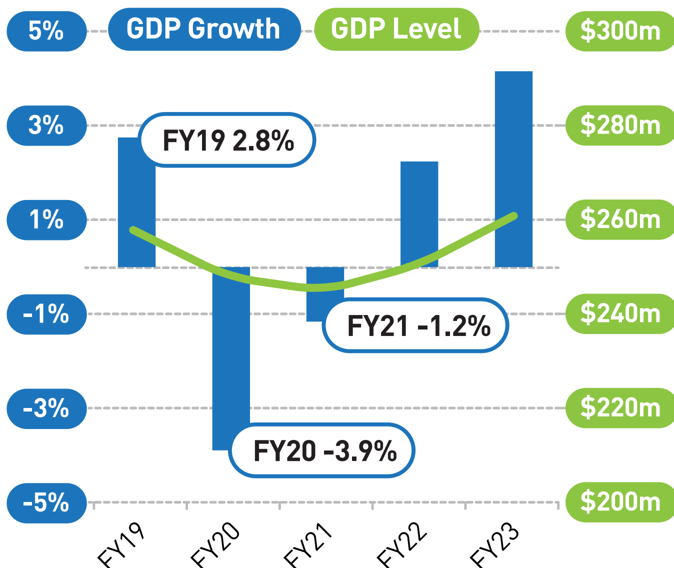
Initial funds of $36 million were awarded, and despite some technical issues related to the drawdown process, that full amount remains available. In the modeling framework, the projected counts of unemployed workers are multiplied by the CARES Act unemployment benefit rates to generate the impact on household incomes.

ADB provided $29.7 million in response to COVID-19. ADB played a major role in funding the FSM mitigation effort. Of the ADB's large $29.7 million mitigation in grants, $14 million is through the COVID-19 Pandemic Response Option (CPRO), $12 million has been funded through the Disaster Resilience Program (DRP), $1.5 million in grants under the COVID-19 Emergency Response, and about $2.2 million in various technical assistance (TA) projects. The CPRO and DRP funds provided budgetary support to cover funding shortfalls in the financing of COVID-19 impact mitigation projects and programs.

Economic Impact

The FSM economy is projected to contract by 5.0 percent by FY21 compared with FY19. The economic impact of COVID-19 on the FSM economy is shown in Figure 13. Projections indicate the COVID-19 pandemic will cause a 3.9 percent drop in GDP in FY20 and a further 1.2 percent reduction in FY21. The overall reduction from FY19 to FY21 is 5.0. This contrasts with a May 2020 economic impact assessment that projected a reduction in GDP of 4.9 percent and 2.0 percent in the two years, respectively[3]. The reduced level of impact results mostly from the positive impact of FSM-managed mitigation and stimulus programs.

Figure 13: GDP Growth and Level, FY04 Prices
Economy hard hit in FY20 with recovery postponed till FY23



Mitigation programs have helped reduce the impact on GDP, but not as much as may have been generally anticipated. Our estimates indicate that the impact of these programs has reduced the decline in GDP from the earlier estimate of 6.9 percent to 5.0 percent over the two-year period. Given that the various mitigation efforts did not directly impact production levels in the worst-affected sectors of transport and tourism, their effect on measured GDP is not as great as may have been anticipated. The stimulus added to aggregate demand and, indirectly, to some additional output in the economy when spent. This is not a critique of the programs as designed and implemented. In fact, programs aiming to protect the disposable income of affected households are preferable to programs designed to purely protect measured GDP. Similarly, programs to address national health system vulnerabilities are meritorious despite their minimal impact on GDP due to their import-intensive character.

The economic impact of COVID-19 has resulted in one of the more severe periods of economic decline during the amended Compact period. Notably, the total loss to the economy projected during this period is one of the more severe experienced by the FSM economy since FY04. However, the various mitigation programs have significantly reduced the negative impact on the economy, even though some elements of the overall response program did not affect GDP directly. The $36.5 million in health sector programs to prepare the FSM for a possible COVID-19 community outbreak mostly impacts the level of government expenditures and demand for imported items such as PPE, medicines, ventilators, etc. The FSM's own internally generated stimulus package and tourism sector mitigation relief fund of $15 million provides cash transfers to the private sector to support business that otherwise might have gone bankrupt. Both the US CARES program of $44 million and ADB CPRO grant funding of $14 million place funds directly in the hands of the population and generate an increase in aggregate demand for goods and services. In sum, including the FSM national government's supplemental funding, about $70 million

3 GSUSA, *Assessing the Impact of COVID-19 on the FSM Economy* (EconMAP Technical Note, posted June 3, 2020). ***https://pubs.pitiviti.org/fsm-covid-impact***

of funds will have been pumped into the FSM economy during FY20-FY21, amounting to 19 percent of GDP.

The hotel, restaurant and transport sectors have been the worst hit by the pandemic. Figure 14 shows the major industries which have been affected by the pandemic. Fisheries is projected to remain stable through FY21 despite earlier concerns that it might be adversely affected. The hotel and restaurant sectors are projected to fall by 40 percent in FY20 and then a further 73 percent in FY21, reflecting the absence of tourists and minimal interstate visitors. Recovery is projected to commence in FY22 with full recovery achieved in FY23. Similarly, the transport and communications sector is projected to decline by 28 percent in FY20 and a further 14 percent in FY21 with the impact predominantly in the transport component. Given the higher total output in the transport and communications sector, the impact on GDP loss is greater than the impact of the hotels and restaurants sector.

Construction activity is projected to pick up post-pandemic, reflecting implementation of donor projects put on hold during the pandemic. Construction activity is projected to remain largely unchanged in FY20 and FY21. Despite the demand for infrastructure from a backlog of donor-funded projects, travel restrictions and shortages of supplies, engineers and other skilled personnel have limited the construction industry's growth capacity. After the pandemic, projections indicate something of a boom in construction work as constraints ease and donor projects, including the Compact infrastructure grant, proceed. Finally, the large wholesale/retail sector declines by 4.1 percent in FY20, despite a booming retail sector, reflecting weak demand for building materials and a large reduction in demand for aviation gas. In post-pandemic years, projections suggest continuing growth in the sector as the economy picks up.

Private sector GDP is projected to contract by 12.3 percent during FY20 and FY21. Figure 15 indicates the impact of the pandemic on private and public sector GDP. The public sector is projected to decline only incrementally in FY20 and then grow slightly in FY21, with some contraction through FY23. The main COVID-19 impact has been on the private sector: a 7.9 percent reduction is indicated for FY20, and a further reduction of 4.8 percent in FY21. Overall, a 12.3 percent loss in cumulative value-added is projected for the private sector, which is 4.3 percent less than the 17 percent loss projected without the mitigation programs.

Impact on Employment and Household Income

Original projections indicated a potential large increase in unemployment, but revised projections suggest that employment in FY21 was only 157 jobs, or 1 percent lower than FY19. The impact of COVID-19 on employment is shown in Figure 16, indicating both the level of jobs and annual changes.

Figure 14: Major Industries Affected by the Pandemic (Value Added, FY04 prices)
Transport and tourism are the worst affected by the pandemic

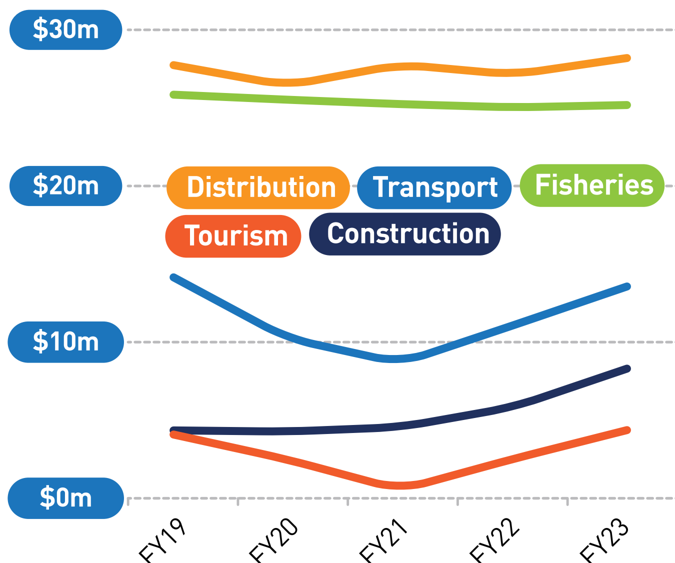


Figure 15: Private and Public Sector Growth, FY04 Prices
Private sector GDP contracted by 12% over FY19-FY21

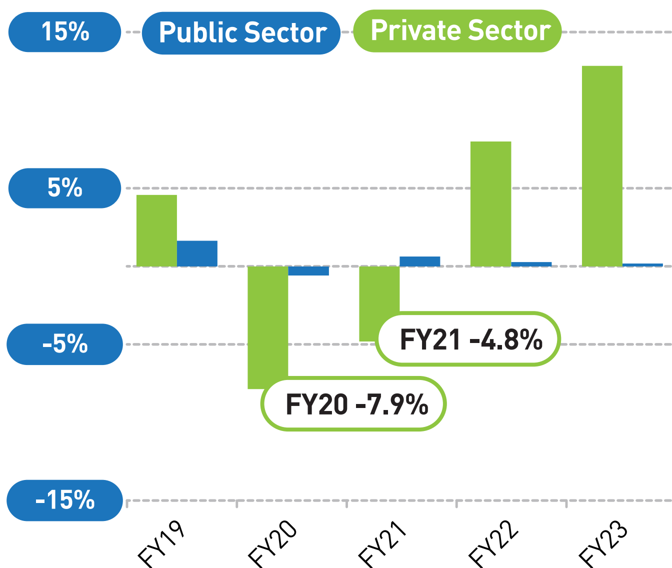
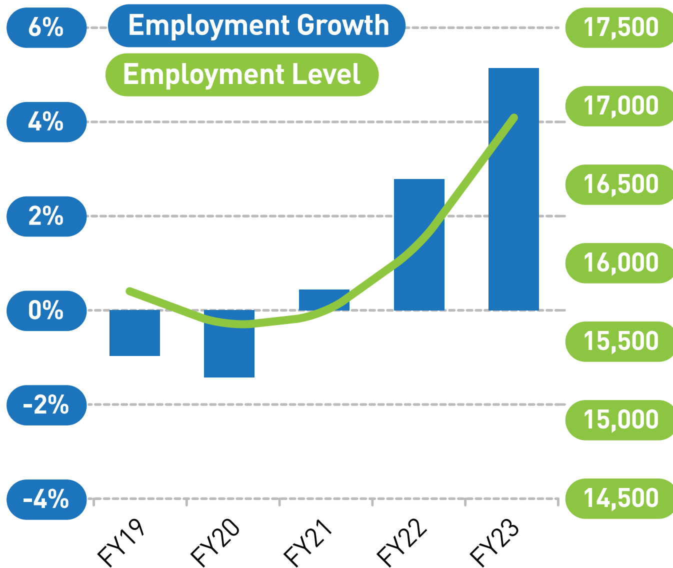


Figure 16: Employment Level and Growth
Employment impact is considerably less than originally projected



Original projections of the impact of the pandemic in May 2020 projected a loss of 1,800 jobs over FY20 and FY21, representing a reduction of 11 percent in FSM-wide employment from FY19 levels. This projection was based on two important factors: a constant labor-output ratio or relationship between output and employment and not incorporating the impact of the various mitigation programs on the economy.

Since then, preliminary employment estimates for FY20 have become available based on data for larger employers. The employment figures shown in Figure 16 indicate an actual job loss of 225 people in FY20 and project an increase of 68 full-time equivalents (FTEs) for FY21. However, in the COVID-19 impacted tourism and transport sectors, the job loss was 278 FTEs for FY20 in a year when COVID impacted the last two quarters. This implies offsetting job creation in other sectors, mainly in retail and government, reflecting the impact of the mitigation efforts in FY2020.

Household incomes rose during the pandemic but are projected to fall in FY22 once mitigation programs end. The impact of the various mitigation programs -- the US CARES Act and ADB CPRO -- have positively impacted household incomes, as shown in Figure 17. Without those two programs, this study indicates household incomes would have fallen by 6.3 percent. The US CARES Act came into force shortly after the start of the pandemic, supporting household incomes in both FY20 and FY21. Funds from the ADB CPRO were not released until FY21 and are projected to continue supporting household incomes into FY22. Combining both mitigation programs, household incomes are projected to have risen by less than 0.1 percent in FY20, but then by 3.1 percent in FY21, thus above their FY19 levels. Looking forward, however, a major issue of policy concern will be an estimated 4.7 percent reduction in incomes in FY22, once the programs are withdrawn and before the economy has fully recovered.

Fiscal Impact

State governments are projected to maintain fiscal balance during the COVID-19 pandemic. National and state government fiscal outcomes are projected in Figure 18. The state governments are assumed to operate on a balanced budget rule and adjust to the annual fiscal drag implicit in the amended Compact and the COVID-19 cyclical downturn to attain fiscal balance. That said, there may be short-term deviations such as a surplus in FY20 and deficit in FY21 where the fiscal outturn is worse than budgeted and the response is delayed.

Sovereign rents are projected to return to normal levels during the pandemic and remain stable through FY25. The national government has achieved large fiscal surpluses in recent years, averaging 16 percent of GDP from FY15 through FY19. In FY19, an unusual level of corporate tax receipts from the FSM domicile for major Japanese corporations resulted in a large fiscal surplus. For FY20, sovereign rent revenues returned to normal levels from the FSM domicile industry and fishing royalties. The impact of the COVID-19 pandemic on domestic taxes is minor and domestic revenues (excluding grants) are projected to remain stable.

The overall impact of COVID-19 on the fiscal position of the national government is projected to be minor. On the expense side, the national government has financed the Tourism Sector Mitigation Relief Fund. However, the drawdown of funds has been limited due to the number of firms enrolled. Discretionary national government expenditures on legislative projects rose to a record $28 million in FY19. In the current study, a level of $14 million in legislative projects has been projected through FY25. In FY20, a fiscal surplus of $24 million is projected and the surplus rises to $27 million in FY21, due to accumulated reserves of unspent grants. As unspent funds are drawn down in FY22, a reduced, but stable fiscal surplus of $19 million on average is projected through FY25 with a reduced surplus in FY24 and FY25.

Figure 17: Household Income (FY04 prices): With and Without Mitigation
Mitigation programs have significant impact on real household incomes

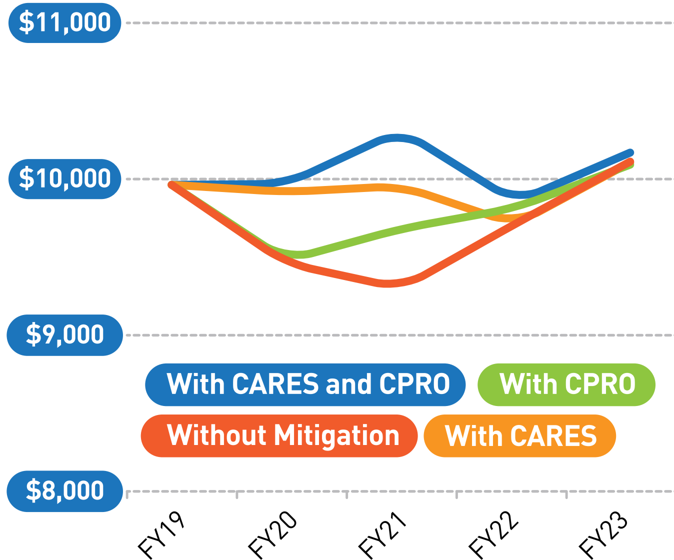
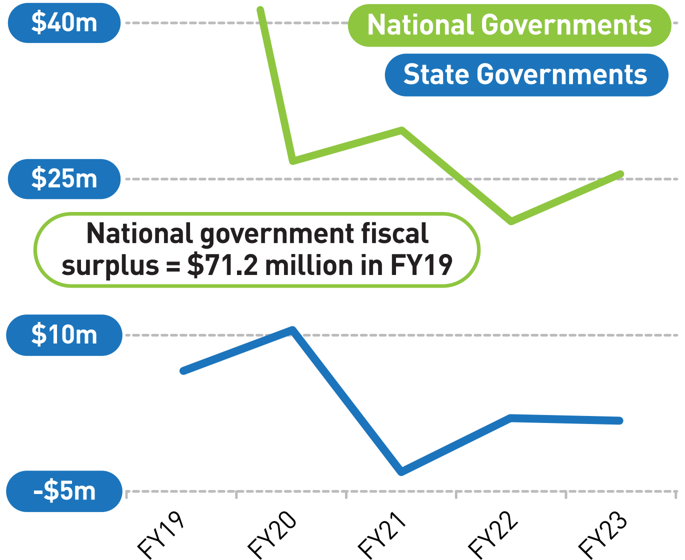


Figure 18: Projected State and National Government Fiscal Deficit
National government continues to run large fiscal surpluses during COVID-19



Conclusion

Strong government action coupled with generous support from the donor community has left the economy well positioned for recovery. At the onset of the COVID-19 pandemic, the need for financing was unclear. The FSM was initially spared any outbreak of COVID-19 and donors provided sufficient resources for health needs. The US CARES Act supported the unemployed with generous funding and the ADB CPRO provided resources for low-income households and vulnerable populations. The FSM's own stimulus program supported the small tourism industry. The combination of these factors has ensured the financial stability and security of the FSM economy and the FSM economy will be well positioned for recovery.

4

MODELING THE IMPACT OF NON-RENEWAL OF FSM COMPACT ECONOMIC ASSISTANCE

4 MODELING THE IMPACT OF NON-RENEWAL OF FSM COMPACT ECONOMIC ASSISTANCE

This chapter outlines the potential impacts of nonrenewal of funding provisions associated with the amended FSM Compact after FY23. The chapter also explores the impact of the FSM's full independence from any US assistance (Compact plus non-Compact).

The "**Non-Renewal of Compact Assistance Scenario**" assumes the FSM moves to a regime outlined in its amended Compact and its implementing law. This regime has two key features—both resulting in a downward fiscal adjustment. First, the FSM transitions from sector grants funded by annual US appropriations to annual distributions from its CTF. In this projection, rather than have the "maximum" allowed CTF distribution each year, the model assumes the initial level of annual CTF distributions is set to be sustainable (with a high degree of confidence). After the initial, one-time downward adjustment, distributions would thereafter be adjusted annually to fully offset the impact of inflation with some potential for further rules-based upward or downward adjustments based on CTF investment performance. The second key feature of the Non-Renewal of Compact Assistance Scenario is the assumption that SEG funding would cease, consistent with current US law.

The "**Independence Illustration**" is presented to indicate the impact that would occur if the FSM became fully independent of any US assistance, federal programs or services, both Compact and non-Compact. It assumes that in addition to the adjustment to a sustainable level of CTF distributions and loss of SEG as outlined in the non-renewal scenario, the FSM would face the additional challenge of losing all US federal programs and services. This illustration is presented not as a likely outcome, as the relationship between the US and the FSM remains strong, but rather to show the ongoing value of the US relationship to the FSM.

Scenario analysis utilizes economic models developed by the GSUSA for the FSM. The analysis utilizes a modeling framework, developed by GSUSA, which utilizes programming techniques similar to those used by the International Monetary Fund[1].

For this study, the GSUSA team estimates the sustainable distribution from the FSM Compact Trust Fund, using a "Sustainability Adjustment for Enhanced Reliability" method hereafter referred to as the SAFER method. (The methodology is described in the team's published works.) Using a statistical method called Monte Carlo analysis, the study projects the median value of the trust fund at the end of FY23 and computes a SAFER estimated distribution for FY24.

Non-Renewal Scenario

The sustainable draw from the FSMCTF in FY24 is estimated to be $31.4 million, $52.1 million below the estimated grant level in FY23, which is a reduction that is equivalent in size to 12.4 percent of projected FY23 GDP. The Compact non-renewal adjustment scenario projects what will happen in the FSM if the economic assistance provisions of the FSM Compact are not renewed. Under the terms of the amended Compact, the level of final Compact sector grants

1 See recent GSUSA *Economic Reviews* of the three FAS for a discussion of the models. About EconMAP (***www.pitiviti.org***)

projected for FY23 is $83.5 million. Absent a renewal of Compact economic assistance, in FY24 that distribution amount plus a full inflation adjustment during FY23 could be covered by a distribution from the FSMCTF, though it would require a greater-than-average investment return during FY23 or an immediate draw from the CTF's buffer fund (C-account). Instead, for this study, the modeling assumes an immediate adjustment to sustainable distributions by applying the SAFER method. Since the projections were prepared, in May 2022, FSM portfolio values have varied significantly, and markets remain volatile[2].

In our presented model, with the median projected FSMCTF value of $1.17 billion at the end of FY23 the SAFER estimated annual distribution would be just $31.4 million to support FSM government operations and capital investments. This sustainability adjustment in transfers to support FSM government operations and capital investments is specified in Figure 19 as a $52.1 million annual reduction, which is equivalent in size to 12.4 percent of projected FY23 GDP.

The loss of the Supplemental Education Grant is equivalent in size to 2.6 percent of projected FY23 GDP. In the absence of a renewal to Compact economic assistance, the FSM will also lose the SEG grant. The FSMCTF never had any provision to replace this grant. This reduction in support to education programs (mostly for pre-K) in the FSM is specified in Figure 19 as $11.1 million annually, which is equivalent in size to 2.6 percent percent of projected FY23 GDP.

The total adjustment thus required under the non-renewal scenario is $63.2 million, or an extraordinary fiscal shock equivalent in size to 15.0 percent of projected FY23 GDP. The analysis under the Compact non-renewal scenario assumes a "status quo" FSM policy environment. The FSM national government policies described in Chapter 2 are assumed to continue: (i) allocation of two thirds of the structural fiscal surplus to the FSM Trust Fund, with the remaining one third supporting a large outlay on congressionally identified projects and use of goods and services, and (ii) the FSM Trust Fund is not used to offset reduced US grants. Further, US federal programs and services not scheduled to terminate after FY23 are assumed to continue uninterrupted.

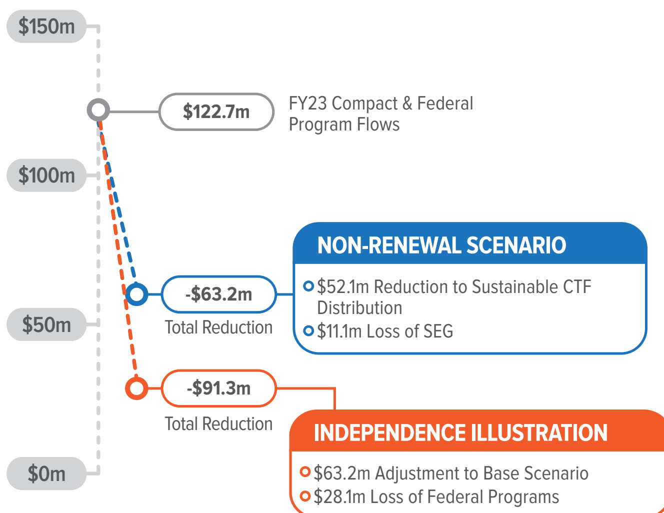
The full brunt of adjustment falls on the FSM state governments: As the national government only spent $3.3 million from Compact sector grants and the SEG in FY19, the impact of the Compact non-renewal scenario on national government recurrent operations is negligible. The Compact non-renewal scenario assumes—for the purpose of modeling and to avoid the necessity of predicting the FSM national government's policy approach—that nearly all fiscal adjustment would be absorbed by the four state governments. Given the virtual inability of the state governments to raise taxes or to finance their deficits through borrowing, they would have no alternative but to undertake an austerity program with deep expenditure cuts, such as:

- A wage cut on all state-level civil servants of 20 percent. This might be introduced through a simple reduction in wages or through a 2-day reduction in the bi-weekly pay period.
- A Reduction-In-Force in state government civil servants of 30 percent in Kosrae, Pohnpei and Yap, with a 40 percent reduction in Chuuk.
- The reductions in payroll numbers would be accompanied by a similar level of cuts in the use of goods and services.
- The reductions in payroll and use of goods and services are assumed to apply equally to public administration, education and health.

Spending on infrastructure would be maintained, but only through accelerated use of unused

2 When report simulations were done in May 2022, the FSMCTF had a value of $965 million with a projected end of FY23 value of $1,186 million and SAFER distribution of $36.3 million. By year end of 2022 the FSMCTF had risen to $999 million, reflecting the US contribution to the CTF of $39.5 million in October of 2022, but also declines in market values. Updated projections are for an end FY23 value of $1,089 million and a SAFER distribution of $33.4 million.

Figure 19: FSM Downward Adjustment Scenarios
Components and Magnitudes



Note: Sustainable distributions from the CTF ($31.4 million in FY23 prices) are assumed to be available.

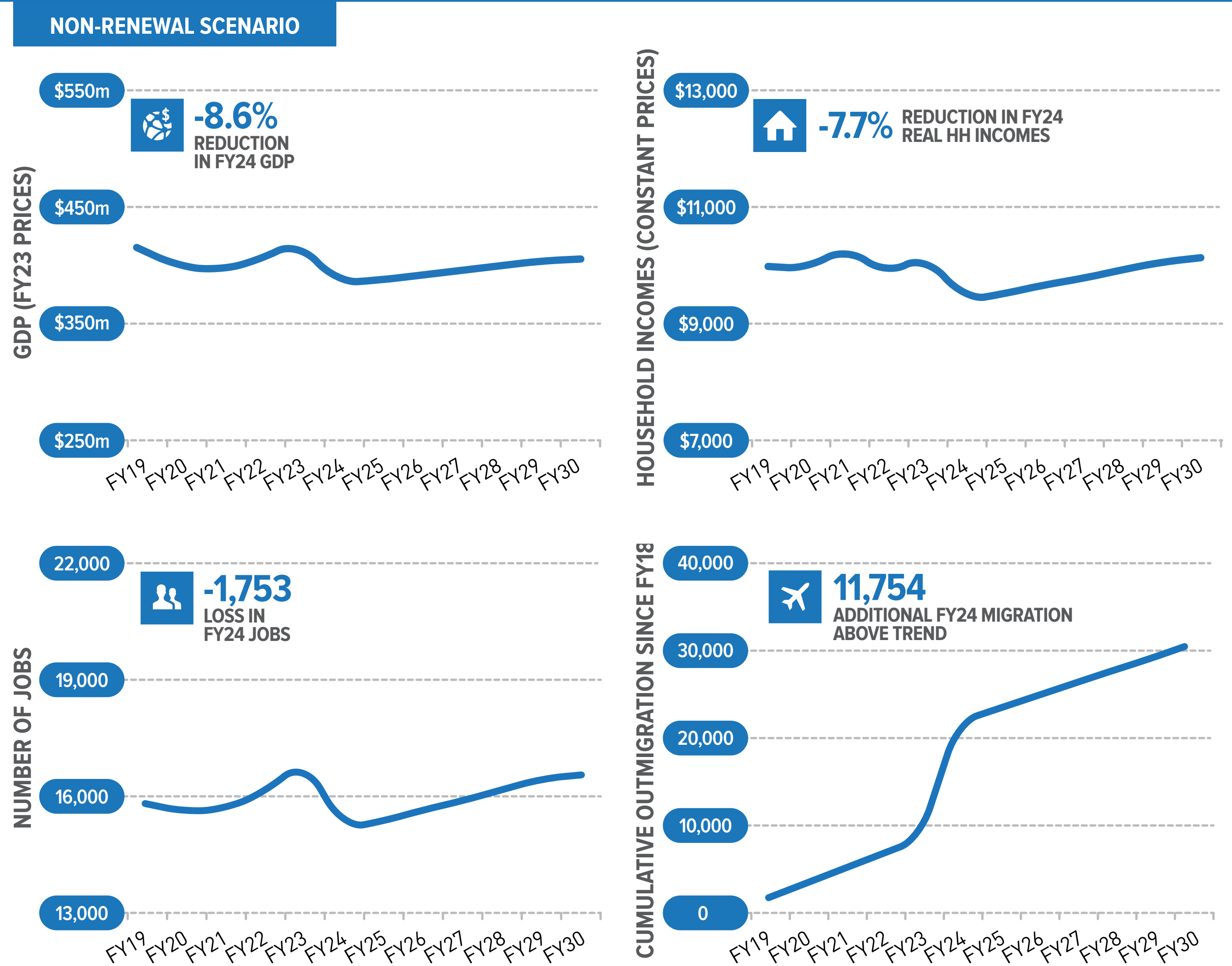
Compact funds: While the national government is largely unaffected by the loss of Compact grants, it is responsible for disbursing resources under the Compact infrastructure sector grant for state-based projects. Under the non-renewal scenario, funding for these projects will also be subject to a cut of $14.3 million from an FY23 annual level of $25.1 million. However, unused FSM Compact infrastructure funds amounted to over $200 million at the end of FY19. The non-renewal scenario has assumed that the use of these funds will steadily increase through FY30, temporarily offsetting the reduction in overall funding for infrastructure from the lower SAFER CTF distributions[3].

The FSM economy is projected to contract by 8.6 percent under the non-renewal scenario in FY24 and a larger amount after FY30 once unused infrastructure funds have been depleted. Figure 20 illustrates the impacts of the non-renewal scenario on FSM GDP. While the overall FSM economy is projected to contract by 8.6 percent, the impact by FSM state is uneven. Chuuk and Kosrae are the most severely impacted, with declines in state GDP of 11.9 percent and 12.8 percent, respectively. Yap is projected to decline by 8.2 percent and Pohnpei by 6.2 percent; the smaller contraction in Pohnpei reflects its status as the seat of the national government. Most of the adjustment will be felt in the public sector, which contracts by 20.4 percent while the private sector contracts by a still large 5.1 percent.

The loss in jobs proportionately exceeds that of GDP. The total loss in jobs is greater than the impact on GDP, with a loss of 1,753 or 10.4 percent of the employed work force, primarily in the public sector. At the state level, job loss is highest in Chuuk and Kosrae where employment declines by 18 percent and 15 percent, respectively. In

3 Once unused infrastructure funds have been exhausted, a further shock to the economy could be anticipated.

Figures 20-23: FSM Non-Renewal Scenario: GDP, Household Income, Employment, and Migration



Yap and Pohnpei the decline is less, 10 percent and 6 percent, respectively.

The migration function reflects the underlying trend plus a component that is sensitive to employment prospects: The simulation model incorporates a migration function that allows for trend migration and a component that is sensitive to economic and job conditions in the FSM.

- The migration function's underlying trend assumes that 1.6 percent of the population of the FSM—and its sister FAS nations—migrate to the US each year, regardless of economic or social conditions in the FAS. That rate reflects the long-term trend. Annual baseline FSM migration to the US is 1,680 people per year.
- In addition to the baseline trend, the migration function is designed to indicate the implied level of migration associated with a certain level of job loss. Migration to the US has risen during past periods of severe fiscal adjustment in specific localities, such as during the large-scale civil service retrenchment required in the FSM and RMI as a result of the second step-down of funding during the initial Compact period (FY97-FY99), and during the large adjustments in Chuuk and Kosrae early in the amended Compact period (FY08-FY09).

Under the non-renewal scenario with large job losses, migration is projected to rise to an extraordinary level. The model assumes an employee who loses his or her job migrates with dependents. With a dependency ratio of 6.7 people per job, the impact on FSM migration would be 11,754 new migrants to the US, or 12 percent of the population (Figure 23). In practice, actual induced migration due to fiscal shocks would likely be spread over several years, as not all primary job earners or dependents may migrate. The projections, while supported by observed migration spikes during past fiscal shocks, should be considered as an upper boundary.

The impact of projected out-migration—especially in the smaller FSM states—is both dramatic and threatening. The largest states generate the greatest number of migrants to the U.S. However, the impact is more dramatic on the populations of the smaller states of Kosrae and Yap, which are projected to decline by 20 percent and 14 percent, respectively. Kosrae has been particularly adversely affected by its past loss of population, such that the potential for a further fiscal shock presents a profound threat.

Independence Illustration

If both Compact and non-Compact US assistance were to cease, a very large adjustment, 13.2 percent of GDP, would be required to restore fiscal balance. Under the modeling assumption of loss of all US assistance, the potential additional reduction in US funding (nearly all of the listed programs and services) totals $28.1 million (see Figure 19) annually, which is equivalent in size to 6.7 percent of projected GDP in FY23. Taken in addition to the non-renewal scenario assumptions, the total annual reduction in transfers would be $91.3 million annually, or is equivalent in size to 21.7 percent of projected GDP in FY23. If that funding were withdrawn from the economy, GDP is projected to fall by 13.2 percent. This is, in effect, the degree of reliance of the economy on the Compact and other US assistance (and from withdrawals from the FSM CTF as estimated under SAFER).

Figure 24-27 indicates the outcome of both the non-renewal scenario and the illustration of reliance on total US assistance. The overall impact on economic activity worsens from -8.6 percent in the non-renewal scenario to -13.2 percent in the total absence of ongoing US assistance.

The illustration of reliance on total US assistance does not account for the loss of other important in-kind US federal programs and services. The FSM benefits from Federal Deposit Insurance Corporation (FDIC) deposit insurance and US postal services, and the future of both requires renewal. Losing US postal services would increase costs for FSM consumers and businesses, while losing FDIC insurance could potentially sever correspondent banking relations with foreign banks and have serious implications for the delivery of financial services. The dollar value of FDIC insurance and the cost of subsidizing postal rates in the FSM are not known. Modeling the impact on public services, businesses, and households is beyond the current capability of the GSUSA macroeconomic modeling framework.

A large adjustment is required at the state level to maintain fiscal sustainability. The illustration of reliance on total US assistance assumes the following:

- The national government loses its share of Federal programs estimated at $8.1 million.
- The FSM loses access to Pell grants and the national government offsets the loss through providing $11.1 million to the College of Micronesia.
- There is no transfer of resources from the national government to the states.

- State governments are required to cut expenditures by 50 percent in Chuuk, Kosrae and Yap, and 40 percent in Pohnpei to restore fiscal balance.

Figure 28 indicates the impact from FY23 to FY24 by FSM state. The most adversely impacted state is Kosrae, where GDP falls by 23.9 percent, a massive reduction. The reduction in Chuuk and Yap states is broadly similar, falling by 16.5 percent and 15.0 percent, respectively, while Pohnpei is less affected and falls by 9.1 percent. Given that the impact on GDP is largely felt through the loss in public sector jobs, the least developed states with the largest government sector are the worst hit.

Household incomes at the state level would be adversely affected. Figure 29 indicates the impact on real household incomes, reflecting the dominance of the public sector and development of the local economy. In Pohnpei, the state with the most developed economy and seat of the national government, household incomes are least impacted, with incomes falling by 6.5 percent. Chuuk and the smaller states, however, bear most of the loss of income, in the range of 18 percent to 20 percent.

Jobs lost under the illustration of reliance on total US assistance represent 17 percent of the workforce. Job losses at the national level rise from 1,753 under the non-renewal scenario to 2,811 or 17 percent of total employment. With the national government surplus resources depleted, the incremental adjustment is felt entirely at the state government level, where options are severely limited, resulting in forced reductions in civil servant staffing levels. Figure 30 indicates job losses at the state level and a similar impact in the other economic indicators; Pohnpei is the least impacted state.

Figures 24-27: FSM Independence Illustration: GDP, Household Income, Employment, and Migration

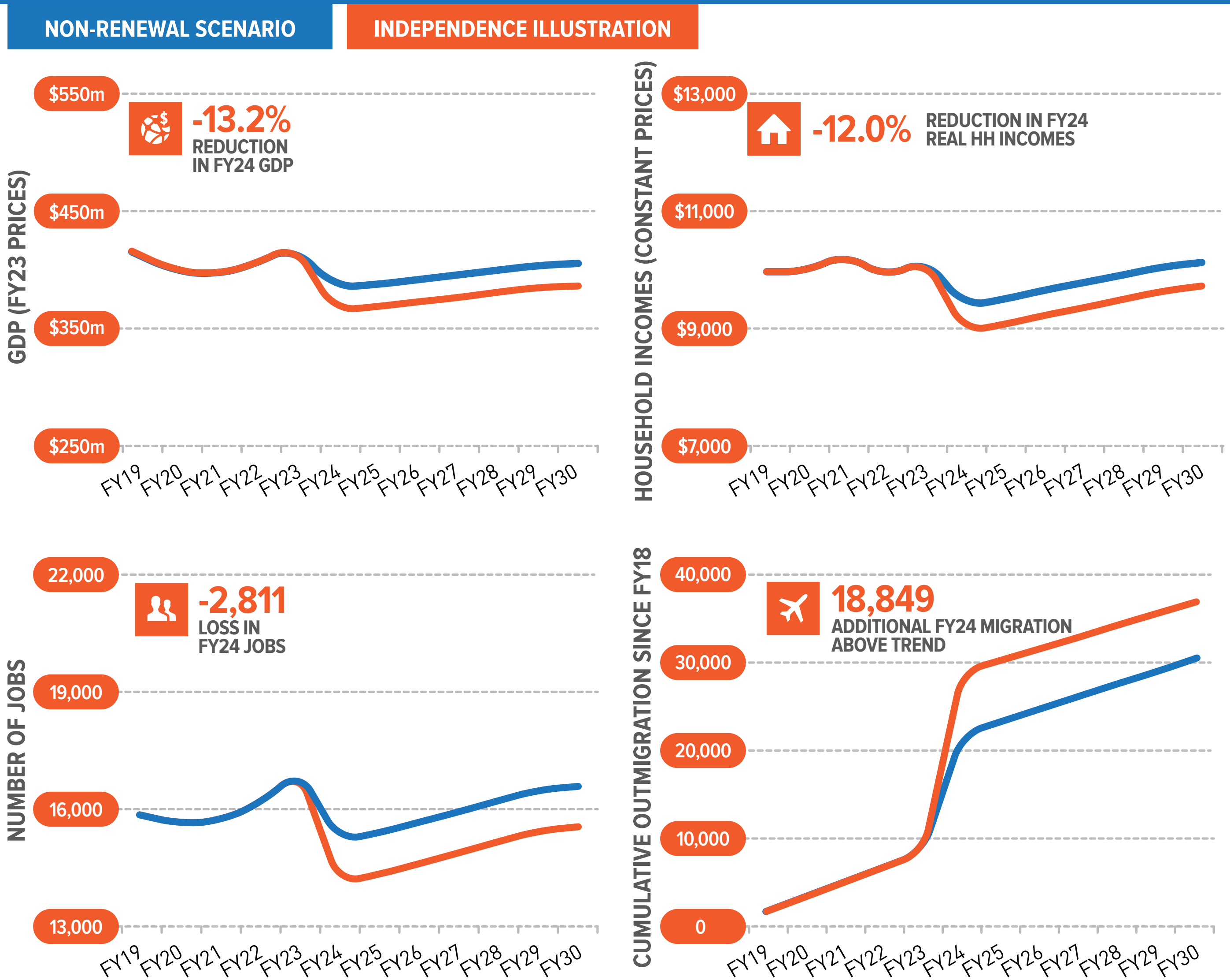


Figure 28: Impact on GDP of the Independence Illustration by State (Index: FY19=100)
Significant reduction in GDP projected in Kosrae

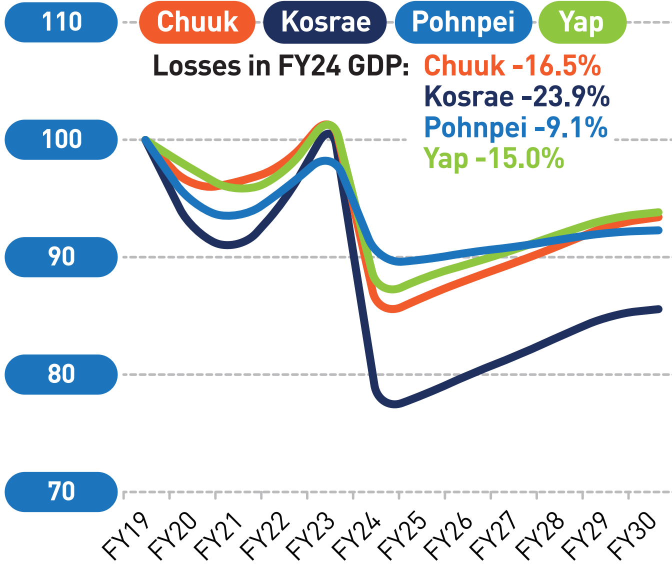
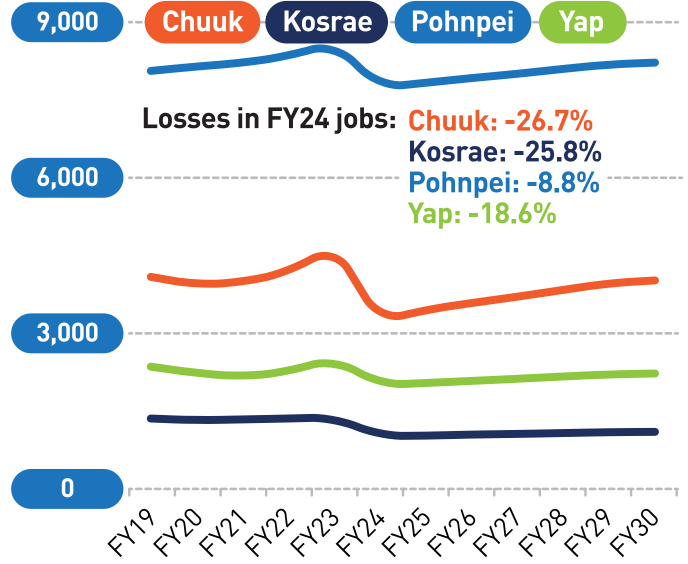


Figure 30: Impact on Employment of the Independence Illustration by State
Job loss greatest in Chuuk



Impact on migration would be extraordinary but likely to be spread over several years. The modeled impact of the loss of all Compact and non-Compact US assistance on migration is exceptionally large, resulting in an estimated 18,849 new migrants to the US, or 18 percent of the population and is indicated in Figure 31. In practice, actual induced migration due to fiscal shocks is likely to be over several years, and not all primary job earners or dependents may migrate. The projections, while supported by observed migration spikes during past fiscal shocks, should be considered as an upper boundary.

At the state level, Figure 31, indicates that the largest states generate the greatest number of migrants to the U.S. However, the impact on the populations of the states, Figure 32, is the reverse and would be devasting

Figure 29: Impact on Household Income of the Independence Illustration by State (FY04 prices)
Household incomes fall by large amounts in non-capitol states

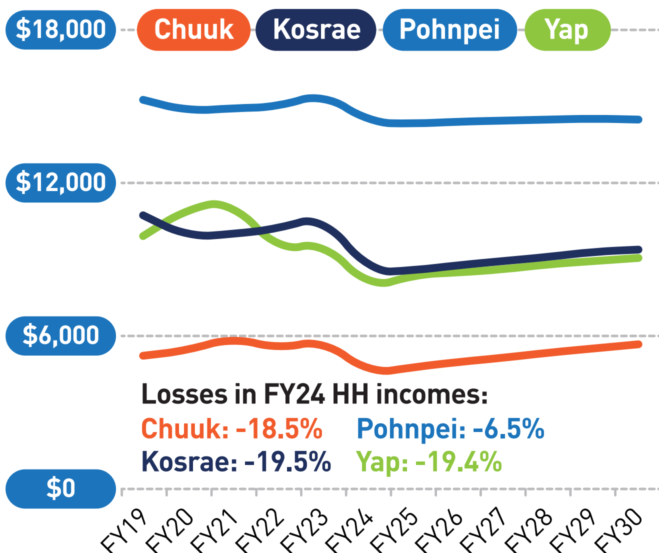


Figure 31: Impact on Cumulative Migration Since FY18 of the Independence Illustration by State
Migration is greatest in the larger states

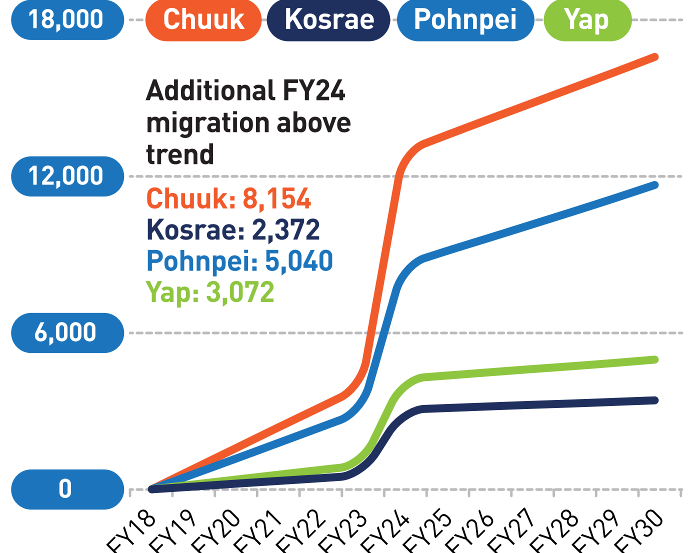
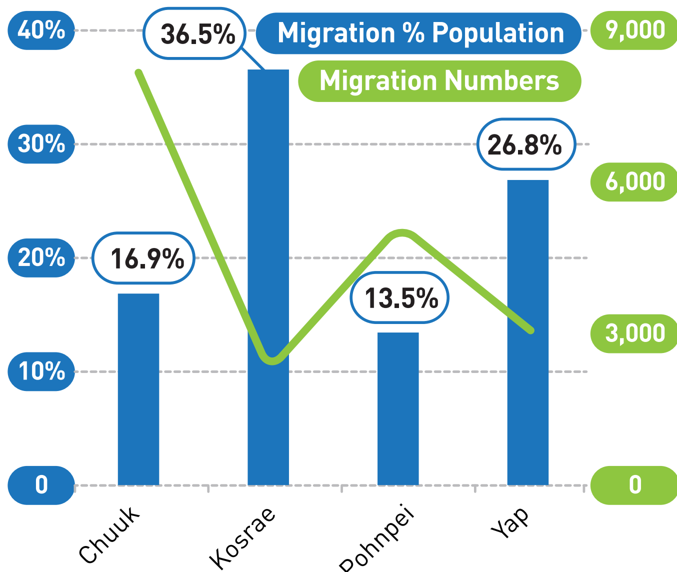


Figure 32: Impact of Migration on Population of the Independence Illustration by State (FY24)
Migration has devasting impact on the smaller states



to the smaller states of Kosrae and Yap. Kosrae has been particularly adversely affected by loss of population, resulting in a profound threat to the community.

Conclusion

The non-renewal scenario and the illustration of reliance on total US assistance indicate an ongoing substantial reliance on US grants, particularly in the smaller states. Our modeling incorporates an immediate and painful adjustment to sustainable CTF distributions. The non-renewal scenario captures the case where no additional Compact grants are extended and SEG ends. The additional modeling is purely illustrative of the full ongoing degree of reliance of the FSM economy and that of its four states on the Compact and other US grants. The modeling assumes that a new equilibrium is obtained at reduced levels of government such that fiscal balance is restored. The impact is massive but highly skewed across the FSM states. Pohnpei, the seat of the national government, is significantly impacted, but much less when compared to the impact on the other three states. For GDP, the new equilibrium is close to 20 percent lower in the three states of Chuuk, Kosrae and Yap. The reduction in jobs is even greater and induced outmigration and reduced population levels would pose a profound threat to the two smaller states.

5 MODELING THE IMPACT OF FSM COMPACT ECONOMIC ASSISTANCE RENEWAL

5 MODELING THE IMPACT OF FSM COMPACT ECONOMIC ASSISTANCE RENEWAL

Leaving behind the painful non-renewal scenario, this chapter investigates the potential impact of Compact economic assistance renewal. Chapter 4 described a plausible FSM response to reduced Compact economic assistance without any modified development partner support and based on fiscal austerity to achieve fiscal balance. The forced adjustments outlined in Chapter 4 assumed no immediate policy reforms and were largely based on expenditure compression. Fiscal balance was restored through the brute force of expenditure cuts and job losses. Now we look forward with optimism, using the GSUSA economic models to project the impact of a funded renewal of the Compact.

While the provision of a more secure future would avoid a shock, it would not in itself place the FSM on a sustained higher growth trajectory. Continued Compact resources would improve economic and fiscal outcomes and avoid the fiscal cliff described in Chapter 4. Compact economic assistance renewal would also, if designed appropriately and funded sufficiently, establish perpetual trust funds that would secure flows of resources with a high degree of confidence and without need for an initial fiscal adjustment in FY24. While such a result would avoid fiscal shocks, the renewal would not by itself place the FSM on a sustained higher economic growth trajectory.

A "Better Results" scenario requires a public sector-led growth strategy with substantial restructuring and reform of domestic fiscal operations. This scenario would combine renewed Compact economic assistance with the large national government structural surplus and resources in the FSM's own Trust Fund to support development and institutional restructuring at the state government level. Increased transfers from the national to the state governments would form the basis for a public sector-led development strategy, with potential for the private sector. In addition, a stream of Calibrated Development Assistance could be distributed when the FSMCTF and/or the FSMTF have achieved a perpetual target without endangering long-run sustainability.

Attaining these better results would require both commitment from the FSM to implementing its internally adopted reform agenda coupled with development partner support through projects and programs to support and reward institutional and policy reforms.

Modeling does not consider the impact of climate events. Credible institutions such as ADB and the World Bank are working to model—and insure against—the costs to nations to better prepare for climate events. The modeling approach used for this report cannot account for the costs of achieving climate resilience. Nevertheless, it is reasonable to assume major infrastructure costs would increase by 25 percent or more for new investments. While resources are being made available to the FAS by donor partners, it is unclear if such assistance will be sustained at levels sufficient to offset the actual magnitude and frequency of climate events.

Compact Renewal Scenario

Compact economic assistance renewal assumes a further 20-year period of annual support, including

the SEG. Continued US support assumes that the US renews the amended Compact economic assistance provisions for the FSM at a level equivalent to the FY23 sum of the annual sector distributions, SEG, audit, and CTF contributions. This "topline" level of ongoing US support would be deposited in the FSMCTF and subject to the same partial inflation adjustment rule that prevailed throughout the amended Compact period (two-thirds of the annual change in the US GDP deflator, capped at 5 percent). However, the various distributions from the FSMCTF would be fully indexed for inflation, ending the 37-year period for the FSM of partial inflation adjustment combined with large periodic step-downs (FY92 and FY97) or annual decrements (FY04-FY23). The model assumes these conditions would continue for the 20-year period from FY24-FY43.

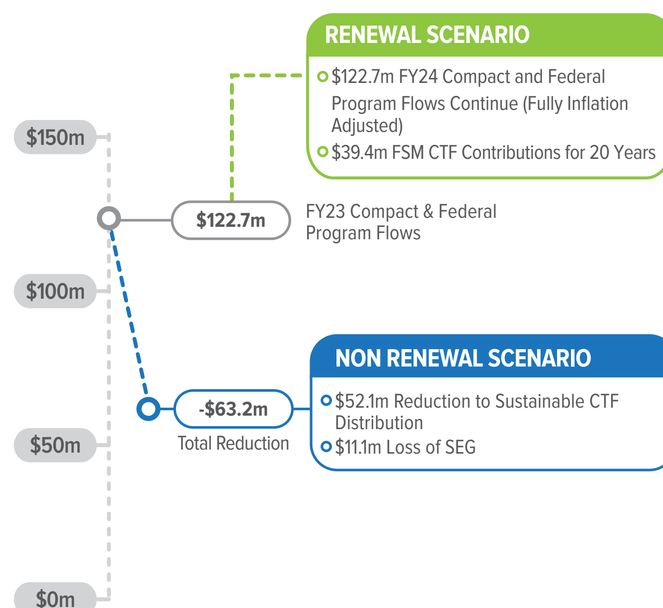
US appropriations would be contributed to the FSMCTF at the start of each fiscal period. The modeled projection assumes that the totality of the annual US appropriations would be contributed to the FSMCTF at the start of each year, while the distributions would proceed during each year by mutual agreement for each expenditure type: replacing sector grants for operations and infrastructure, disaster assistance, SEG, audit, and others. Such an assumption would—on average—allow the benefit of delayed expenditures or unspent funds to accrue to the FSMCTF through investment returns. At a small cost to the US Treasury, a significant benefit of strengthened sustainability would accrue to the CTF.

The Compact economic assistance renewal scenario allows state-level government operations to continue without adjustment, but with greater public spending at the national level. In the FSM Compact economic assistance renewal scenario, sector distributions, including the SEG, are projected to continue at FY23 levels, fully indexed and with no decrement. Figure 33 shows the FSM Compact economic assistance renewal scenario in comparison to the non-renewal scenario outlined in Chapter 4.

The renewal scenario assumes the national government no longer needs to allocate resources from the fiscal surplus into the FSMTF. However, for precautionary needs, the corpus of the fund is allowed to accumulate without drawdown. Absent a need to set aside funds for an uncertain future, the national government may maintain levels of legislative projects and other recurrent expenditures. The state level sees no change in fiscal regime and governments operate at the constrained level of funding that prevailed at the end of the amended Compact.

Full indexation of CTF distributions would release the economy from the fiscal drag experienced in prior Compact periods. In FY23 the fiscal drag imposed on the economy due to the decrement and lack of full indexation during the amended Compact is estimated to be 0.32 percent of GDP. Model estimates indicate that economic growth would have been higher during the full amended Compact period by approximately 0.35 percent annually without the fiscal drag. The impact of continuing the Compact at similar levels to those of the amended Compact, but with full indexation and no decrement, should thus provide a modest boost to annual economic growth of about 0.33 percent. The benefits of full indexation occur at the state government level.

Figure 33: FSM Compact Renewal Scenario



The Compact economic assistance renewal scenario makes the following assumptions:

- Government operations at the state levels remain unchanged at the outset but with full inflation and no decrements.
- The corpus of the FSMTF is allowed to accumulate.
- Expenditures on public congressional projects return to the FY20 level of $28 million in FY24 and are indexed for inflation thereafter.
- Expenses on professional services return to the average level in FY17-FY19 of $21 million and are indexed for inflation thereafter.

The Compact economic assistance renewal scenario positively impacts the economy, creates jobs, raises household income, and reduces outmigration. The impact of the Compact economic assistance renewal scenario, compared with the non-renewal scenario, is

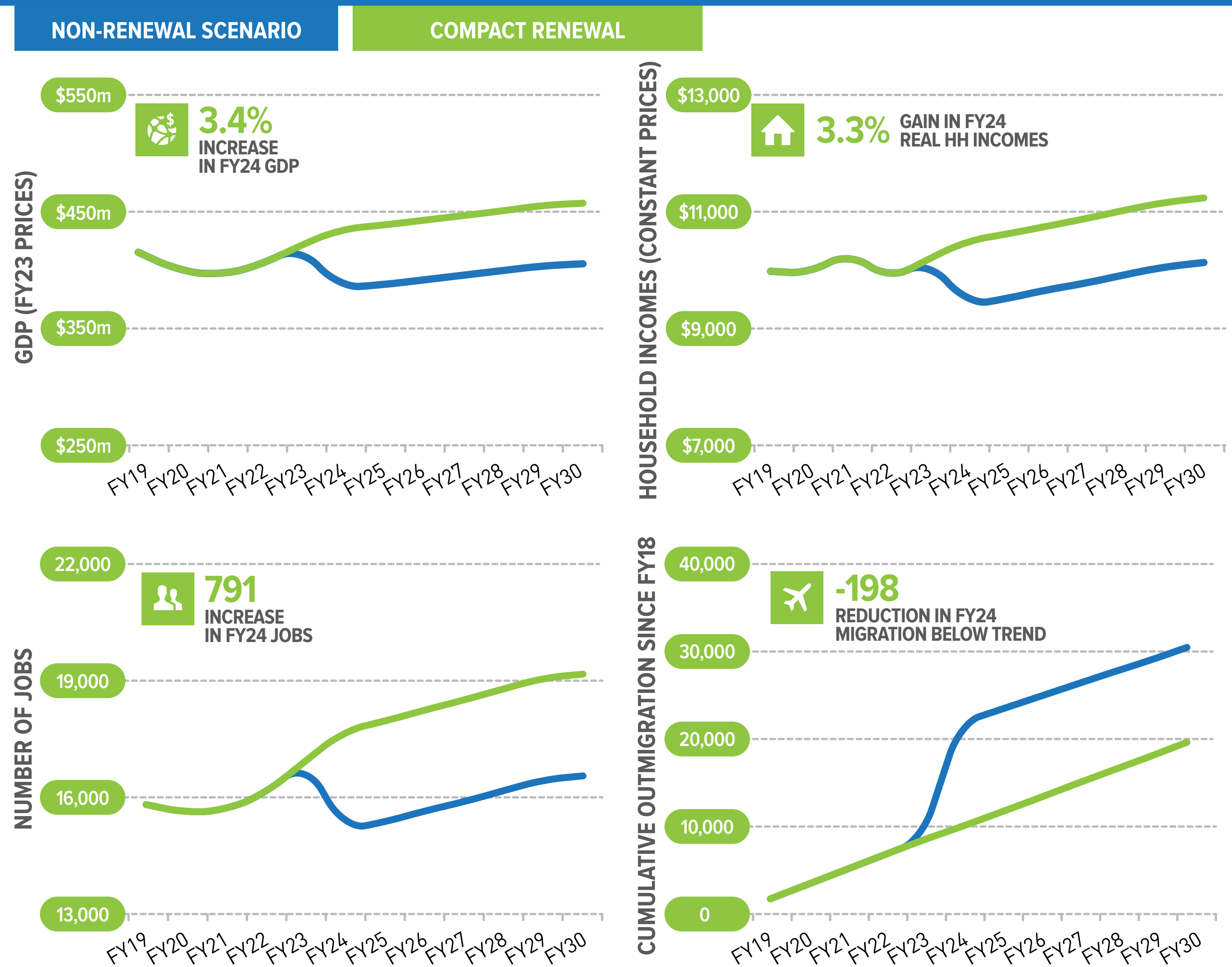
shown in Figure 34-37. GDP is projected to increase by 3.4 percent in FY24 and be maintained at an average annual growth rate of 0.8 percent, through FY30. The impact on the job market is also positive, with an additional 791 jobs created compared with FY23. Most of the jobs are created in the construction industry and other private services, resulting from higher demand in the economy. Further, there is 3.3 percent increase in household income in FY24. Finally, additional jobs slightly reduce the underlying trend in outmigration.

Better Results Scenario

A favorable Compact economic assistance renewal has the potential to radically alter the FSM economic and political environment. In contrast to the Compact economic assistance renewal scenario outlined above, an alternative "Better Results" scenario exists that redeploys the national government structural surplus through a redistributive policy of public sector-led growth at the state level. Under such circumstances, the current revenue-sharing arrangements between national and state governments would be subject to new dynamics. The need to use sovereign rents to prepare for a fiscal "cliff" would no longer be relevant. The new revenue-sharing arrangements with the state governments for such a growth strategy would be structured as follows:

- The national government terminates further contributions to the FSMTF. The fund's most prominent objective, which is to provide a source of revenue to replace insufficient FSMCTF resources, would no longer be required.

Figures 34-37: FSM Renewal Scenario: GDP, Household Income, Employment, and Migration



- Out of the FSMTF's projected $485 million in FY23, $100 million is set aside to support climate change and natural disasters.
- The remaining FSMTF corpus would provide a perpetual yield to be distributed to the state governments. Distributions would commence in FY24 at a low initial rate and increase through FY30 until the SAFER drawdown target was attained. In the interim, funds would be accumulated in the FSMTF.
- Expenditures on public congressional projects are restrained at the level of $14 million annually.
- Out of the continuing national government sovereign rents, a target transfer to the state governments of $15 million is projected. As in the case of the transfers to the state governments from the FSMTF, these additional funds would be released in an increasing amount over the FY24-FY30 period until the target was attained.

Additional funds for state government would be equivalent in size to 6.5 percent of GDP by FY30. The above assumptions, while providing enough funds to maintain national government services at current levels, would initiate a wholly new environment at the state level. By FY30, the additional transfers for the states would be close to $17 million and with a further $19 million in drawdowns from the FSMTF, the total is equivalent in size to 6.5 percent of the projected level of GDP for FY30. It is further assumed that state funds would be used to support basic services in education and health. After 37 years of fiscal drag, austerity, and reduced real state-level funding, the period under a Compact renewal could materially improve essential government services. Securing such improvements will require capacity building, development partner support, monitoring, and oversight to support the most effective and efficient use of the gradually increasing fund levels.

The FSM economy is projected to grow by an average of 2.1 percent during FY23-FY30 through adoption of a public sector-led redistributed growth strategy. Figure 38-41 shows the impact of renewing the Compact economic assistance provisions and the benefits of internal fiscal redistribution on FSM's economy. The impact on GDP is favorable, with the economy growing by 2.4 percent in FY24. This compares with the projected 8.6 percent reduction under the non-renewal scenario and the 3.4 percent growth under the base Compact economic assistance renewal scenario. The higher rate of growth under the renewal scenario reflects the assumption that FSM funds released at the national level result in an immediate increase in public expenditures. However, the rate of increase in FY24 cannot be sustained and economic growth slows to an average of 0.8 percent during the remainder of the projection period. Conversely, the gradual increase in funding under the better results scenario permits structural state-level changes and a high sustained growth of 2.1 percent over the whole period. Compared with the historical average during the amended Compact period, this would be a monumental change.

The Better Results scenario has a strong impact on employment, generating an additional 3,718 jobs over the period through FY30 or a 22 percent increase from the FY23 employed work force. The impact on employment reflects a similar pattern to that of GDP, but the structure is different. In FY24 an additional 540 jobs are created in the better results scenario compared with 791 under the Compact renewal scenario. But over time the state-level redistributive policy has more employment potential. By FY30, the better results scenario results in 3,718 additional jobs while the base renewal strategy results in just 2,249 additional jobs. The distribution of the created jobs is also different. Under the base renewal scenario, the jobs are created in the private sector, while under the better results case the jobs are focused in the public sector, reflecting the nature of the strategy. Clearly, the greater job creation under the better results scenario would have a greater long-term mitigating impact on outmigration. Extending the Compact would significantly mitigate the migration shock projected under the non-renewal scenario. Migration is projected to fall slightly below the underlying trend rate of 1.6 percent under the Better Results scenario.

As transfers to state governments plateau, development strategy would need to switch to private sector-led growth. The projections are based on a gradual increase in the volume of resources transferred to the state governments. In time, the increasing source of funds would plateau, and the period of public sector-led growth would end. However, the radical shift in relation between national and state governments would place the FSM on a higher growth trajectory and, with adoption of a more favorable environment for the private sector, could potentially be sustained into the future. The pattern of impact on the state economies is shown in Figure 42 but the greatest beneficial GDP impact would be on the smallest state, Kosrae, which is projected to grow by 3.6 percent in FY24. Chuuk, Pohnpei and Yap are projected to grow by 2.7 percent, 2.4 percent, and 2.3 percent, respectively. With respect to employment and household income growth, Chuuk has the greatest sustained growth, followed by Kosrae, Yap, and then Pohnpei (Figures 43 and 44).

Compact Trust Fund Issues and Cost of Renewal

Renewal of the Compact economic assistance provisions for a further 20-year period would achieve a highly satisfactory result. If the described renewal of Compact funding were to last for another 20-year period, the FSMCTF is likely to have achieved a high degree of sustainability at the end of FY43 (see Table 1). The scoring methodology used to optimize for the SAFER method uses scores for three categories: real value of the FSMCTF, the level of annual distributions, and (lack of) volatility of annual distributions. Each of these in turn is broken out into a set of sub-measures: the first an intergenerational measure estimated over the distribution period and the second a measure of long-run sustainability. A performance index score of 95 percent is analogous to a 95 percent statistical confidence level. Under the modeled Compact funding renewal using SAFER distribution rules, the FSMCTF achieves a performance index score of 95 percent.

The existing COFA trust fund rules fail dramatically to achieve a sustainable and perpetual trust fund. In the absence of Compact funding renewal, the FSMCTF would achieve a performance index score of 48 percent using existing COFA rules and in 75 percent of cases the FSM is projected to suffer one or more years of zero distributions over the period FY44-FY63. Notably, simply shifting from existing COFA rules to the optimized SAFER rules results in an improved performance index score of 81 percent without any additional resources provided to the FSM, demonstrating the “win-win” nature of improved rules, but still falling well short of the desired high confidence level. The 20-year renewal of the Compact coupled with additional contributions

Figures 38-41: FSM Better Results Scenario: GDP, Household Income, Employment, and Migration

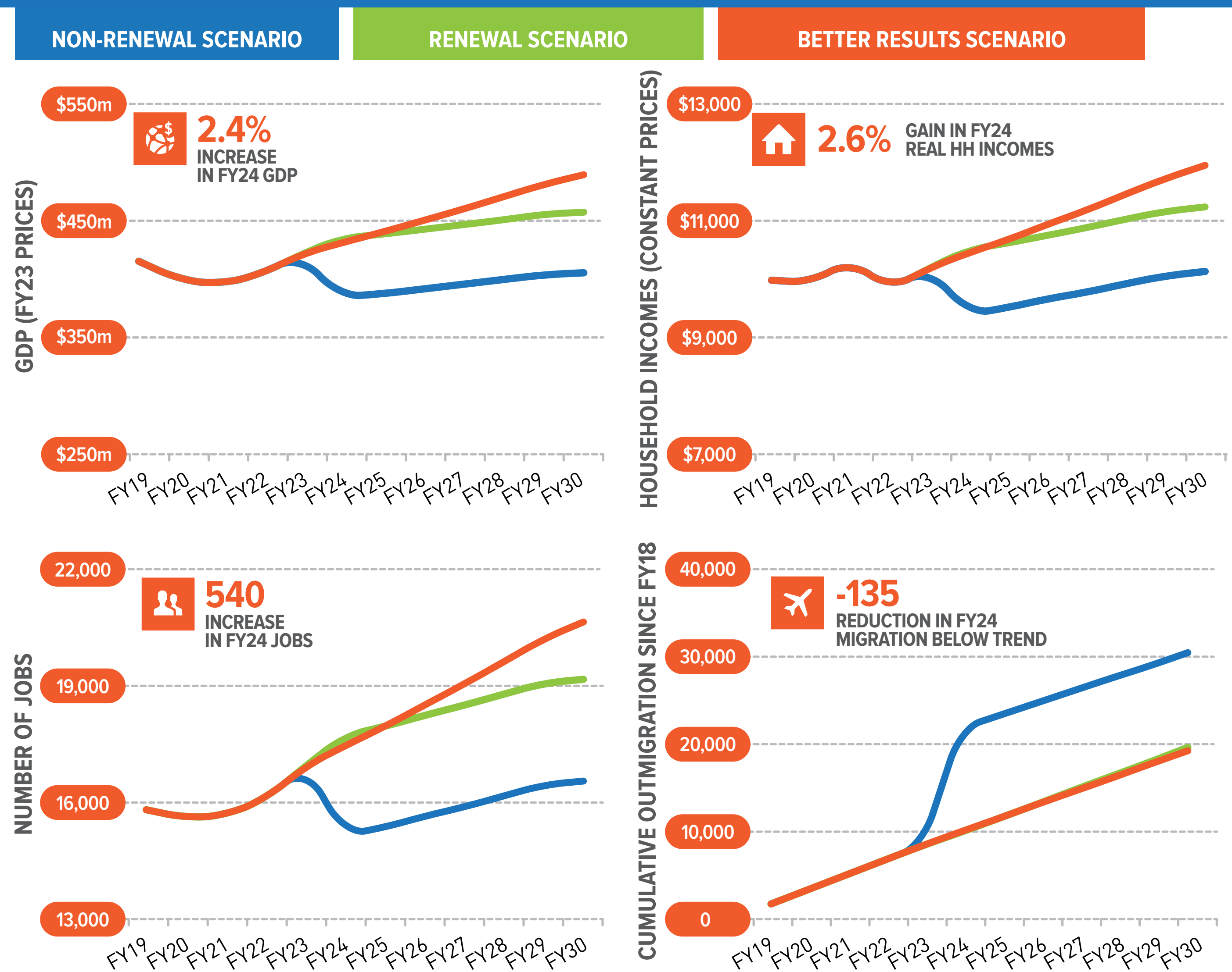


Figure 42: Impact on GDP of the Better Results Scenario by State (Index: FY19=100)
Significant increase in GDP projected in Kosrae

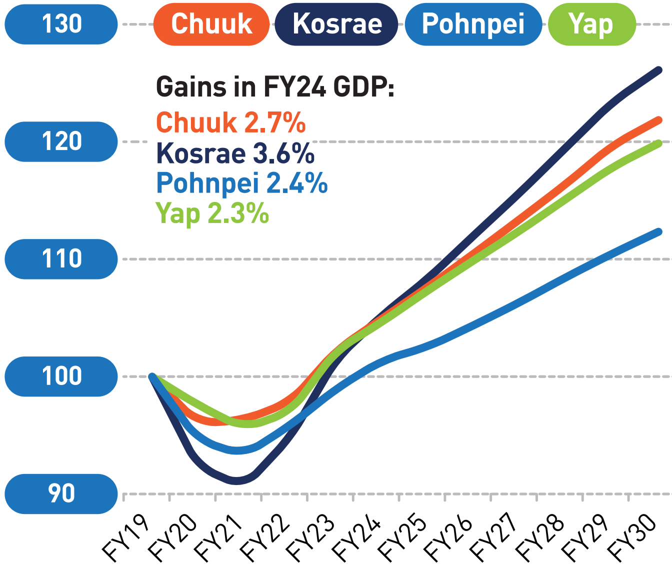
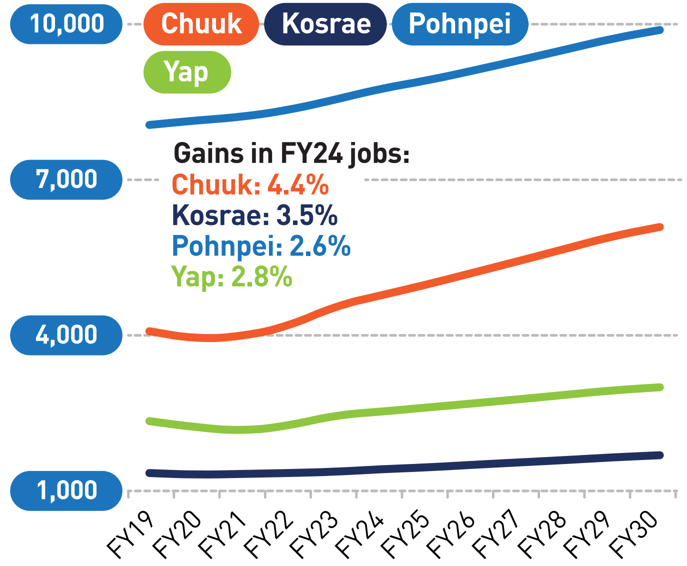


Figure 44: Impact on Employment of the Better Results Scenario by State
Job creation greatest in Chuuk



achieves a score of 95, just a fraction above target, and would be highly satisfactory from a financial security perspective for the FSM. Table 1 indicates the clear failure of the existing arrangements to achieve a sustainable and perpetual trust fund that safeguards the long-term interests of the people of the FSM. Greater details on the Trust Fund simulations, measures and methodology deployed by the Graduate School USA can be found online.

Cost to the US of the modeled renewal scenario is estimated to be $2.54 billion and achieves a sustainability score of 95 percent. The Compact economic assistance renewal scenarios for the FSM can be readily estimated based on the topline funding

Figure 43: Impact on Household Income of the Better Results Scenario by State (FY04 prices)

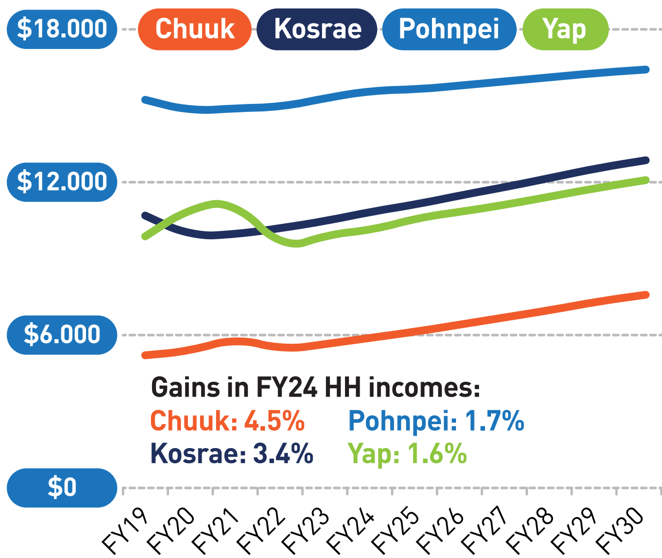
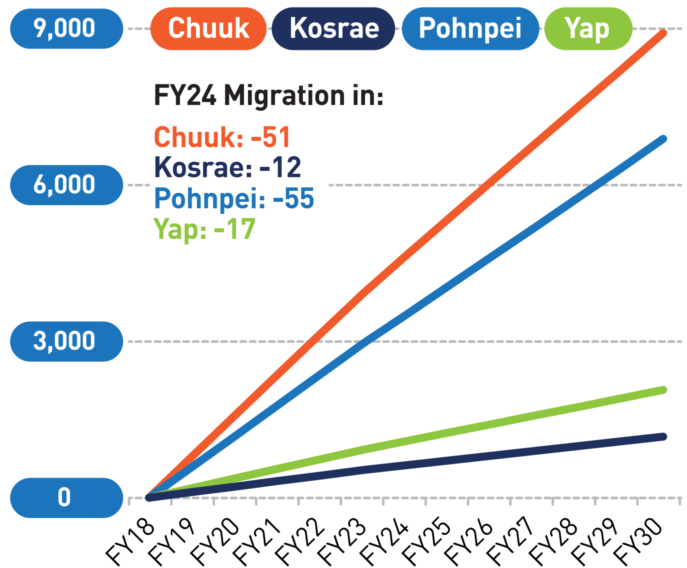


Figure 45: Impact on Cumulative Migration Since FY2018 of the Better Results Scenario by State
Out migration falls to underlying rate



level and assumptions about inflation over the 20-year period. Recall that the topline funding level includes sector distributions, SEG, audit, and CTF contributions for the FSM and RMI. The sector distributions are generally assumed to retain the 70:30 proportion of operating-to-infrastructure support. Table 2 below shows the estimated costs to the US for the modeled Compact economic assistance renewal scenario. Also included is the projected score of the CTF at the end of the 20-year renewal period, FY43.

In the case of the CTF achieving perpetual status with a high confidence level, the potential use of excess funds could be considered under a new Calibrated Development Assistance approach. Distributions from the FSMCTF to finance a stream of "Calibrated Development Assistance" (CDA) distributions creates the potential to generate a further stream of resources to enhance development. In those circumstances where the CTF has achieved perpetual status with a high level of confidence, funds could be withdrawn without jeopardizing CTF sustainability. The potential for a CDA distribution would be carefully monitored each year and only in those cases where funds could be safely withdrawn would distribution be made. The desired confidence level of, say 95 percent, would be the target. In the sister report to this country study, this concept was explored in greater detail in the Republic of the Marshall Islands where the CTF is projected to be exceedingly well-funded by FY44. In that case, additional disbursement from the Republic of the Marshall Islands Compact Trust Fund (RMICTF) for potential annual CDA distributions formed the basis of a "Better Results" scenario. In the FSM, our projections suggest that the FSMCTF will attain a perpetual status by FY44, but only just barely. Still, the concept, which on current projections would only allow for an average annual CDA distribution of $2.5 million, might actually be higher if CTF performance exceeds the median result. Similarly, the CDA concept could be implemented in tandem with the FSMTF which is likely to produce a somewhat more meaningful annual average distribution while still maintaining a sustainability index at/near 95 percent.

Table 2: Cost to the US of a 20-Year Compact Funding Extension (As Modeled)

Key metrics	Compact extension
Cost of Compact extension in FY24 $s	$2.541m
Cost of Compact extension in current prices	$3.127m
Drawdown in FY24/FY44	$96m
Years of Compact extension	20
Probability of not attaining SAFER by FY43	24%
Probability of not attaining SAFER by FY63	9%
Contribution in FY24	$136m
CTF Performance Index	95%

Reforms and Donor Support

The US has committed to a negotiation process that is likely to lead to renewal. The discussion in the previous sections indicated potential economic benefits of the modeled Compact economic assistance renewal. As Chapter 1 outlined, the specific outcomes of the negotiations are uncertain. It is clear, though, that the US is committed to a negotiation process that is likely to lead to a renewal. While the eventual

Table 1: FSM Compact Trust Fund Performance Under the Existing Arrangement and Compact Renewal

Performance Measures	Compact renewal	Non-renewal COFA rules	Non-renewal SAFER rules
Evaluation period	FY44-FY63	FY24-FY63	FY24-FY63
Percent cases where real CTF in FY64 is above FY23 sim value	89%	23%	84%
Percent cases where CTF value is above the primary target in FY63	98%	20%	75%
Average distribution through FY44-FY63 percent target	96%	72%	63%
Probability of attaining target distribution in FY63	87%	31%	67%
Percent of cases with zero distribution in FY24-FY63	0%	75%	0%
Value of distribution % prior year - counted for reduction years only	0%	16%	1%
CTF Performance Index	95%	48%	81%
CTF Performance Index	95%	48%	81%

outcome of negotiations will likely be above the non-renewal scenario, it is less clear if the best-case robust Compact economic assistance renewal scenarios can be matched or even exceeded.

Commitment to economic sustainability and development are likely to remain key objectives of Compact renewal. The renewal scenario growth projections in Chapter 5, although an improvement over the downward adjustment scenarios of Chapter 4, indicate the impact of public sector-led growth through a sustained fiscal stimulus rather than through enhanced private sector activity. The initial and amended Compact periods both placed emphasis on economic sustainability and development. These important objectives will likely continue to feature in any mutually agreed Compact economic assistance renewal. Implementation would, therefore, entail reform programs to improve not only the efficiency and effectiveness of public sector service delivery, but also institutional and policy reforms to support private sector development. In the case of favorable Compact negotiations, reforms coupled with a secure and known future, would place the FSM on a higher growth trajectory. In the case of less favorable Compact economic assistance renewal terms, donor assistance and domestic reform will become essential to sustain even disappointing economic performance.

KEY AREAS OF PUBLIC SECTOR REFORM

It is not within the scope of this study to outline a specific program of reform for the FSM. More importantly, the FSM has, in most instances, internally adopted reform agenda components in most, if not all, of the areas highlighted below. Donor assistance can be targeted to support reform implementation and to reward reform progress over time.

The following list indicates some of the areas with potential for improvement within the public sector:

- Redistribution of resources between the national government and states.
- Fiscal responsibility
- External debt
- Tax reform
- Public financial management
- Fiscal reserves
- Social security reform
- State-owned enterprise (SOE) reform

KEY AREAS OF REFORM FOR PRIVATE SECTOR DEVELOPMENT

The World Bank 2020 "Doing Business Survey" indicates the FSM ranks in the lowest quartile, suggesting room for improvement. The World Bank 2020 "Doing Business Survey"[1] provided an overall assessment of the environment for private sector development in the three FAS. The FSM, RMI and Palau rank 158, 153 and 145, respectively, out of the total 190 countries included in the study, indicating a weak environment for private sector growth.[2] The following are some of the issues affecting private sector growth in need of reform:

- The regulatory environment
- Land reform
- Credit availability
- Foreign direct investment
- Domestic fishing policies

DEVELOPMENT PARTNER SUPPORT AND COORDINATION

Donor support can provide a key role in supporting reform. The development partner community has supported reforms in the past, but the opportunity provided by a Compact economic assistance renewal could be an impetus to accelerate the reform agenda. While opportunities for growth in small, remote island economies are limited, reforms in both the public sector and in the environment for private sector growth could create better results. The development partner community has a vital role to play in building capacity and supporting reforms.

Donor support can provide a key role in support under both the non-renewal and renewal scenarios. During the last few years—with the emergence of the World Bank as a major player in the subregion, coupled with an increase in resources from ADB—

1 World Bank, *Doing Business 2020*. The World Bank, Washington DC, 2020. ***https://openknowledge.worldbank.org/handle/10986/32436***

2 Two further studies conducted by the Pacific Private Sector Development Initiative provide an excellent analysis of the environment for private sector development in the RMI and Palau, confirming the picture presented in the World Bank overview. No similar evaluation has been conducted for the FSM in recent years. See: Pacific Private Sector Development Initiative (PSDI), *Republic of the Marshall Islands: Private Sector Assessment*, Sydney, Australia, 2017; and, Asian Development Bank, A private sector assessment for Palau: Policies for sustainable growth revisited, Mandaluyong City, Philippines, 2017.

the development partner community has been well placed to finance public infrastructure alongside sustained, complementary technical assistance. While budgetary support has not been a prominent part of recent development partner programs, it could be used to support and reward the implementation of the FSM's internally adopted reform agenda components. In summary, in the case of less favorable compact negotiations, coordinated donor action will be essential for mitigating shocks and smoothing adjustments. In the case of a favorable outcome of Compact economic assistance renewal, development partner actions can assist the FSM to improve its economic growth rate and help ensure growth is increasingly likely to be driven by the private sector.

6

CONCLUDING OBSERVATIONS

6 CONCLUDING OBSERVATIONS

This study provides relevant and timely analysis of a few Compact scenarios for the FSM. Following discussions with the principal parties, it is clear that the range of likely scenarios differs in some important ways from the specific scenarios modeled in this study. Still, this study's scenarios are intended to elucidate the economic and fiscal outcomes from plausible scenarios.

It seems clear that all likely negotiated outcomes will be an improvement on the Compact economic assistance "non-renewal" scenario. However, given the potential for delay in achieving mutual agreement and subsequent US Congressional approval for all three FAS, the results of that relatively dismal scenario are indicative of the potential economic and fiscal shock the FSM might face even during a period of delayed and uncertain renewal. In such circumstances, transitional financial support from the US could clearly mitigate some or all of the painful outcomes projected for the FSM.

The authors note that the scenario analysis used in this study relies heavily on a specific approach to how the Compact Trust Funds may be managed in the future. It is recognized, for example, that in the "Compact economic assistance non-renewal" scenarios, the immediate shift to what is defined as a SAFER distribution rule calls for a potentially severe, one-time adjustment at the very outset of the new period. The FSM could choose to take larger—even maximized—distributions in the early years. However, the modeling indicates that such an approach increases—and in the case of the FSM—virtually ensures future years with minimal or even zero distributions. The approach modeled with an insistence on shifting immediately to a sustainable distribution level may lead to an overstatement of the adjustment that might be required in the near term. But this approach has one important virtue. Painful adjustments are not masked by pushing them just beyond the horizon of the modeling results. In the event of a robust Compact economic assistance renewal, the benefits of a SAFER distribution rule will remain, while the immediate pain of a substantial adjustment would likely be eliminated entirely.

It is hoped that the analysis of FSM Compact economic assistance scenarios in this report may prove useful to the affected parties. The modeling shows that the opportunities for improved economic performance, job creation, and perhaps even a modest reversal of migration trends for the FSM are enhanced in proportion to the level and length of ongoing Compact and related federal economic assistance.

The authors are hopeful that in an "all good things go together" scenario, the combination of a robust Compact economic assistance renewal will be coupled in time with an increase in major development partner financial and technical assistance. Such a confluence may motivate and empower each FAS to implement institutional, fiscal, and economic policy reforms consistent with its own desired path to sustained economic growth.

APPENDIX: WHAT’S WRONG WITH THE COFA TRUST FUND RULES?

What's Wrong with the COFA Trust Fund Rules?

The CTFs for FSM and RMI each operate under a "Trust Fund Agreement" established by US PL-108-188. The Agreements establish rules that we refer to as COFA rules. Amendments require mutual agreement of the parties and subsequent action of the US Congress.

Various studies of the FSM and RMI CTFs conducted by the US Government Accountability Office (GAO), ADB and GSUSA have identified common concerns about the COFA rules. Those studies have also identified opportunities to achieve better performance. Such improvements can be achieved at no cost and result in greater protection of the real value of each Trust Fund over the long run. Practical administrative amendments are also required to enable each CTF to be used as a source of annual distributions to support the FSM and the RMI on a timely and predictable basis. There now appears to be consensus among the principals that amendments are needed.

The most important change required in the operation of the CTFs is to establish a direct relationship between the allowable distribution (in FY24) and the size of each CTF at the end of FY23. Under the current COFA rules there is no such linkage. The smaller the Trust Fund value in relation to the allowable distribution, the more severe this flaw becomes. The FSMCTF, with its smaller projected value relative to its allowable distribution size, faces more severe problems than does the RMICTF.

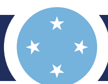
The Trust Fund Committees for both CTFs are exploring alternative distribution rules to move away from the expectation that the distributions in FY24 would match the real value of the FY23 sector distributions. The methods considered include using a fixed percentage rate of distribution (4 or 4.5 percent) applied to the value of the CTF at the end of FY23 (or to a multi-year rolling average value of the CTF).

The figure below shows the devastating results that might occur if the prevailing COFA rules are followed, based on the case of the FSM on the left and the RMI on the right where the projected value of the CTF at the end of FY23 is undeniably too small to sustain the real value of FY23 sector distributions going forward. "Sim 9" is just one of 10,000 cases studied using a statistical method (Monte Carlo analysis) based on actual market returns of six asset classes allocated in a typical institutional investing approach.

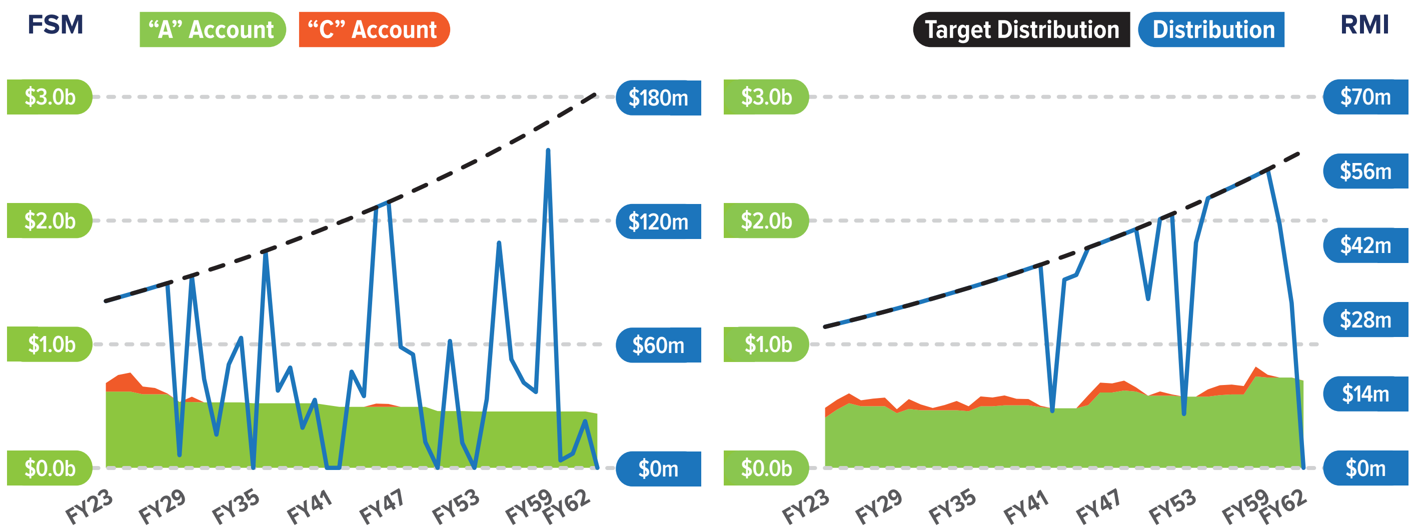
In the case shown, the FSM would suffer 6 years of zero distributions and several more years of near-zero over the period from FY24 through FY63. The RMI, with a relatively smaller distribution level relative to the projected size of its CTF, still is shown to have several years of substantially reduced distributions, including one zero distribution year. This performance compares unfavorably to the much smoother results from the same Sim 9 case using improved "SAFER" rules as shown for the FSM and RMI at the bottom of the opposite page. For the FSM, Sim 9 is not an especially poor case. However, Monte Carlo projections find that the FSM would suffer one or more years of zero distributions in 89 percent of total cases.

Can "SAFER" or Other Rules Achieve Better Results?

The GSUSA has worked collaboratively with the ADB and the GAO studies. The GSUSA analysis has put a greater focus on comparing a wide range of potential distribution rules to find an optimal distribution rule. Knowing there is now widespread understanding that the COFA Trust Fund Agreements for the FSM and RMI need to be amended



FSM and RMI CTFs under COFA Rules (Sim 9)



(even if only for administrative viability) the ongoing work will be published and available for consideration by the principal parties. While many rules-based distribution policies can improve upon the existing rules, optimization of any rules-based distribution policy can best be achieved through the introduction of an objective scoring mechanism. Such a scoring mechanism can then be used to compare alternative policies for any given level of a CTF.

It can be said that the primary, and perhaps only, principle of the COFA Trust Fund Rules as enacted into law was to protect the value of each CTF. Unfortunately, the rules as described have a tendency, supported by statistical analysis, to protect only the nominal value of each CTF and not the real value. GSUSA has proposed that there are three important principles to be considered: (i) the real value of the trust fund should be protected (over the long run); (ii) the trust fund should provide a targeted annual level of real distributions; and (iii) annual distributions should entail minimal volatility from period to period and, when volatility is required, the volatility should be of known magnitude to limit disruption to fiscal policy.

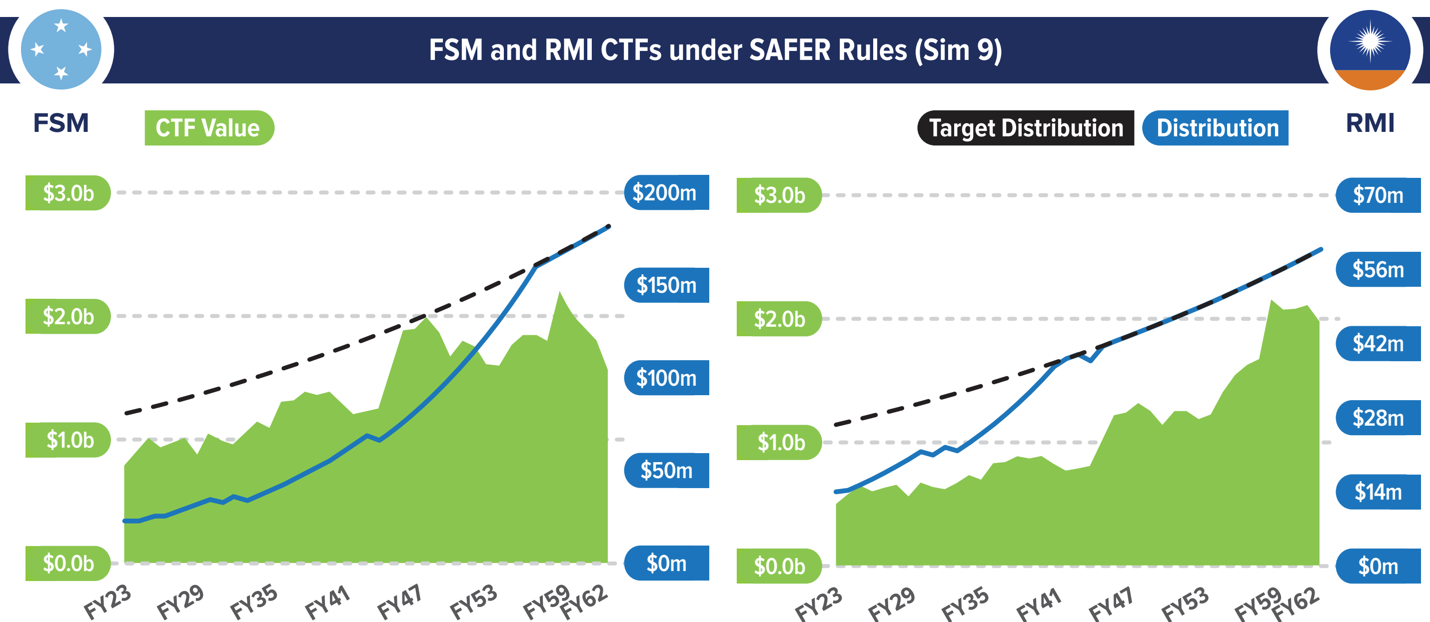
Once these three principles are considered, the method we have identified involves a one-time adjustment—in the first year of distributions. With that adjustment, the CTF can be expected to perform well when assessed against the three identified principles. We call the one-time adjustment a "sustainability adjustment." We couple that with specific rules about annual distributions from year-to-year and label the holistic approach as the Sustainability Adjustment for Enhanced Reliability (SAFER) method. The size of the sustainability adjustment has been estimated in our Monte Carlo modeling approach so that our scoring method will yield a score of 95 percent. In statistical terms, this is equivalent to a 95 percent confidence level while allowing for equal weighting of the three principles.

The accompanying rules are important. While more detailed than a simple "fixed-rate" rule, they address the unavoidable reality in the investment world of upside and downside risks. Very briefly, once the SAFER adjustment is made, annual distributions stay the same in real terms every year unless an adjustment is necessary after an annual test. An up or down adjustment will only occur if the CTF value has gone outside of defined guardrails. On the upside, annual increases can be as much as 5 percent until the fund value falls below a defined guardrail. On the downside, annual decreases of 5 percent are called for until the fund value returns above a defined lower guardrail. The method is designed to keep volatility low.

The figure below shows the improved results that occur if the SAFER method is utilized. "Sim 9" is used again. It is based on the same randomly chosen annual rates of return, in the same sequence, for the 40-year period from FY24-FY63.

As compared to the same case using COFA Rules, the SAFER results are scored higher but have one major downside. The bulk of the adjustment needed under SAFER occurs at the beginning of the distribution period—hence the fiscal adjustment we describe in the base and severe adjustment cases in Chapter 4. The results for the FSM are even more favorable using SAFER rather than COFA rules.

One important observation is that renewing the Compact economic assistance period to strengthen the value of each CTF in proportion to the desired value of annual distributions is, unsurprisingly, the most advantageous way forward for each FAS. Combining such a renewal with improved rules yields compounded benefits.



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